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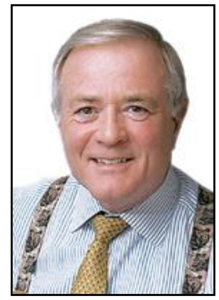

William Rutherford

Stock market experiences exuberant October; Fed still isn't sure whether it will raise interest rates

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The markets in October had their biggest monthly gain since October 2011. Over the course of the month the Dow Jones rose 8.5 percent and the S&P rose 8.3 percent. Both turned positive for the year during the month. The S&P had a final closing price of 2,079.36 on the last trading day in October. The Stoxx Europe 600 climbed 8 percent and the Nikkei jumped nearly 10 percent.

For the quarter overall, however, equities plummeted. The U.S. was down 6.9 percent – nine out of 10 U.S economic sectors finished in the red, with energy the worst. All developed markets finished in the red, with the Pacific, except Japan, down the most at minus 16 percent.

Now, large U.S. companies warn of a slowing economy. The industrial environment is in a recession, according to Daniel Florness, chief financial officer of Fastenal Co. Transportation companies are generally thought to be a leading indicator of the economy, and the "… data is not good," said Alex Vecchio, a transportation analyst at Morgan Stanley.

Profits and revenues fell in tandem for the first time in six years, with a third of S&P 500 companies reporting so far. Analysts expect the S&P index's companies to book a 2.8 percent decline per share earnings from last year's third quarter, according to Thomson Reuters. Much of the decline comes from the hard-hit energy sector, where sales are likely to plummet more than 65 percent. Basic material companies expect a 17 percent drop in profits, according to Thomson Reuters. The government reported a 1.2 percent drop in manufactured durable goods following the prior month's 3 percent decline.

At some companies, foreign currency effects hurt results significantly. Consumer products maker Kimberly-Clark predicted that currency swings would slash their earnings 25 percent this year. The dollar continued strong against foreign currencies and can be expected to trade higher if the Federal Reserve raises interest rates. Goldman Sachs predicts that the dollar and euro will trade at parity before the year ends. Parity between the two has not happened since 2002.

While lower oil prices have hurt some sectors, autos have noticeably been helped, with companies like Ford and Toyota announcing big profit increases. Auto sales have been very strong across the board, running at 18 million per year. Airlines have benefited from lower fuel prices since fuel is the largest operating expense for airlines.

Some observers worry that the slowdown is spreading to consumer stocks. Walmart reported weak earnings and predicted flat sales this year. It also cut its earnings forecast for the year because of rising labor expenses resulting from minimum wage increases. Consumer confidence fell in October to 97.6 from 102.8, a disappointing drop.

The markets have been buoyed in spite of weak economies largely because of central bank support. Around the globe central banks have been underpinning their economies with low rates, and except for the U.S., have weakened their currencies to increase exports. The result of this is the dichotomy of weakening economies with strong financial markets. Bad news is good news (lower interest rates), and good news is bad news (lower equity prices). Now we are faced again with the question of whether the Fed will raise rates.

At the recent October meeting, Chairwoman Janet Yellen emphatically placed the question of a rate increase on the December agenda. During congressional testimony Nov. 4 she again emphasized a rate increase, but said no decision had been made. Clearly she wants to raise rates, but so far has not had the right set of circumstances.

In September we had a weakening Chinese economy, or so we thought, and a strengthening dollar. A majority of economists now think the Fed will raise rates at the next meeting, but they have been saying that for months.

Futures markets, the most reliable indicator, say no increase, by a narrow margin. It did not help the Fed case for a rate increase that China reported week economic data just as the new month began. But the jobs report released Nov. 6 buoyed the case for a rate increase. This dithering to and fro has confused the markets and is not good for the Fed's credibility.

Nevertheless, I now think the Fed will raise rates at its December meeting – barring some major negative event. This week the Bank of England deferred a rate rise, citing the slowing global economy. Can the Fed raise rates in a slowing economy? Should it? Yellen says the Fed is data-driven, but it's clearly following the Treasury market. None of this uncertainty is good for the economy or markets.

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