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Reasons for Optimism into 2015
By Scott P. Noyes, CFA® CFP®

Global stock markets finished the third quarter on a disappointing note. U.S. small-cap stocks were down 7.33% in the quarter versus a modest gain of 0.5% for the Dow Jones Index. International stock markets also suffered a decline (-5.56%), erasing their gains for the year, as the effects of the Ukraine conflict spilled into both European markets and Chinese commodity markets. The return of stock market volatility has whipped the "Doom and Gloom" crowd into a lather. Since this bull market started in March of 2009, it has had five corrections of over 8%, and is now up 173%. While another correction may be upon us, the fundamentals for a higher stock market remain intact.

I expect the bull market to continue to be driven by a growing global economy, post-midterm election gridlock, strong seasonal buying patterns and improving investor sentiment. Bull markets typically run until widespread euphoria or a big, unexpected negative event occurs which knocks the wind out of its sails. Currently, neither of these negative factors appears to be present. I believe it is premature to give up on this Bull market and I remain optimistic for an improved stock market over the next 6-9 months.

Exhibit 1. The Bull Market is Intact and Deserves Patience

Monthly Dow Jones Industrial Average since 1998

The Biggest Current Concerns

European economic growth is stagnant. The conflict in the Ukraine and the resulting economic sanctions against Russia have had a direct negative impact on European economic growth. There is some concern that Europe could enter a recession this winter. In addition, there is a risk that Russia will cut off Europe's gas supply in retaliation for the Ukraine sanctions. This would have devastating consequences on economic growth in both Europe and Russia. If there is some rapprochement between the West and Russia over the Ukraine, European and Russian stock markets could put in a spectacular bullish performance. But, that's a big IF! A turn for the worse in the Ukrainian conflict could lead all global stock markets lower.

Strong U.S. Dollar vs. Europe and Japan. The massive 9.5% decline in the Euro against the dollar has been caused by differences in interest rates between the continents. German 10-year bund rates are below 1% while U.S. 10-year Treasuries yield 2.5%, a tremendous differential. This has redirected currency flows into U.S. dollars. Over time, the decline in the Euro will make European multinational companies more competitive and profitable in the near future when compared to their U.S. counterparts. U.S. multinationals may suffer declines in foreign sales which could affect future earnings reports.

Ebola and Enterovirus D68 could change people's behavior this winter. The doom and gloom industry is in a frenzy over Ebola. However, Enterovirus D68 is of greater concern. There have been over 500 cases in the U.S. over the last few months resulting in several deaths. A 4 year-old died in New Jersey last week. Buy your face masks, Lysol and rubber gloves before the stores sell out!

Positive Factors to Consider

U.S. Economic Growth remains strong. After a cold-weather-related slowdown that caused first-quarter GDP to come in at -2.9%, we saw a rebound in the second quarter. The economy grew at 4.6% in the second quarter and is expected to continue to expand by over 3% for the remainder of 2014. Year-over-year holiday sales forecasts are in the 4% range with consumer confidence at the highest level since the recovery started. Unemployment has declined to 5.9% as the economy continues to add 200,000+ jobs per month.

The technology sector is booming. The rate of technology change has led to rapid industry transformation and increased economic growth. Major cities have been the beneficiaries of this growth as more rural and commodity-dependent regions of the country stagnate. While this is seen as negative for some, the bulk of the country is experiencing an improved economic environment. The Millennial age group is leading the wave of technology change and is reshaping the structure of American living.

Biotechnology remains a leading contributor to growth. New drug advancement, medical technologies and genetics are rapidly improving the health and longevity of the population. The U.S. is the epicenter of the global biotechnology industry.

The U.S. is approaching energy independence. It is hard to believe that new technologies have led to dramatic improvement in U.S. production of both oil and gas. The reduction of our need for energy from outside the U.S. has helped keep global oil prices at or below $100 per barrel since the recovery began. In fact, there is currently a glut of oil globally which acts as the equivalent of a consumer tax cut and should help economic growth worldwide.

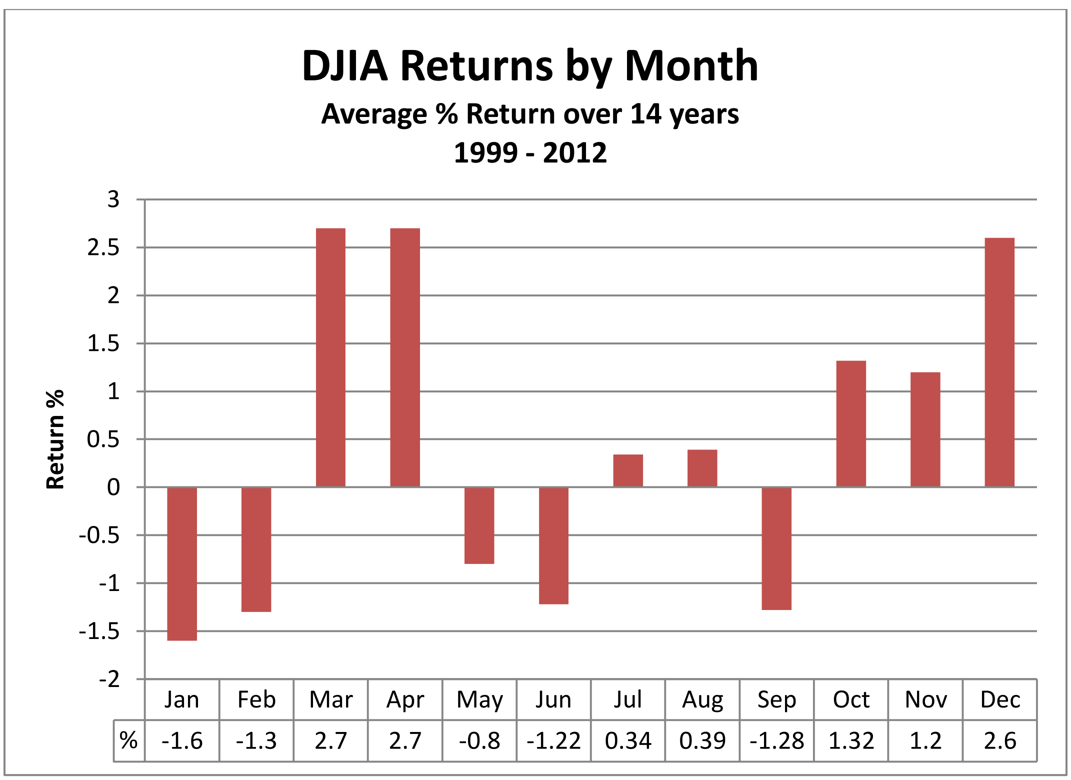
Inflation remains subdued. The U.S. Consumer Price Index (CPI) has grown at 1.7% over the past twelve months. Food, electricity and housing costs have increased while the gasoline, auto and apparel industries have experienced price declines. Most importantly, core wage growth is running at a 2.0% pace. Inflation growth in Europe is minimal ranging from -0.30% in Norway to +0.80% in Germany. The lack of inflation in Europe is holding global interest rates lower than normal.

The Federal Reserve is unlikely to change interest rate policy for the next 6-12 months. Quantitative Easing is virtually over, interest rates have not moved and the economy is continuing to chug along as before. Janet Yellen and the Federal Reserve should be quite happy. With the end of Quantitative Easing, the bond market will debate when the Federal Reserve will take the next step and start to raise short-term interest rates. Janet Yellen has made it clear that unless there is significant wage pressure fueling an increase in the rate of inflation, the Fed will be content to move slowly toward its first interest rate hike. In my opinion, U.S. interest rates are likely to remain near current levels +/- 35 basis points over the next 9-12 months.

The mid-term elections should bring more gridlock. Whichever party controls the Senate, the vote count will be close enough to ensure that not much gets accomplished. If the Republicans win the Senate, I am hopeful that they will pursue something useful such as corporate tax reform or negotiate new trade agreements. Probably just a silly thought. Either way, gridlock is good for business and the stock market.

The seasonal pattern of the Stock Market turns positive. On a historical basis the U.S. stock market is entering the 7-month stretch (October – April) during which most gains are made (Exhibit 2). I am hopeful this pattern will assert itself after the November election and October 26th elections in Ukraine.

Exhibit 2. The Stock Market is entering its seasonally strong period.



A Correction is Inevitable… and may be an Opportunity

Many believe that a correction is inevitable and is a normal part of all market cycles. However, the exact tops and bottoms are all but impossible to forecast. It may happen next week, triggered by a slowdown in European economic growth, Russia invading Ukraine, Chinese credit concerns or a major change in the spread of diseases. While corrections can be scary, they're a normal part of bull markets. Volatility is the price you pay for higher long-term equity returns. The key to surviving these regular fears and market corrections is to make a plan while you are still objective and unemotional.

I expect the bull market to continue to be driven by a modestly growing global economy, post-midterm election gridlock, strong seasonal buying patterns and improving investor sentiment. When I aggregate the current economic conditions and conflicting market opinions, our strategy continues to focus on reducing risk to normal target levels by selling higher beta (more volatile) securities and concentrating holdings in U.S. and developed-country dividend-growth securities. We are maintaining 8%-10% in cash equivalents that can be redeployed into the market if a material correction occurs.

In the event of a major market dislocation, we would view it as a buying opportunity as there are few good alternatives to equities. I remain optimistic for a higher stock market in the next 6-9 months.

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