Financial Wanderings

October 2014

A masterful examination of the previous month's financial events, written by Brad Blackburn, CFP ®
(and made even awesomer by Andrea Dickerson)

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September Market Numbers:

S&P 500: +2.34% to 2,018

NASDAQ: +3.07% to 4,631

DJIA: +2.04% to 17,391

10-Year Treasury Yield:

-6.75% to 2.35%

Gold: -3.3% to $1,172/oz

Although the commentary in this newsletter has been thoroughly researched, well-reasoned and contains many impressive multi-syllabled words, please enjoy it responsibly. There are many economic minds that are far smarter than mine—and even they can't agree on even the simplest economic questions. In other words, please enjoy this newsletter with the full understanding that it may be entirely wrong.

Why'd it do what it did?

There's a very well-established economic theory that the stock market is perfectly "efficient." That means every single piece of relevant information is perfectly and immediately considered by the markets – so stocks are properly valued at all times. In other words: The stock market is never wrong.

Here's my theory: *The efficient market theory is a bunch of hooey*. Exhibit #1 is the action of the markets over the last six weeks. From the middle of September to the middle of October, trillions of dollars were lost as the S&P 500 plummeted 9.8%. After that painful episode, the markets promptly recovered in even more dramatic fashion and finished October at record high levels. You cannot convince me that any of this was based solely on any carefully calculated rationale. The only way to make sense of it is that the markets are made up of humans – and humans are crazy.

But that doesn't mean there isn't some small degree of logic in the way the markets moved. As it turns out, the moment the markets rebounded was almost exactly as the losses reach 10%. In other words, as soon as the markets dropped 10% from their all-time high, there were suddenly a bunch of people eager to buy stocks again. What does that tell you? It tells me that my current philosophy on the markets might be wrong. My theory was that the pattern of the last two years was done – we wouldn't see the markets hitting new highs every month, but rather a roller-coaster ride leading to very small gains. I still think that's the most likely scenario, but the quick recovery from this downturn indicates there's still lots of money waiting to jump into stocks. That's a good sign for the stock market.

So why did the markets drop so much?

It's not U.S.: The economy here in America is stronger than it's been since before the financial crisis. Unfortunately, the rest of the world didn't get the memo. Europe, China and Japan are all struggling. The Question is: How much will that impact us? Nearly half of the revenues from the stocks in the S&P 500 come from abroad. When consumers have less money in Europe, it leads to consumers

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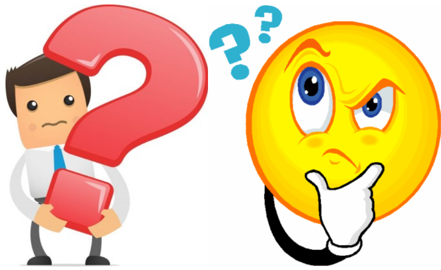
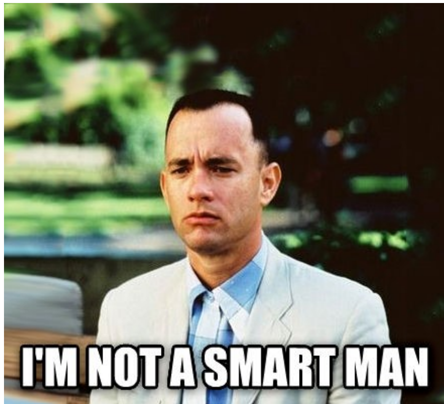
having less money here in America. Perhaps our economy is strong enough to power through it, but the markets aren't so sure.



Interestingly, weak global growth has focused the markets much more on positive economic news here in America. For those of you keeping score, that's exactly the opposite of what I've been saying for the last few months.



My theory was that the markets would be rooting for slower economic growth because that would lead the Fed to keep rates low well into next year. That backwards logic did make a short appearance a couple months ago. But the markets are now back to celebrating good news.

Oil: With the mid-term elections upon us, Obama is once again making oil prices fall. You have to admit, he's pretty shrewd. Thankfully, he's also rigged the stock market to rise throughout his entire presidency, so he can't be all that bad (I'm just kidding Conservatives, I think every single thing he does is evil and communist) (I'm just kidding Liberals, the only problem with him is he isn't liberal enough).

The worrisome part about oil falling so much is that it indicates less global demand. When economies around the globe are growing, there's typically increasing demand for all kinds of energy. We're not seeing that now. Of particular importance is China, as Chinese growth has powered the global economy for years. There's no doubt China is slowing down, but you'd have to be a sucker to believe Chinese economic "statistics" at face value. Thankfully, there's indirect ways to judge the Chinese economy, like its energy demand. According to Bloomberg, Chinese energy demand has flat-lined over the last year. That indicates that China may be slowing much more than the "official" numbers show. If that's true, it's bad news.

But the falling price of oil isn't all bad news. In fact, it's mostly good news as it helps consumers have more money in their pockets. It's also not entirely the fault of less global demand. The dollar is rising, which allows Americans to buy more oil with each dollar (another way of saying that is the price of oil drops when the dollar rises). There's also a larger supply of oil from America and around the world. In fact, Saudi Arabia is actively producing more oil in an attempt to keep prices low. Their rationale is the cheaper it is for us to buy oil from them, the less incentive we'll have to keep producing our own oil – or move to other forms of energy.

So why did the markets gain so much?

Good economic news: Remember the first quarter of 2014, when our GDP dropped a painful 2.1%? Those days are long gone. In the second quarter, our economy grew 4.6%. In the third quarter, it grew 3.5%. Those are strong numbers! Let's pause for a celebratory cigar.

Lebron is still awesome!

It wasn't just GDP that was strong. The employment situation continues to improve. The economy added almost 250,000 jobs in October. Even better, many of those jobs were in "career" industries like business services, construction and health care. While the employment picture is undoubtedly improving, there are still significant problems. The "labor force participation rate" is still far too low (meaning lots of people aren't even trying to get jobs), and wages aren't increasing very quickly.

When you add GDP and jobs to other good news, including real estate, consumer confidence and more, the economy continues to look fairly strong. I hope that trend continues.

Earnings: Before I get to the details, let me set the stage with two important points: First, if you block out all the noise, the core of what makes stocks grow over the long term is earnings. As corporations make more money, they are worth more money, which means stock prices go up – and everyone is happy.

Second, as I've been saying for months, because of this record-breaking run in the stock markets, we really need earnings to continue growing if we want the stock market to hold those gains. Fortunately, that's exactly what's happening.

According to Marketwatch, after 80% of the S&P 500 companies have reported, earnings are beating expectations by almost 5%. Even more importantly, revenues have increased nearly 5%. That is a very important number.

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There are two ways to increase earnings: Increased revenue or decreased expenses. One is definitely better than the other for the economy at large. Since the financial crisis, corporate earnings have grown primarily because of cost cutting (which means cutting jobs and buying less stuff). Increasing revenues means good things for the economy, which means good things for stocks, which means good things for the economy…

There aren't many other good options: Let's say you are a conservative investor. You'd like to get a decent amount of income without too much risk. What are your choices? Stocks, as measured by the S&P 500, are currently paying out close to 2% in dividend income every year. That's not going to make anyone rich, but at least stocks also offer you the potential for growth. But what about bonds? Aren't they built to provide income? Not in today's world… The 5-year US government Treasury yield is 1.60%. That is significantly less than stocks.

It's sad when interest rates are so low that stocks are the only game in town. But that's the evil genius behind the Fed keeping rates low. Either you find a way to be happy with a terrible interest rate that won't even keep up with inflation, or you take more risk than you'd like. That's a tough spot for investors (and financial advisors) to be in.

Given such a tough choice, many investors are choosing stocks. That creates more demand for stocks, which helps prices rise. That's probably not a sustainable equation over the long-term... But for now, I'll take it.

<u>So what should you make of all this?</u>

The steep drop we experienced in October is the fourth significant drop we've seen this year. Stocks fell 7% in January, 4% in April and 5% in August. Through all that, the S&P 500 is still up more than 9% on the year. I'll take that every time. However, since the end of June, the S&P is up less than 3%, and we've seen more and more volatility since then. That's the kind of market I think we're in for in the near future. A few exciting rallies, some scary downturns, and not much progress. After a fantastic run over the last few years, I'm going to be okay with that.

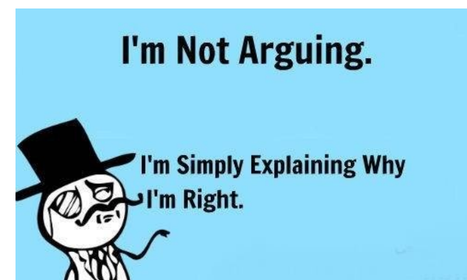
QE is dead! Ummmm… Kinda

In October, the Fed announced the end of their third round of Quantitative Easing (QE), also known as "*we're desperate to do something to help the economy because Congress is so hopelessly broken that China's governing system is starting to look kind of appealing*."

All along, I've argued that QE may have been a reasonable response to the financial crisis. But for the last few years, although the economy was still languishing, we were clearly past the crisis. That didn't stop the Fed from QE1… and QE2… and QE3…

All those cartwheels from the Fed helped convince investors, consumers and businesses we were still in crisis-land, which hurt the economy far more than it helped. But that's not all. QE meant that a government agency was inserting itself into the markets to a degree that had never been done before. That led to years of skittishness about the potential impacts of QE – and the impact it would have when QE was taken away. That uncertainty is still hurting the markets and the economy – and not just here in America, but across the globe.

The markets' response to the end of QE did more to make my point than I ever could have. Keep in mind, QE was put in place to keep interest rates low. Well… Since the Fed announced the "tapering" of their QE program last year, rates have fallen – A LOT. Does that mean the Fed could have avoided the spectacle of QE entirely and merely kept the Fed Funds Rate at zero for the last few years and had the same impact??? I'm going to leave that question unanswered as a way to dramatically make my point.



Unfortunately, the rest of the world seems to think QE was a wild success. Japan and Europe are both undergoing their own versions of it. Japan in particular is taking it to levels that might make the Fed cringe. I'm afraid the era of central banks thrusting themselves wildly into the financial markets is here to stay. That is, until it truly backfires one day.

Probably a
Mountain or a Lake

This photo was taken in early October from just below Lake Edna, which is accessed up the Icicle via the Chatter Creek trail. I was lucky enough to hike through this area on the clearest, calmest, warmest, most beautiful fall day I've ever experienced – and I had it all to myself.

I literally took hundreds of photographs that day, so I'll be sharing more of them with you in the coming months.

Here's a bonus picture of a tiny yellow larch tree hanging onto the edge of Lake Edna.

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