<u>Outlook for November, 2014: "New Highs! (Again?)…"</u>

Despite the sharp declines in October along with a litany of worries (Ebola, ISIS, Syria, Fed tightening, you name it!), the equity market is ***climbing to new highs*** again in early November. It is as if the sharp declines in October were just a bad dream and all the worries have been ***waved away by a magic wand***, with markets feeling fine about taking on risk again.

In a world with ***financial repression*** characterized by ***compressed risk premiums***, volatility has been dampened by expanding Central Bank balance sheets. While there is beginning to be a ***dichotomy*** in expectations of where the Federal Reserve's policies are headed compared to the European Central Bank and the Bank of Japan, it is hard to expect lower volatility going forward.

Economic data released recently have been ***positive***: ***US GDP for 3Q14*** came in better than expected with the initial estimate showing a 3.5% expansion (seasonally adjusted annual rate). A large share of the increase was attributed to stronger military spending by the Pentagon, a shrinking trade deficit, and a boost in real final sales. Over the past year, GDP has expanded by a meager 2.3% (saar), much lower than previous U.S. recoveries, but better than most developed economies since 2008.

The employment picture is also looking a bit better in the U.S., with the unemployment rate falling to 5.8% in October, down from 5.9% in September. The economy added 214,000 jobs in October, slightly below expectations for 233k. However, this marks the 49th straight month of positive job gains, surpassing the recovery period in the late 1980s. Since 2009, the sectors with the highest job growth have been health care and social assistance (+1.75M), leisure and hospitality (+1.68M), and temporary help services (+1.19M), according to the Labor Department.

It was no surprise that the ***Federal Reserve*** ended its ***quantitative easing program***, having telegraphed its intentions for the past several months. What remains unclear, however, is when and how it will begin to shrink its ***$4.5 trillion*** balance sheet. The consensus among market participants implies a first rate hike in mid-2015, with steep increases in the fall. Indeed, the Euro-Dollar forward strip implies that the Fed Funds Target will likely be close to 1.00% by the end of 2015 – a scenario that suggests aggressive rate hikes by the Fed.

However, Janet Yellen has repeatedly stressed that rates will be held near the zero lower bound for a ***"considerable time"*** and any deterioration of underlying fundamentals could further delay the move. We would like to believe that a "normal" interest rate environment is not a fantasy, but when Ms. Yellen spends an afternoon discussing her growing discomfort about income inequality in the U.S., we begin to re-evaluate that belief.

The statement about ***"income and wealth inequality"*** itself is not the issue; there is probably some truth to the idea that the well-off have gained ground as a result of a better stock market. Certainly the lower and middle income folks appear to have less in the way of portfolio balances and therefore the famous ***"wealth effect"*** tends to be attenuated for this income cohort.

What is at issue, however, is whether income inequality should become a policy concern for the Federal Reserve. The Congress' ***mandate*** to the Federal Reserve is "full employment" and "price stability", not income equality. For Janet Yellen to focus on income inequality and somehow imply that policies ought to be put in place to combat this smacks very much of ***"social engineering"***, the likes of which we have not seen from the leadership at the Federal Reserve. Enough said, time to get off our high horse!

Farther afield, the BOJ telegraphed its intention to increase the size of its balance sheet by roughly a third (yes, 33%) to combat incessant deflation and a sputtering economy. We are not sure what was more surprising, the magnitude of the purchase program, or the statement by Bank of Japan Governor, Haruhiko Kuroda, that the stimulus will be partially funded by the purchase of ***stocks and real estate funds***! While many of us here in the U.S. feel that the Fed has already done too much and taken us to uncharted waters, the Bank of Japan's strategy looks ***downright reckless.***

Not to be outdone, Mario Draghi announced that the ***ECB*** is also willing to ***expand its balance sheet***. Such a move would require $1.25 trillion in additional lending or bond purchases to meet the target. Draghi has already indicated that although Europe's markets are not as deep as the U.S., the bank would not be opposed to owning upwards of ***70% of the covered bond market***! Draghi has been "jawboning" – talking up a storm – trying desperately to get the European economy on an upward trajectory.

GDP was lower than expected in the 4 biggest countries in Europe: Germany, Italy, Spain and France. ***GDP for the entire Euro bloc*** is forecast to increase a mere ***0.8% (saar) for all of 2014***. Tensions in the Ukraine, fiscal austerity and structural impediments are often cited as reasons for the recent deterioration. However, a weaker Euro should help exports out of Europe, as goods become "cheaper" for U.S. consumers.

GDP forecasts for 2014 in China have been lowered, with the latest quarterly estimate at 7.3%. Many China watchers and analysts believe that the true Chinese GDP is likely a lot lower than published figures. Commodity purchase orders, electricity usage and railcar loading activity point to a growth rate more in the ***range of 4-5%.*** There is some unease among investors that Chinese growth is slipping amidst a backdrop of a stalling real estate boom and mounting local government debt.

US mid-term elections have brought about a change in the Senate – with the Republicans now gaining control of that august body and extending their gains in the House of Representatives. Even more than the Senate, the change in Governorship to Republican in states like the People's Republic of Maryland, Florida, and Arkansas signals that the electorate now wants "government to work" rather than the partisan gridlock that has characterized dysfunctional Washington DC these past few years.

In recent Monthly Outlooks we have written about our fears with ***shrinking depth in equity and debt markets.*** While the causes are many, regulations that have effectively eliminated securities inventories at large banks as well as the increasing importance of leveraged players (whose threshold for pain is much lower) has been partly to blame. The month of October gave us a glimpse of what can happen when liquidity is tight, leverage is high, and trading is rapid fire. Investor sentiment swung from being quite bullish to the depths of despair and then rose to euphoric heights again – all in the space of a mere four weeks.

There is a ***valuable lesson here***: It is important to remember that wealth is not built in months or quarters, but over years of ***patient and disciplined investing***. Sometimes that means turning off the television or that hand held device to escape the constant barrage of negativity that seems to ***masquerade for serious analysis*** these days in the financial media.

Central banks may continue to influence markets for some more time to come, but ultimately ***fundamentals will always win***. While it has been painful (and at times lonely) to have a diversified portfolio this year (the S&P500 continues to go from strength to strength), we remain convinced that having a fully diversified, high quality portfolio is the certain way to ensure ***favorable investment outcomes*** over the long haul.

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