<u>Outlook for October, 2014: “More Blocking and Tackling…”</u>

Another NFL title, in keeping with our theme from last month, you say? Well, with equity market volatility rising somewhat, we do feel ***fundamentals favor more blocking and tackling*** rather than an aggressive West Coast offense over the next twelve to eighteen months. This is all the more apparent given all the uncertainties regarding policy choices and outcomes over the medium term.

Economic data released in the US implies that ***the labor market might finally be hitting its stride***: The US economy added ***248,000 jobs in September***, with the figures for the previous two months seeing a total positive revision of +69,000 jobs. Private service providing jobs (+207k) led the way again, with professional and business services (+81k) and trade, transportation and utilities (+37k) being the leading sectors. Other services (0k) and manufacturing (+4k) were the laggards from a sector standpoint.

The politically sensitive ***unemployment rate fell two-tenths to a cycle low of 5.9% -*** providing enough ammunition to those that feel the Federal Reserve ought to start tightening monetary policy soon. A broader measure of unemployment (the so called U-6 measure) also fell two-tenths to a still “too high” rate of 11.8%. In looking at the innards of the labor market report, the story is more nuanced and mixed ***(“clear as mud”)***: The labor force participation rate dropped one tenth to 62.7% and the average hourly earnings figure also posted a decline by one cent to $24.53 per hour.

Survey data of manufacturing (the ISM manufacturing survey) and service industries (ISM Non-manufacturing) ***showed slight pullbacks*** in enthusiasm among purchasing managers (with survey results showing declines in September relative to August readings), but both surveys do point to the robust nature of new orders and business activity. The Bureau of Economic Analysis of the Department of Commerce also pegged 2Q GDP at a robust 4.6% (seasonally adjusted annual rate), a significant improvement from 1Q pace of -2.1% (also saar).

The Federal Open Market Committee of the Federal Reserve met for two days in mid-September and put out a Statement confirming that ***Quantitative Easing (or QE) would end in October***. Simply put, members of the FOMC in their collective wisdom decided to reduce the largesse of purchases of both Treasury instruments as well as mortgage notes - something they had telegraphed at earlier FOMC meetings. The FOMC Statement was mum about sales of existing holdings on the Fed’s balance sheet nor did it shed any light on the timing of the first rate hike.

During a press conference following the FOMC meeting, Fed Chairperson Janet Yellen went to great lengths to suggest that much would depend on incoming data and the Fed would not look at a single indicator like the unemployment rate, but would ***analyze a range of indicators*** including those relating to the labor market, inflation expectations and readings on financial developments. Markets are currently pricing in a rate hike sometime during 2Q2015 – which we suspect is too early.

Media coverage of the ***Yellen press conference*** painted her in a much more favorable light – some even suggesting that she was “hawkish”. Nothing could be farther from the truth: Given that every word and utterance by her is scrutinized by market participants, she has no choice but to appear to be “hawkish”. Any appearance by her of being “dovish” could set off inflation alarm bells among market participants thus calling into question the Fed’s credibility.

The Fed's "exit" from Quantitative Easing has also raised concerns about issues with financial system plumbing. The Fed believes it can use an esoteric money market instrument called ***reverse repurchases*** to drain excess liquidity from the financial system in future quarters. A number of analysts and market participants in the know have suggested that the size of the Fed's balance sheet might be ***disruptive*** to the "normal" functioning of money markets. More to come on this subject, we are sure.

Farther afield, ***economic data out of Europe***, has generally been weaker amidst ***worries about another recession***. Indeed, in looking at data from Ireland, Spain, Italy, Portugal and Greece – all those countries that had austerity imposed on them – appear to certainly be doing better than the dark days of 2011/2012. However, the marked slowdown in economic activity now seems to be impacting Germany, the Netherlands, France and the U.K.

France appears to be the real "sick man" in Europe: Very little economic growth coupled with high tax rates and a Government that is far from popular even with the common man – makes for a witch's concoction. Historically, French Governments have been quite ***dirigisme*** in their conduct of economic affairs and this does not bode well in a world that is globalized and capital can move freely across borders without much of a hindrance.

Much media attention has been expended on a "successful" visit by ***India's Prime Minister Narendra Modi*** to the US last fortnight. Mr. Modi held a congregation for Indian diaspora in New York where he was feted by a number of leaders and Congressmen. Newspapers have likened him to Ronald Reagan (for the promise of business friendly reforms and unshackling the economy). There does appear to be widespread euphoria about the potential for reforms – we remain skeptical that he can get the slumbering giant (which is used to a "Hindu" rate of growth) to rouse quickly.

The ongoing strength in the US Dollar – particularly relative to the Euro and the Yen has also managed to keep a lid on prices of precious metals as well as hydrocarbons recently. The ***decline in crude oil prices*** acts as a "benefit" to consumers – with gasoline prices now below $3.00 per gallon in many parts of the country – allowing them to spend on other goods and services. Absent a supply disruption coming out of the Middle East, we expect the declining trend in crude oil to continue over the near to medium term.

From a ***portfolio standpoint***, we have reduced allocations to domestic small-capitalization and mid-capitalization equities in favor of larger capitalization equities recently. We do believe that the time for small and mid to outperform large might be behind us in this cycle. Further, going up in capitalization also improves the "quality" of the portfolio – as larger capitalization companies, as a rule, are more stable and have the ability to sustain increases in interest rates and stomach economic volatility better as well.

Equity market volatility has risen somewhat in the past few weeks as fears of a global Ebola epidemic, more skirmishes with Islamic State in the Middle East and a growth scare in Europe have all come to the fore. The litany of things to worry about does not seem to abate in any way. Also, the US will have mid-term Congressional elections in a few weeks and the outcome of those could impact policy over the medium term. We do think, therefore that the ***prudent thing to do with your portfolios is to reduce risk*** and spend time blocking and tackling to move the ball forward!

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