Investment Outlook: Trick or Treat Markets

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The fall is traditionally a time for celebration–time to celebrate the harvest by going pumpkin- and apple-picking, as well as getting ready for the big holidays ahead. It is also a time with some spooky moments, connected to Halloween.

The United States has many additional things to celebrate this season: We've seen unemployment drop below 6%. The federal budget deficit has fallen to levels last seen in 2008. Oil prices have fallen to four-year lows, which could help consumers as we go into the holiday shopping season. We've walked a long, hard path to get here, so celebration is definitely in order!

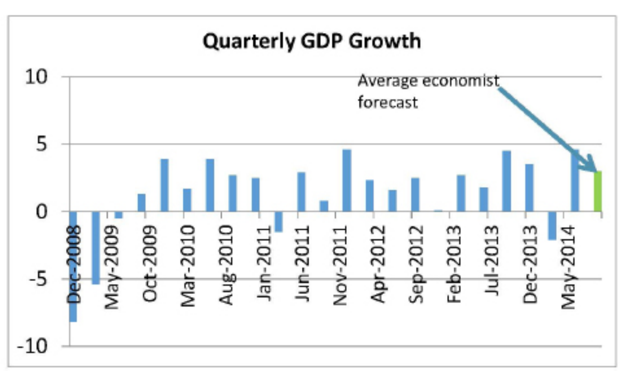
The spooky angle here, though, is the market and its performance since mid-September. In a vacuum, one might expect lower unemployment, better government finances, and cheap oil to be a big boost to the economy and the markets. We won't know exactly how the economy will react to these stimuli for a few months, but it's clear that the market has not yet held up its end of the bargain.

A fairly brief set of worries seems to have overwhelmed all the other good news in investors' minds. The Federal Reserve is tightening monetary policy and providing less support to the economy, while the U.S. dollar's rising value is threatening the competitiveness of American business abroad. As of mid-October, the global stock market as measured by the Morgan Stanley Capital International All Country World Index (MSCI ACWI) had fallen as much as 9% from its September peaks, in direct response to these worries.

In a broader context, however, these kinds of declines are normal. They stimulate the natural process by which markets absorb new data and adjust stock prices to reflect reality. In a typical year, the stocks in the MSCI ACWI usually see a decline of nearly 16% from that year's highest prices. Those declines have been fully recovered in more than two out of three years, enabling global stocks to deliver annualized returns of 10.5% since the early 1990s.

U.S ECONOMY: COMING BACK STRONG AFTER WINTER WORRIES

An unseasonably cold winter put a lot of stress on the economy earlier this year. The media began to worry about U.S. growth and the potential for a recession. Because of all the snow and the business interruptions it caused, the U.S. economy actually did contract at an annualized rate of 2% in the first quarter. This was driven mostly by temporary setbacks. For instance, snowfall that keeps workers from coming to work for a day or two can suspend work on a big construction project. What's important to keep in mind, though, is that weather-driven setbacks are temporary. Taking a "snow day" simply means that more work needs to get done in the next several weeks and months to make up the deficit.



That's exactly what happened in the economy after the winter's end. For the period from March 31st to June 30th,we registered annualized growth of nearly 5% in U.S. gross domestic product (GDP)—the fastest since the start of the recovery in 2009—as workers made up for productivity lost in the winter.

Although the numbers are not in yet, economists broadly expect the U.S. economy to continue to grow at a pace of about 3% for the rest of the year, a rate considered normal for our country.
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FOREIGN STOCKS: CURRENCY MOVEMENTS MAY DRIVE PROFITS

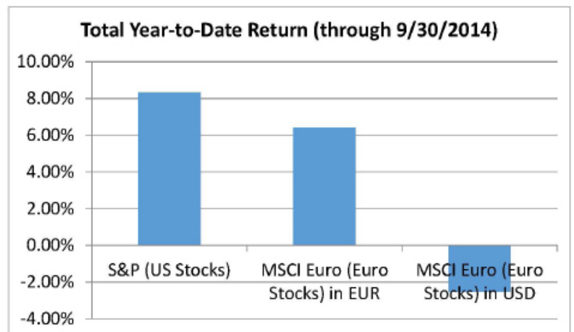
Looking to the markets, we've seen some dispersion in the performance of U.S. markets compared to markets abroad, especially those in Europe. The difference has mostly been driven by changing currency values, and may create an interesting opportunity.

At the end of September, U.S. stocks (as measured by the S&P 500) were up about 8%. European investors also had much to cheer about at the end of that month: Their stocks had delivered a return of more than 6% for the year. Why, then, were so many foreign stocks looking at losses for 2014? The difference was driven by fluctuating currencies.

One of the worries hitting the United States this fall is that a strong dollar, while boosting our purchasing power and helping put a lid on commodity prices, may also hurt our competitiveness abroad. A strong dollar, though, means that other currencies are getting cheaper. The euro, for example, is down about 8% for the year and is the primary wedge between rising stock prices in Europe and low fund performance in the United States.

This should not be a cause for concern, though. In fact, it's an opportunity! If a strong dollar raises worries that some U.S. companies may lose market share and struggle to grow, a cheaper euro does the opposite for European businesses. Customers considering buying anything made in Europe essentially have gotten an 8% discount from the markets. This could help companies in Europe improve their competitive position, win more business, and grow their profits.

Although in the interim, it may mean that a U.S. investor has not earned as high a return as they'd like on foreign investments, it creates the potential for these companies to increase earnings and potentially see their stock prices increase over time.



So as we enjoy autumn and the holidays to come, let's strive to keep turbulent markets in perspective. Market volatility and periodic declines will occur every year, and market declines—both big and small—are usually recovered with time. Even though the strong U.S. dollar may be a worry that adds to the volatility, let's also remember that the dollar is only as strong as it is because solid economic growth and the prospect of higher interest rates has helped it along. And of course, foreign investments whose prices have temporarily lagged due to inexpensive currencies may also be aided by the faster profit growth that cheap currencies may stoke.

Source for all data in this article: Bloomberg

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Index Definitions

MSCI All Country World Index (ACWI)

The MSCI All Country World Index (ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

S&P 500 Index

The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. The price return of an index is a measure of the cap-weighted price movement of each constituent within the index.

MSCI Euro

The MSCI Euro Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the European Monetary Union (EMU). The index covers approximately 85% of the free float adjusted capitalization of the EMU. The index consists of stocks in 10 developed market countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain.

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