

Markets await Fed, election decisions

October gains defy expectations

October 29, 2010 – Stock markets in Canada and the U.S. churned out another month of gains in October. But investors lost some of their drive towards the end of the month, ahead of the U.S. mid-term elections next week, and the impending announcement by the Federal Reserve Board on the size and extent of its much-telegraphed second round of quantitative easing (i.e., money printing).

For a month with a bad reputation for stocks, this October turned out to be relatively benign. Building on a winning September (also notoriously fickle), stock markets continued edging up through a month that saw perilous dips and gyrations, a fading dollar, a record high price for gold, and the growing threat of trade friction arising from perceived currency “imbalances.” So the markets’ advance was not too bad, when you consider all the anxiety-inducing events investors had to take into account when weighing earnings outlook and growth potential against current valuations.

Perhaps the biggest among the uncertainties placed on investors’ scales was the coy little hide-and-seek game the U.S. Federal Reserve Board played with financial markets on the size of its next round of “quantitative easing,” or QE2 as it’s been dubbed. With the target federal funds rate in the U.S. already at zero, the Fed must resort to other measures to stimulate economic growth, reduce the unemployment rate, and prevent what it sees as an incipient deflationary trend. Those measures largely involve some form of money creation through asset purchases – in this case the purchase of U.S. Treasury bonds. The hope is that the injection of new liquidity will drive down consumer interest rates and stimulate consumer and business borrowing and spending.

The Fed’s last effort at quantitative easing injected about US\$1 trillion into the financial system, buying up crummy mortgage debt and generally bailing out millions of consumers, investors, and businesses alike from their bad financial decisions. Although the Fed has given absolutely no indication over the past few weeks of how large another round of quantitative easing might be, the mystical machinery of the market somehow came to the conclusion that it would be another US\$1 trillion. That bit of total fiction got “baked in” to ever-rising market valuations. However, the *soufflé* collapsed when *The Wall Street Journal* reported a couple of weeks ago that QE2, if any, is more likely to be in the range of US\$500 billion.

Stock markets plummeted perilously for a day or so after the report, while gold retreated from its record high, and the U.S. dollar firmed up against a basket of major currencies.

Of course, things settled down a bit again, the greenback fell back into disrepute, stocks recovered lost ground, and markets remained rangebound to the end of the month, as investors held their collective breath before next week's developments. If anything, this is a textbook example of how "extraordinary popular delusions and the madness of crowds" can still govern market movements.

Back on the planet earth, the U.S. Commerce Dept. reported that third-quarter U.S. gross domestic product (GDP) rose 2% from the same quarter in 2009. The slower growth reading came in pretty much as expected by consensus estimates, and along with a lower inflation rate, lends more support to another round of quantitative easing by the Fed. The bad news is that lower U.S. economic growth rates may be here to stay for awhile.

Adding a little angst to the mix, U.S. home prices fell in August, as the widely-watched S&P/Case-Shiller home-prices index slipped 0.1% in the month. The housing market is a good barometer of consumer sentiment and outlook for demand. A weak housing market is a sign that consumer de-leveraging and balance sheet repair continue to preoccupy consumers, who'd rather pay off debt than shop. In fact, the Thomson Reuters/University of Michigan consumer sentiment index fell to 67.7 in October, from 68.2 in September. Perhaps QE2, if it happens next Wednesday as expected, will restore a little confidence and get consumer spending (70% of economic activity in the U.S.) going in time for the peak year-end shopping season.

Stock markets, certainly are counting on it. With third quarter earnings season already discounted (S&P 500 with estimated +28% operating earnings growth, and S&P/TSX earnings estimated to grow +7%), investors have been focusing on next week's U.S. mid-term elections and the Fed's plans for further monetary stimulation.

As a result, markets ended the week relatively flat week-over-week, but maintained month-over-month and year-to-date gains.

Toronto's S&P/TSX Composite Index advanced 2.5% month over month in October, as commodities and is ahead 7.9% year to date. Last week, the index edged up 0.6% for the week, gaining on Friday's news that Canada's GDP edged up 0.3% month over month in August after falling 0.1% in July.

The Dow Jones Industrial Average gained 3.7% in October, for a 6.1% year-to-date advance. The DJIA ended the week just a hair below breakeven. And the S&P 500 Composite similarly posted a 3.1% increase for the month, closing Friday with a 6.6% year-to-date gain. For the week, the S&P 500 slipped a minuscule 0.1%. All in all, to a bad end to a notoriously volatile month, and not a bad way to celebrate the 81st anniversary of the Oct. 29, 1929, stock market crash.

A combination of a Fed QE2 announcement and a Republican resurgence in the U.S. House of Representatives could ease investor anxieties and uncertainties considerably. And that could light the proverbial fire under stock markets.■

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