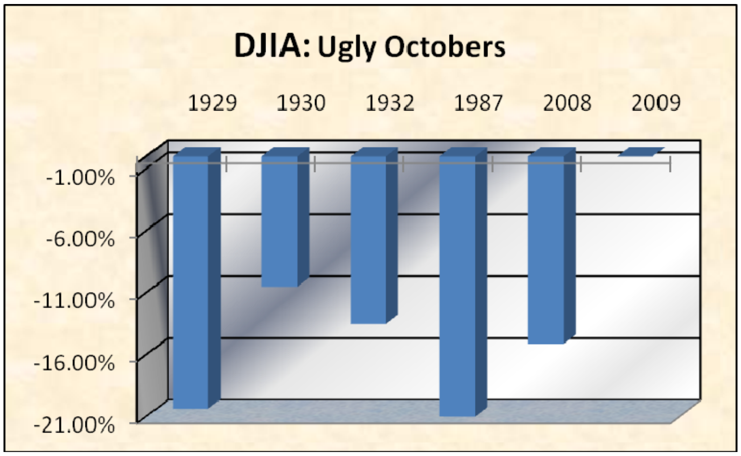
October (mostly) Un-Ugly

Market Summary October 2009

April might be the cruelest month for poets, but stock traders know October can take a very wicked turn. In 2008, for example, October was virtually 31 days of Halloween, as the Dow Jones Industrial Average careened to a 15% loss. Still, that was only number three among ugly Octobers (see chart).

So October 2009, which actually concluded with a miniscule gain on the DJIA, was no occasion for tears – especially in light of the seven consecutive months of market gains that preceded it.



Economic News Mixed

The ambivalent behavior of the capital markets last month was reflective of the conflicted quality of the economic news. For example, a robust expansion (3.5% annualized) was reported for the third quarter GDP – the first growth seen since the 1.5% gain eked out in the second quarter of 2008 – but the news was greeted with a shower of questions about sustainability. As in 2008, when tax rebates boosted consumer spending, the economy this summer was juiced by transitory governmental stimuli factors, such as the now-defunct cash-forclunkers program for automobile purchases, and the $8000 tax credit for first-time home buyers, recently extended to April.

Manufacturing Expands

A bit of good news with a more solid feel: manufacturing activity expanded for the third straight month in October, as reported by the Institute for Supply Management (ISM). Thirteen of the 18 manufacturing groups in the survey reported expansion in their business last month. That was good enough to push the ISM's composite index up 3.1 points to 55.7% – its highest level since April 2006 (more than 50% represents expansion).

Better yet, manufacturing employment expanded for the first time in 15 months, rising a robust 6.9 points to 53.1%.

However, the ISM's survey of non-manufacturing businesses might have been closer to the pulse of the current economy. Activity continued to expand in this sector, but just barely, and at a slower pace than it had in September (50.6% vs. 50.9%). Employment in the non-manufacturing sector dropped 3.6 points to 41.1%, the 21st time in 22 months that employment has contracted in the non-manufacturing sector.

Unemployment Rate Hits Double Digits

The unemployment rate rose 0.4 points in October, reaching 10.2% – its highest level in 26 years – the Department of Labor reported. Nonfarm payrolls (separately surveyed) showed a loss of 190,000 jobs, for the month, indicating the recession, which now has claimed 8.2 million jobs, continues to do damage, even as a recovery grudgingly gets underway.

Housing Recovery (?)

The original catalyst for the Great Recession presumably was the collapse in housing in mid-2006. After a steady pounding for 40 months, home sales appear to be rebounding: The S&P/Case-Shiller Home Price Index for 20 cities – the most respected metric in the industry – ticked up a for third straight month in August, rising 1.2% from July. Though the index still is down 11.3% year-over-year (and 29.3% since the 2006 peak), it seems clear that depressed prices and low interest rates are beginning to stimulaten demand.

The complicating factor is that the extension of the tax credit for first-time home buyers (and October (mostly) Un-Ugly creation of a new $6,500 credit for homeswappers) eventually will expire.

Fed Has Doubts

This point prompted skepticism about home prices from members of the Federal Reserve's Open Markets Committee (FOMC), according to minutes of its last meeting, released in October. However, the members voiced more explicit concern about "deteriorating fundamentals" in the commercial real estate market. Bad investments in the commercial sector could leave some regional and smaller banks vulnerable, the members said.

Although reports of economic activity generally were improving, the FOMC members said "virtually every reference to improvement was qualified as either small or scattered."

Employment Officially an Interest Rate Signal

The FOMC also spelled out in larger letters than usual its policy on maintaining the current zero-to- 0.25% target rate for Fed funds.

The Fed will watch for "resource utilization" (interpreted as employment) as well as signs of inflation. Employment therefore has been tied explicitly to interest rates, absent inflation.

Consumers Still Skeptical

If members of the FOMC see contradictory signals from the economy, it cannot be surprising that consumers are taking a wait-and-see attitude as well. The Conference Board reported that its Consumer Confidence Index fell in October for the second straight month, dropping 6.7 points to 47.7 (1985=100). The Expectations Index, based on respondents' views of longer-term business and employment prospects, fell 8.0 points to 65.7.

Markets Mixed

Amid such conditions, it could hardly be surprising to find markets mixed in October, and they were. The only large-cap index to log a gain was the Dow Jones Industrial Average, which nudged up the meek 0.1% cited above. The S&P 500 Index dropped 1.9%; the Russell 1000 aggregate dropped 2.2% – Growth fell 1.4%; Value was down 3.1%.

U.S. small-cap stocks were handled more roughly. The aggregate Russell 2000 Index dropped 6.8%; its Growth component fell 6.9% and its Value component fell 6.6%. The NASDAQ fell 3.3%.

Mid-caps, true to their name, produced returns between those of small and large issues. The S&P 400 Index fell 4.5% in October. The Russell MidCap Growth Index dropped 4.0%; Russell MidCap Value was down 4.8%.

International Equities Follow Suit

The MSCI EAFE Index fell 1.3%. Smaller-cap internationals were mixed; the S&P/Citigroup EMI-EPAC dropped 2.6%; the MSCI Emerging Markets Index gained 0.1%.

Though October provided some rough treatment, growth equities were the story globally for the first 10 months of the year. Among U.S. stocks, growth issues led in all categories: among largecaps, it was the Russell 1000 Growth (+25.4%); in mid-caps, the Russell MidCap Growth (+31.6%); in small-caps, the Russell 2000 Growth (+20.2%). Internationally, the MSCI Emerging Markets benchmark ended October +64.7%, year-to-date.

Bonds Healthy

The Barclays Aggregate Index produced a healthy 0.5% gain for October and finished the month up 6.2% for the year. Barclay's Capital U.S. Credit Index gained 0.6% for the month and was up 15.5% year-to-date.

The Citigroup High Yield Index ended October up 1.5% for the month and 49.1% for the year. REITS were punished in October: The Dow-Jones Wilshire fell 4.5%; the NAREIT (All REITS) dropped 4.8%. YTD the two indices are +12.3% and +12.1%, respectively.

Commodities spiked in October, as the Goldman Sachs Commodities Index gained 5.9% and the DJ-UBS Commodity Index 3.3%. The Alerian Master Limited Partnership Index gained 2.9%.

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