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Traders Whipsawed as Bank of Japan and U.S. Fundamentals Surprise

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At this point last month, investors may have been sorely tempted to back away from equities. September had turned bleak after domestic large cap markets set new highs mid-way through, and stretched valuations suggested we were more than due for a correction. And with October's infamous reputation for market crashes, the bull got wobbly.

This uneasiness continued throughout the first half of October, but suddenly the bull pivoted with newfound strength as economic reports out of Germany showed improvement, third quarter earnings season in the U.S. got off to a strong start and domestic unemployment dropped to an impressive and unexpected 5.9%. But the big jolt came from Japan. Just two days after the U.S. Federal Reserve announced the end of its latest asset-purchase program, the Bank of Japan (BOJ) surprised everyone with an enormous expansion of its quantitative easing effort, sending the Nikkei up nearly 5% on the day and providing a jolt of confidence to markets worldwide — and perhaps inspiration to central banks in Europe and China.

BOJ as Global Trendsetter?

Will the BOJ's bold action inspire other central banks to step up to the plate? Let's look first to Europe. Like Japan, Europe relies heavily on exports; however, the euro zone is increasingly at a competitive disadvantage as its currency surges against the yen. Meanwhile, Europe's economic woes are many, and it appears unlikely to return to sustainable growth anytime soon. That said, we're not advising an avoidance of the region, not when a country a fraction of Europe's size like Japan unleashes massive U.S.-scale stimulus. Despite its many legal and political constraints, the European Central Bank (ECB) certainly is more formidable than the BOJ. While the risk remains that Europe will continue to struggle as the ECB drags its feet, at this juncture risk seems more skewed to the upside.

China, meanwhile, has the biggest stockpile of foreign exchange reserves in the world, at nearly $4 trillion, and the firepower to engage in almost any form of stimulus it wants. That said, the People's Bank of China (PBoC) currently is managing only a very modest effort, injecting ¥500 billion ($81 billion) into the nation's five largest banks. Though it remains cautious at this stage, the central bank's concerns are well founded:

- China's third quarter GDP growth of 7.3% represented the slowest pace in five years.
- The country's property market is experiencing a sharp slowdown, as average new-home prices fell in October for a sixth consecutive month, nearly wiping out the gains made over the last year.
- Manufacturing PMI slowed to 50.8 in September, below expectations and very near contraction territory.
- September also saw disappointing retail sales, as year-over-year growth fell for the fourth month in a row.

Executive Summary

- After weeks of struggles, market strength returned quickly in mid-October.
- The expansion of the BOJ's quantitative easing program surprised markets and may provide inspiration to central banks in Europe and China.
- As corporate America surges to all-time high EPS, domestic macro conditions continue to improve.
- While Republicans took control of Congress with the midterm elections, policy impact may be minimal.

Most Markets Rebounded in October

Index	Oct-14	YTD
Equity		
S&P 500	2.4	11.0
S&P MidCap 400	3.6	6.9
S&P SmallCap 600	7.1	3.1
Global REITs	6.7	14.4
EAFE	-1.4	-2.4
Emerging Markets	1.2	4.0
Fixed Income		
Corporate	1.0	6.7
U.S. Treasury 20+	2.9	20.0
Global Aggregate	0.0	1.7
High Yield	1.2	4.7
Senior Loans	0.4	2.6

Source: FactSet, FTSE NAREIT, Voya Investment Management

Despite the limited constraints on the PBoC, massive stimulus is not without cost; just look at the excesses in debt and non-performing loans that the economy has developed in recent years. While Beijing mulls over an acceptable rate of growth, it is clear China is slowing and is contributing to the global economic slowdown — and likely the weakness in oil and other commodities — as well.

U.S. Fundamentals Remain Strong; Midterm Elections Unlikely to Impact Policy

U.S. fundamentals have continued to accelerate as we move into the fourth quarter. With 82% of S&P 500 companies having reported third quarter results, year-over-year earnings growth stands at 9.3% while top-line revenues are up 3.9%. We expect earnings growth for the quarter to finish above 8.0%, which would push earnings per share for the index to its highest level ever.

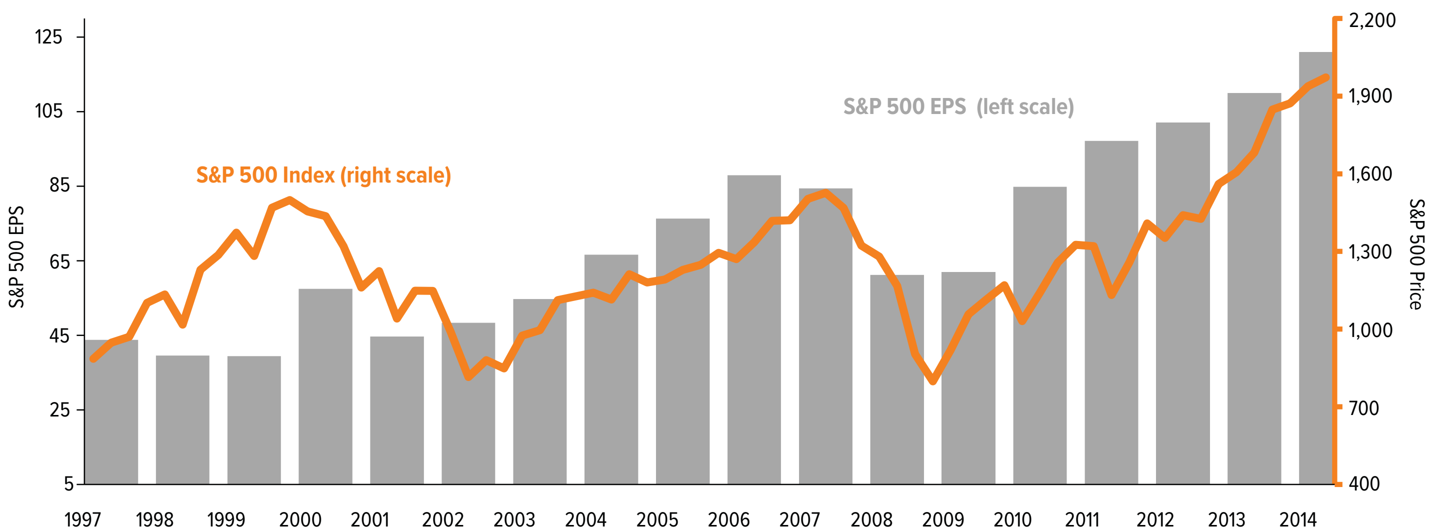
We'll say it again: Fundamentals drive markets. Given the success of corporate America combined with attractive macro data points like those below, it's no wonder the markets reversed course in October.

- The ISM manufacturing index soared to 59 in October; manufacturing is extremely energy intensive and the drop in gas prices — down $0.70 since June — has created a tailwind for factories.
- While October consumer spending disappointed, declining for the first time since January, consumer sentiment is running at the highest levels since 2007. Meanwhile, falling gas prices should help consumers spend their way through the holiday season.
- The housing market continues to grind higher; the latest Case-Shiller index reported home prices up 5.7% from last year.
- Though the labor market was slow to come around, recent trends suggest the long-awaited upward wage pressures may soon emerge: initial unemployment claims have been under 300,000 for the past six weeks, unemployment fell below 6% in its latest reading and job openings are at the highest level in 14 years.

The midterm elections saw Republicans gain a majority in the Senate while widening their advantage in the House of Representatives, giving them control of Congress for the first time since 2006. However, the GOP's lack of a supermajority in either chamber means that it would likely be unable to override any presidential veto, suggesting DC gridlock may persist for at least another two years. That said, there are a few economy-enhancing legislative initiatives that we'd like to see sooner rather than later:

- Cutting corporate income taxes toward the Organization of Economic Cooperation and Development (OECD) average of 23.4%. U.S. corporate taxes, at 35%, are the second highest in the world; China, in contrast, has a rate of 25%.
- Approving energy exports (likely liquefied natural gas first, followed by

New Record Highs for S&P 500 Price and EPS



Source: FactSet

crude oil), which would abruptly reduce the trade deficit, expand tax revenues and create an enormous number of jobs.

- Increasing infrastructure spending to update U.S. transportation, power and water facilities.
- Bolstering global trade with the enactment of "trade promotion authority" to fast-track trade deals like the Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership.

Building Wealth in Increasingly Volatile Markets

Though the Federal Reserve's slow migration back to normal policy took a large symbolic step with the end of QE3, the BOJ in October upped its stimulus efforts and other central banks may soon follow. Central bank intervention only exacerbates volatility, and last month's narrative serves as an important lesson for investors attempting to time markets. After plummeting 5.4% in the first two weeks of October on the heels of September's second-half swoon, the S&P 500 rocketed 8.4% over the balance of the month to finish at a new all-time high. Investors who blinked during the dip missed out on the rebound.

The danger of focusing on price volatility is that it reflects the market's point-in-time assessment of investment conditions, not the underlying fundamentals by which the market is driven across cycles. A prudent investment approach that emphasizes an accurate assessment of the fundamentals is crucial for overcoming this timing discrepancy and building long-term wealth.

Making Global Trade Easier Could Bolster Economies Worldwide

Countries	GDP			Trade (% of GDP)	Demographics		
Developed Markets	USD (Billions)	Per Capita	1-Yr Change	Exports	Population (Millions)	Unemployment %	Median Age
U.S.	17,328	54.3	4.1%	9.4 %	319	5.9	37
Germany	3,971	42.8	0.9%	38.8 %	82	5	45
Canada	1,794	49.4	1.7%	27.1 %	34	6.8	41
U.K.	3,015	44.1	0.7%	17.9 %	63	7.6	40
Euro Zone	13,319	40.2	-0.6%	19.7 %	331	11.5	
Japan	4,768	38.2	1.5%	14.5 %	127	3.6	45
Ireland	253	45.8	-0.3%	48.6 %	5	11.1	35
France	2,928	45.0	0.4%	20.4 %	65	10.3	40
Emerging Markets							
Brazil	2,280	11.2	1.0%	10.7 %	203	4.9	29
Russia	2,024	13.9	3.5%	26.1 %	143	4.9	39
India	2,038	1.6	4.9%	15.3 %	1,236	6.5	26
China	9,040	6.7	7.9%	25.3 %	1,356	4.1	36
Mexico	1,229	10.6	3.7%	33.2 %	120	4.8	27

Younger demographics in emerging countries

Source: FactSet. Data is most recent available.

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