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"October Surprise" Is not About Elections This Year, but Corporate Earnings

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Driven by overseas revenue, corporate earnings delivered year-over-year growth for 11 consecutive quarters — i.e., nearly three straight years — to ultimately reach all-time highs. But that winning streak is in jeopardy. "October surprise" is political jargon for an unexpected event that influences the outcome of an election, in particular the U.S. presidency. This year, however, it could be equity markets that are whipsawed by a transformative development, as declining corporate earnings could change the direction of the market from positive to negative.

Advancing corporate earnings are a reliable indicator of the times to be in the market, and declining corporate earnings are an equally strong signal to adopt a defensive position. September's coordinated global monetary stimulus featured big bids in the form of the European Central Bank's Outright Monetary Transactions (OMT) and the U.S. Federal Reserve's QE3, while central banks in Japan and China also eased. In the aggregate, the actions may have pushed enough growth forward to make a 12th quarterly advance possible; like the election, however, it is going to be a squeaker.

The market noticeably weakened in October, but we managed to breeze past the 25th anniversary of the Black Monday 1987 market crash without drama. Despite a flat month for a diversified portfolio, all asset classes across the board have posted year-to-date gains, especially in equity. October saw corporate bonds and high yield bonds shine as volatility and risk aversion increased. In terms of sectors, S&P 500 technology was hammered, losing 6.7% for the month as bellwether stocks reported earnings that fell short of expectations.

Executive Summary

- **Third quarter earnings growth for S&P 500 companies is at risk of being negative for the first time in three years.**
- **While the presidential election is important, Congress will ultimately control spending and tax legislation.**
- **Monetary stimulus alone is both inadequate and unsustainable; pro-growth taxation, spending and regulatory policy is key to our economic revival.**

Though Some Risk Assets Softened in October, All Are Solidly Positive Year to Date

Index	Wgt	Oct-12	YTD	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity												
S&P 500	10%	(1.8)	14.3	2.1	15.1	26.5	(37.0)	5.5	15.2	13.2	0.4	6.9
S&P MidCap 400	10%	(0.8)	12.9	(1.7)	26.6	37.4	(36.2)	8.0	12.1	15.8	3.1	10.2
S&P SmallCap 600	10%	(2.0)	11.5	1.0	26.3	25.6	(31.1)	(0.3)	13.6	16.6	2.5	10.2
Global REITs	10%	0.8	23.1	(8.1)	20.0	41.3	(48.9)	(4.7)	16.7	12.7	(2.9)	9.4
EAFE	10%	0.8	11.5	(11.7)	8.2	32.5	(43.1)	11.6	5.1	3.3	(5.3)	8.2
Emerging Markets	10%	0.9	8.7	(22.7)	9.8	93.5	(59.3)	59.1	(2.2)	(0.4)	(7.2)	20.0
Average		(0.3)	13.7	(6.9)	17.7	42.8	(42.6)	13.2	10.1	10.2	(1.6)	10.8
Fixed Income												
Corporate	10%	1.3	10.1	8.1	9.0	18.7	(4.9)	4.6	10.2	9.3	8.1	6.8
U.S. Treasury 20+	10%	(0.1)	4.2	33.8	9.4	(21.4)	33.7	10.2	11.1	13.1	10.9	8.3
Global Aggregate	10%	(0.1)	4.7	5.6	5.5	6.9	4.8	9.5	3.5	4.8	5.8	6.5
High Yield	10%	0.9	13.1	5.0	15.1	58.2	(26.2)	1.9	13.6	12.6	9.4	11.2
Average		0.5	8.0	13.2	9.8	15.6	1.9	6.5	9.6	9.9	8.6	8.2
60/40 Porfolio		**0.0**	**11.4**	**1.1**	**14.5**	**31.9**	**(24.8)**	**10.5**	**9.9**	**10.1**	**2.5**	**9.8**

Source: ING Global Perspectives, FactSet

Presidential Contest Gets Attention, but Congress Defines Possibilities

The presidential election took top billing in October, with the three debates turning this into a neck-and-neck race heading into the final stretch. Just as with the markets, the media have focused on the sensational while missing the real action — the balance of power in the U.S. Congress. While the Republicans are likely to maintain control of the House of Representatives, the Senate is up for grabs. A Democrat victory in the Senate will mean another divided Congress that may once again descend into partisan bickering with little or nothing to show for it. If the sun shines on the Republicans, the GOP will control Congress and be able to usher through their legislative favorites. Incredibly, this political fundamental has been largely ignored by the media, but maybe it's not surprising since they also tend to miss the fundamentals that are the primary driver of markets.

Be careful what you wish for: Either party will have its hands full dealing with all the problems the country faces, such as shortfalls in Medicare and Social Security, chronic fiscal deficits, rising debt-to-GDP and more. But the real problem lurking below the surface is how to revive the economy through pro-growth economic policies. Superficially, the candidates advocate very different views on spending and taxation; however, it is not clear that either philosophy will match its hype to substantially rekindle the growth fires that would overcome our fiscal dilemma. Austerity alone is not enough, and higher taxes suffocate the incentive for businesses to grow and for consumers to spend. In any event, it is increasingly obvious that monetary stimulus is both inadequate and unsustainable.

As usual, the clearest signal emanates from the markets, where monotonic positive earnings gains over the past three years seem to be nearing an inflection point. Only sustainable growth policies on taxation, spending and regulation can change the tide. Sadly, the quantitative easing that has kept markets afloat is interfering with the market's pricing mechanism. In the absence of the Federal Reserve's excessive support, the signal would come through loud and clear, making the urgent need for more effective fiscal policy indisputable.

Fundamentals Are Mixed but Depend on U.S.-Derived Profits

Advancing corporate earnings. U.S. corporate earnings have marched through extraordinary global risks to defy negative forecasts before, but growth in the third quarter is currently negative (with 350 of the S&P 500 companies reporting). Extremely strong earnings in third quarter 2011 — the second-highest on record — are proving to be a difficult hurdle to clear. Energy and materials have fared the worst, with earnings growth of -10.8% and -24.8%, respectively.

Broadening manufacturing. Manufacturing has expanded the last two months after contracting over the summer, boding well for future positive earnings although it may be too late for this quarter. The ISM Index released on November 1 surprised the market by improving to 51.7 and combined with a positive China manufacturing report to set off a sharp rally. Major regional indices — including the Empire State, Philadelphia and Chicago surveys — rebounded from prior months. Durable goods reversed a miserable decline in August, rising 9.9% in September.

Consumer as game changer. The consumer once again took retail sales levels to all-time highs in September; in fact, the consumer component was the biggest driver behind the stronger-than-expected 2.0% GDP report for the third quarter. Consumer spending rose 0.8% in September, the most since February. The housing market's turnaround has been a catalyst for buoyed consumer sentiment. The construction of new homes accelerated by 15% to an annual rate of 872,000 last month, the fastest pace in more than four years.

Developing economies. Technology is one of the Global Perspectives "tectonic shifts" that will increasingly change the global economic landscape. Mobile phones, for example, have obviously changed business in the U.S., but the mobile revolution extends far beyond our shores. Today, three quarters of the world's inhabitants have mobile phones.

Materials and Energy Have Dragged Down Third Quarter Earnings

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Financials	67	/	81	16.0%	44	22	10.3%	50	15
Industrials	48	/	61	4.4%	27	21	4.3%	32	13
Information Technology	53	/	70	2.2%	32	20	0.5%	34	14
Consumer Staples	25	/	41	(0.2%)	16	9	3.5%	16	4
Consumer Discretionary	42	/	81	(0.3%)	24	17	3.2%	28	11
Health Care	39	/	52	(2.3%)	27	12	4.0%	31	6
Utilities	13	/	33	(3.1%)	7	6	1.7%	7	5
Telecommunication Services	5	/	8	(3.1%)	3	1	16.0%	4	0
Energy	33	/	43	(10.8%)	9	24	6.1%	15	17
Materials	25	/	30	(24.8%)	9	15	(1.8%)	12	9
S&P 500	**350**	**/**	**500**	**(1.7%)**	**198**	**147**	**4.7%**	**229**	**94**

Source: FactSet

The number of mobile subscribers (though individuals may have multiple subscriptions) has surpassed 6 billion; surprisingly, almost 5 billion of these subscriptions are in developing countries.

- 80–95% of the populations in Kenya, Mexico and Indonesia send text messages.
- Ten years ago, less than 1% of African people had landline phones. Now more than 70% of the population has a mobile phone.
- According to the World Bank, in many developing countries it is easier to get a mobile phone than a bank account, clean water or electricity.

Mobile phone apps can be used not just to entertain but also to build and educate, provide access to health and financial information, spur job growth and create feelings of empowerment for the global consumer.

The Risks in Spain Fall Mainly on the German Taxpayer

True risk is what sneaks up behind you and hits you in the back of the head. So as a practical matter the fiscal cliff, the U.S. debt problems and the elections are not real risks, since they are discussed ad nauseum. There is little risk in what you can clearly see, plan for and, in market terms, discount.

On the other hand, the real risks are not known, or at least not broadly known; for example, the China hard landing that we believe is underway. Europe's problems have been discussed for years, and we have effectively taken the other side, saying that the Europeans have built an effective fence around their debt crisis, at least buying themselves some time. Last year, the expectation of an imminent collapse of the euro zone was greatly exaggerated. But a valid concern is that Spain, in particular, seems no closer to reforming its economy toward sustainable growth than it was a year ago. Instead, Spain seems to be playing chicken to get the best possible terms before it inevitably signs up for the ECB's sovereign bond-buying program (the OMT) that will require strict conditions. Spain is becoming the next Greece. Its unemployment sits above 25%. Its economy is in recession. Its credit rating was cut to BBB- by Standard & Poor's. The northern region of Catalonia, which produces 19% of Spain's growth, is openly talking of secession. Its tax reform policies mean ever higher taxes for Spanish citizens.

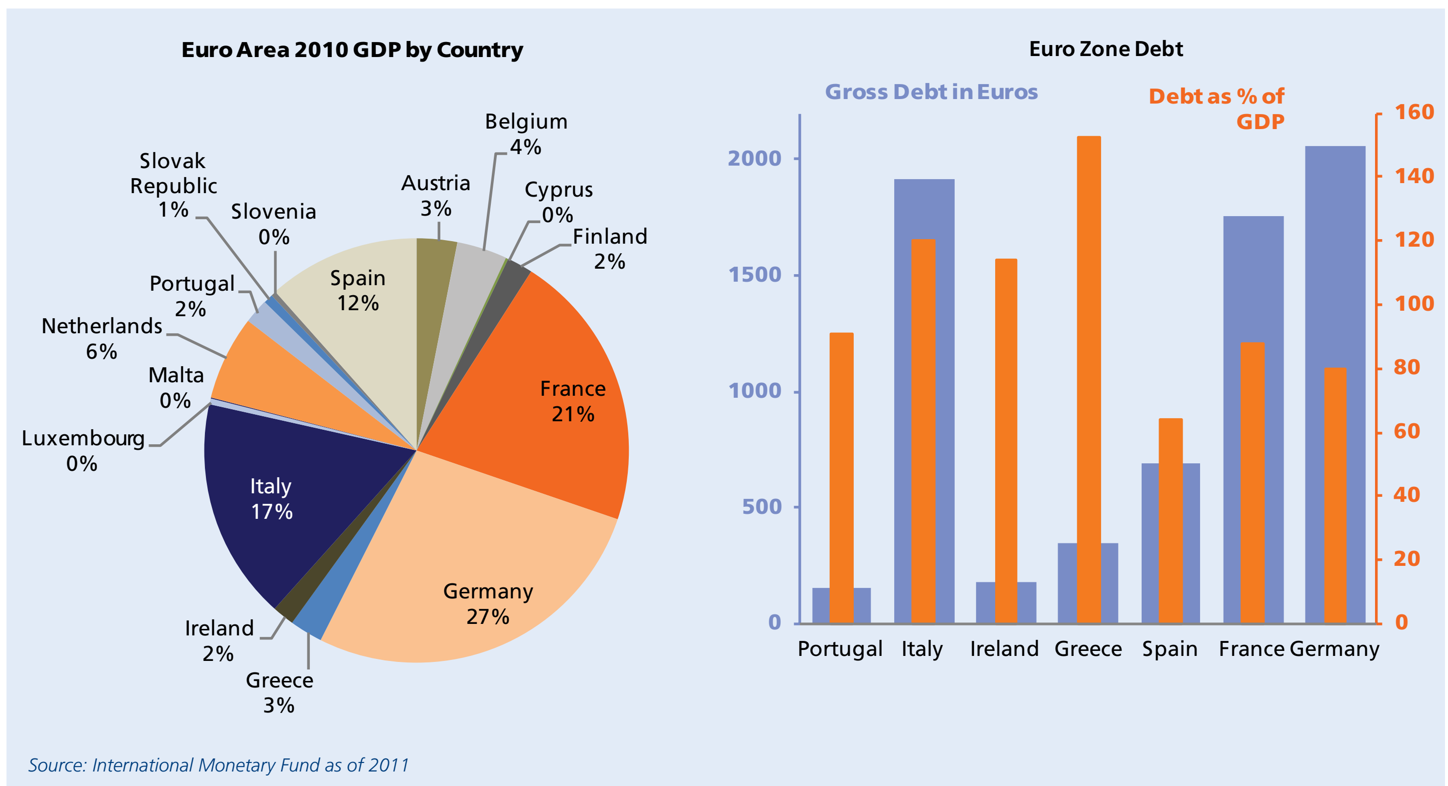
Spain says it is "too hard", but it is not too hard to ask a German taxpayer to share the pain that was self-inflicted? As we acknowledged about a year ago, "a crisis is a terrible thing to waste". Spain is wasting it; the problem is not going away, and the ECB is stimulating with reckless abandon.

The Risks in the U.S. Fall Mainly on the Federal Reserve

The U.S., while not approaching the difficulties Spain faces, is likewise relying on extraordinary monetary stimulus to avoid confronting its debt and growth problems. The Fed has gone beyond price stability and is now single-handedly attempting to solve the unemployment problem with unsustainable policies. The Fed has abandoned the price rule for a quantity rule (quantitative easing) by buying bonds from banks in tranches dubbed "QE1","QE2", "Operation Twist" and now "QE3". Admittedly, this sequence of Q policies has effectively boosted housing prices and reduced mortgage rates — a big benefit to consumers — a good target since the consumer accounts for 70% of the economy.

The cost of this aggressive, unprecedented Fed action remains to be seen. It may adversely impact inflation and/or have other

The Euro Crisis May Have Been Fenced Off, But It Has Not Gone Away



Source: International Monetary Fund as of 2011

unintended consequences. But clearly it is enabling Congress to avoid addressing the fiscal cliff with reasonable pro-growth economic policies and entitlement reform.

Outlook for the Final Months of 2012

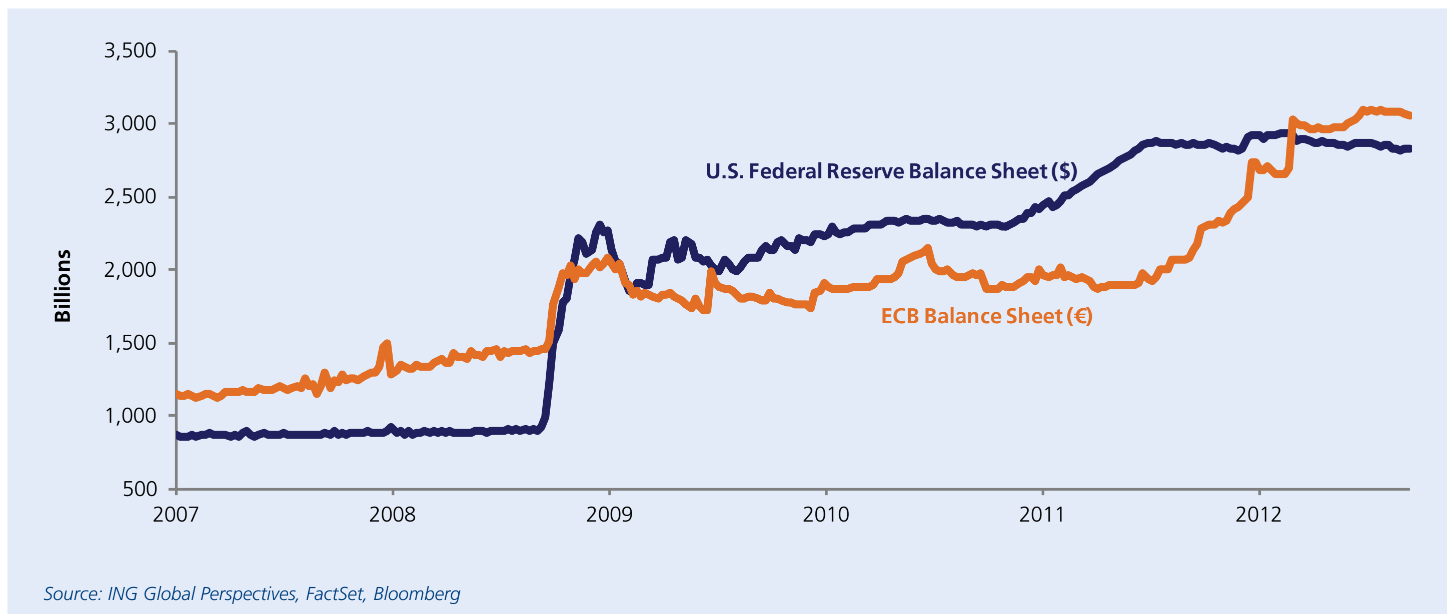
This election matters greatly to the markets, but it is impossible to forecast probable effects ahead of time. The best outcome would find markets pleasantly surprised that gridlock will end, the fiscal cliff will be postponed, and economic realities will be addressed.

But we are at a crossroads. The fundamentals that are the main driver of market prices are signaling the weight of too much uncertainty about the lack of good economic policies that will promote sustainable growth. Tectonic shifts in the global economy are underlying catalysts for growth that are evident in consumer statistics, but the headwinds are building.

Fed Chairman Bernanke's dedication to achieving full employment is admirable, but the markets increasingly aren't buying it. Clearly, monetary stimulus alone cannot revive the economy, and his dovish policies are giving Congress an excuse not to take action. Stimulus has been very effective in stabilizing markets, aiding housing and especially the consumer, but it is time to take the monetary punch bowl away to get a sober look at reality.

The popularized "kick the can down the road" is making bonds essential ballast for the path ahead. Equities are cheap and some pay extraordinary dividends. Cash has been and continues to be a drag. ■

The Fed and ECB Have Expanded Their Balance Sheets Sharply in Recent Years



Source: ING Global Perspectives, FactSet, Bloomberg

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