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October Data Supports Stock Rally

Following the unsettling August/September decline in stocks around the world, the recovery in October was rewarding for those who held their nerve. Throughout this period, we asserted that the stock markets were assessing the potential for a 2016 global earnings decline and judged it unlikely. We believe that a key reason for the rebound was a month of solid economic data and policy language that appears to have allayed fears.

The October nonfarm payroll data was the headliner, rebounding to an increase of 271,000 jobs from just 142,000 in September. The monthly number is notoriously volatile and often revised, so we like to look at the average of a number of months to get a better picture. According to the Bureau of Labor Statistics (BLS), just over 2 million jobs have been created so far this year, which equates to approximately 200,000 jobs per month on average – the sixth year of growth. In our view, this data suggests continued improvement in the labor market. With the unemployment rate at 5%, the US looks to be close to full employment. We therefore believe that a rate hike in December now looks very likely.

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In addition to reporting on employment, the BLS calculates average hourly earnings. Prior to the last recession, hourly earnings grew around 3.5% per year but have struggled to grow much more than 2% since 2010. There has been anecdotal evidence of higher wages paid to hourly workers from a number of companies including Walmart, and this month's numbers seemed to reflect this with the annual rate climbing to 2.5% for the first time in five years.

Just as important but less spectacular were the monthly Purchasing Managers' reports. This survey provides real-time feedback from companies as to whether certain conditions are improving or deteriorating. This survey is accurately picking up the divergence between the industrial and service sectors of economies around the world, as well as the outperformance by developed economies over developing ones (see Weekly Chart). There is a global recession in energy, materials and certain industrial sectors, which is holding back manufacturing, but the service sector looks healthy in the United States, Japan, and Europe.

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In addition to the rise in global stock markets, there has been a rise in both short- and long-term interest rates and in the dollar. Ten-year Treasury yields are below the high for the year of 2.5%, but they have risen from 2% to 2.3% in the last two weeks. The dollar has risen 6% against the euro and 3% versus the yen in the last month, re-asserting its up-trend. We still envisage modest gains for the S&P 500 this year, but we continue to see better opportunities in Europe and Japan, and our portfolios reflect this.

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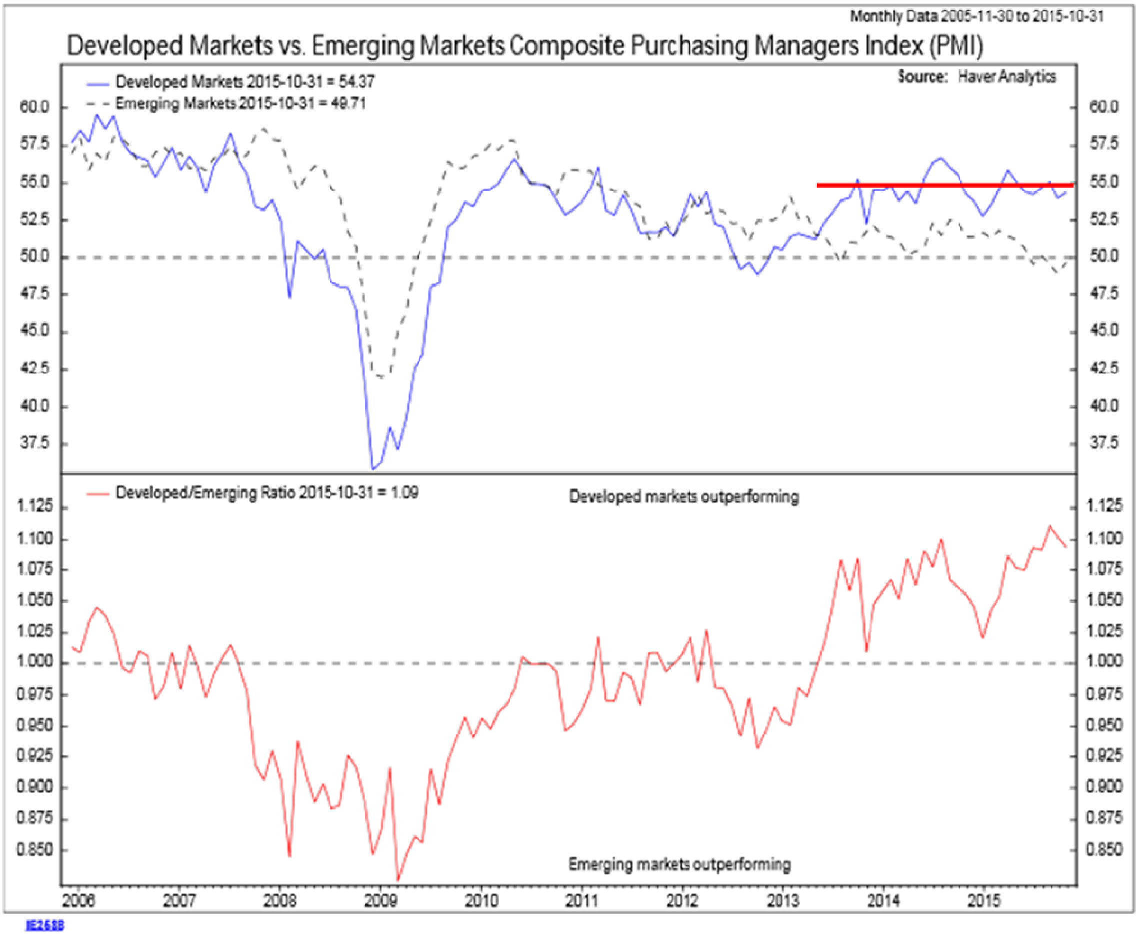
S&P 500 Earnings: Flat Earnings Are Deceptive

There is no doubt that 2015 earnings for the S&P 500 have been disappointing. Analyst estimates are nearly always too optimistic, but this year earnings have missed the mark by a wider margin. That said, the big outlier is the Energy sector, where earnings have fallen some 60%. When that is taken into consideration, the remaining sectors have produced mid-single-digit growth, much as expected.

THE WEEKLY CHART: DEVELOPED GROWTH STEADY



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In the chart above, courtesy of Ned Davis Research, we show the combination of the manufacturing and non-manufacturing PMIs for the economies of developed and emerging markets. The lower clip shows the relationship between the two and highlights the clear outperformance by developed markets in the last two years. The top clip tells us that there is no real sign of a slowing in the developed markets over the last three years, with the level of the survey remaining steady as one would expect during an expansion. We expect the emerging survey to improve in 2016 and the developed to continue to hold steady.