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Europe the Fly in the Ointment as U.S Economy Buzzes

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One of the U.S.'s best exports in recent years may have been policy and not product; namely, the Federal Reserve's balance sheet expansion via quantitative easing. It sure has helped the U.S.; in fact, it worked so well that both the Fed and the financial markets have been surprised by the strength in economic growth, corporate earnings, jobs and inflation. Japan wisely followed suit and has seen certain benefits, although the country remains wracked with structural issues that are impeding a complete return to progress.

Did Europe not get the memo that more is better when it comes to QE, especially in an environment in which growth and inflation are floundering in concert? Perhaps the biggest problem for Europe is its timing; given that QE takes a year or two to kick in, it's far too late for the European Central Bank to be dithering about the magnitude of what in effect is a last-ditch effort to avoid a return to recession and deflation.

In advance of the October 2 European Central Bank meeting there was some speculation that President Mario Draghi would double down on the stimulus measures he announced in September by expanding the bond-buying program to include sovereign debt, especially given that that first tranche of his high-profile TLTRO program (targeted longer-term refinancing operations) was a bust. He opted to punt rather than go for it, however, and the markets summarily plummeted, signaling not only their displeasure but a lack of confidence in Europe's ability to pull out of its malaise.

In terms of GDP, Europe in aggregate is second only to the U.S. in size, but it is quickly losing ground as the U.S. locomotive gains speed and acting as a drag on global economic growth. Meanwhile, Germany — always the bulwark against a European recession — appears to be slipping. As we pointed out in our Global Perspectives 2014 Forecast, "Without Germany, the future of the currency bloc would be bleak". Bad news: In its latest reading, German manufacturing PMI contracted (which is typically a precursor to recession), while factory orders dropped at the quickest pace since January 2009.

Though Germany could blame its economic slowdown on the ongoing Russia/Ukraine conflict, the situation highlights the vulnerability of Germany — and all of Europe, for that matter — to any disruption. Although the health of Europe and its impact on trade flows have only a minor impact on the U.S., China and the other emerging markets have an outsized dependency on the Continent. This dynamic is playing out in the markets in surprising ways. While volatility stays low, the dollar is surging against all currencies and especially the euro, strength that has prices for oil and commodities — gold in particular — plummeting. A robust dollar is usually welcome, as it lowers costs for domestic consumers and businesses.

Executive Summary

- While the success of the Fed's aggressive QE program surprised the markets and the central bank...
- ...Europe hasn't gotten the memo, continuing to dither over the scope of its asset-purchase program as recession and deflation loom.
- Markets across the globe — with the exception of long Treasuries and domestic large cap stocks — were hard hit in the third quarter.
- Though volatility has risen, it remains modest; investors should take this opportunity to broaden their portfolios at more attractive levels.

Most Markets Suffered in September and 3Q14

Index	Sep-14	3Q14	YTD
Equity			
S&P 500	-1.4	1.1	8.3
S&P MidCap 400	-4.5	-4.0	3.2
S&P SmallCap 600	-5.4	-6.7	-3.7
Global REITs	-6.2	-4.4	7.2
EAFE	-3.8	-5.8	-1.0
Emerging Markets	-7.4	-3.4	2.7
Fixed Income			
Corporate	-1.4	-0.1	5.6
U.S. Treasury 20+	-2.0	3.0	16.6
Global Aggregate	-2.8	-3.1	1.6
High Yield	-2.1	-1.9	3.5
Senior Loans	-0.3	0.1	2.3

Source: FactSet, FTSE NAREIT, Voya Investment Management

However, sharp appreciation — the dollar was up nearly 8% in the third quarter — can be disruptive to markets and susceptible to a quick reversal.

Bonds Beat Equity in Tumultuous Third Quarter

Markets across the globe — with the exception of long U.S. Treasury bonds and U.S. large cap equities — were hard hit in the third quarter as investors fled to liquid dollar assets. Fears of recession and deflation in Europe combined with geopolitical unrest and the potential for reduced liquidity out of the U.S. Fed to raise volatility, primarily within the riskiest asset classes. U.S. small caps took the brunt of the hit, while EAFE — more than 50% of which is exposed to the first letter in its acronym — was a close second. The third quarter flight to safety led to reversals in second quarter high-fliers like global REITs and emerging markets; notably, the less widely followed frontier markets posted a positive quarter in expected non-correlated fashion.

With third quarter results suggesting its lower-volatility characteristics were in favor, fixed income returns have outpaced equities in two of the year's three quarters. Long U.S. Treasuries posted the best return among all asset classes, as U.S. debt and currency demonstrated their values as safe havens. Global aggregate bonds were the worst performing fixed income asset class for the quarter as the appetite for risk waned.

U.S. Fundamentals Continue to Surge

Economic data out of the U.S. continues to be positive despite the ongoing concerns in Europe and the various sources of geopolitical unrest. The Fed may be behind the curve in removing accommodation, but you can't fault it for acting aggressively to rescue an ailing economy — unlike the ECB. The proof is in the data, some examples of which are below. This stronger-than-expected economic growth should allow the Fed to exit its extraordinary monetary policy, likely resulting in higher equity market volatility.

- Unemployment fell to 5.9% in the latest reading, the lowest level in six years, on strong September headline numbers and positive revisions to July and August. Meanwhile, job openings are at the highest level in 13 years and layoffs at the lowest level in 14 years.
- Second quarter U.S. corporate earnings growth was strong at 7.2% year-over-year, and growth is expected to have accelerated through the third quarter and into the fourth.
- At 56.9, the ISM manufacturing index illustrates the robust growth in U.S manufacturing, while the production component of the report reached its highest level since January 2010.
- Home prices were up 0.6% month-to-month in July, while year-over-year prices rose 6.7%. Nearly 950,000 homes moved into positive equity territory in the second quarter, and now only 10.7% of U.S. homes are underwater.

After a Strong Second Quarter, Corporate Earnings Growth Is Expected to Accelerate

Sector	Reported			Earnings Growth			Earnings Surprise		
Index	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Telecommunication Services	5	/	5	20%	1	4	1%	2	1
Health Care	54	/	54	16%	41	11	8%	43	5
Materials	30	/	31	12%	22	7	6%	22	7
Consumer Discretionary	84	/	84	10%	62	18	4%	59	17
Information Technology	66	/	65	9%	46	18	2%	51	12
Industrials	64	/	64	8%	52	11	3%	38	18
Consumer Staples	40	/	40	5%	32	8	3%	20	13
Energy	45	/	45	5%	30	14	-1%	26	16
Utilities	30	/	30	1%	20	10	2%	20	10
Financials	83	/	82	-1%	54	24	4%	56	22
S&P 500	**500**	**/**	**500**	**7.2%**	**360**	**125**	**3%**	**337**	**121**

Source: Bloomberg, Standard & Poor's, FactSet

- Second quarter GDP growth was revised up to 4.6%, primarily because of better exports and higher business investment. This is the most robust quarterly expansion since fourth quarter 2011.
- New single family home sales surged 18% month-over-month in July, the biggest jump since 1992.
- Retail sales in July were revised higher to a healthy 0.3%, while August's result doubled that.

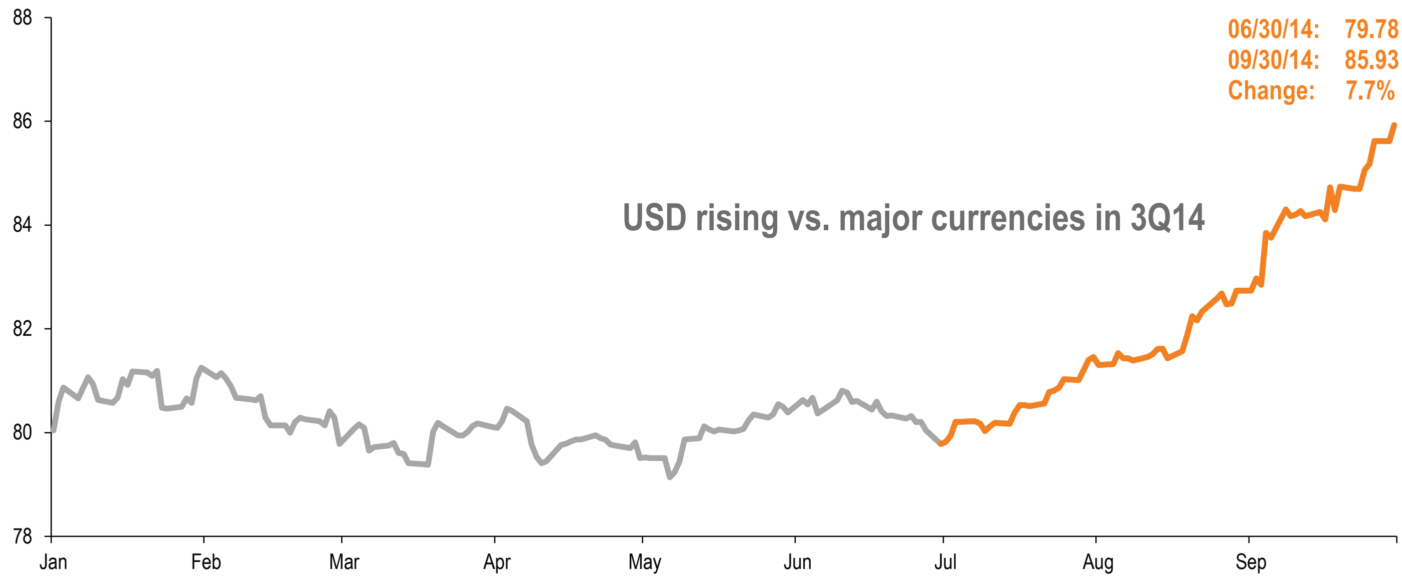
Good Economy, Bad Markets — For Now

If all the data is so good, why does it feel so bad at the opening of the fourth quarter?

Volatility has certainly risen, but it remains modest; at around 16, the CBOE Volatility Index (VIX) remains about 20% below "normal" and should hardly inspire fear. We have pointed out before and we reiterate now that the markets will follow fundamentals, in particular corporate earnings growth that is sustained by broad global growth and economic health.

We advise investors to move toward volatility, not away from it. Recent market activity has presented investors with the opportunity to gain exposure to assets that build wealth and manage risk — that is, a broadly diversified portfolio of stocks and bonds — at more attractive levels.

While a Robust Dollar Is Welcome, Sharp Appreciation May Be Susceptible to Reversal



Source: FactSet

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