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BOTTOM LINE: Stocks are reasonably valued and the U.S. economy is not likely to enter recession. We expect the recent downturn in stock prices to play-out in the weeks ahead and plan to use cash balances to add to equity positions.

It feels worse but the S&P 500 is down only 7% from the closing high of 2011.36 on September 18th. The Fall season has a history of some fairly wicked selloffs and further price weakness is certainly possible. The last time the index declined more than 10% was back in mid-2011 and we are approaching that line now. However, October declines have usually provided outstanding buying opportunities. Here are some of the short-term factors affecting investor perceptions and current market trading:

1. The Eurozone's weak recovery over the past year seems to be stalling. Orders and industrial production in Germany have been surprisingly weak and growth for the overall Eurozone appears to be in decline. The conclusion of the last ECB meeting gave little reason to believe that aggressive action is forthcoming, and the necessary structural reforms necessary in much of Europe, notably France, appear unlikely. Furthermore, since the financial crisis, it has been the private sector that has been put in austerity mode through tax increases, while government spending has gotten even more bloated. Growth requires government spending austerity. The private sector, where innovation and wealth is created, needs to be loosened.

2. China's economy is slowing. We have little clarity of the real risks there as it is still essentially a centrally planned Communist country, but a property market crash risks triggering a hard economic landing in China.

3. The Bank of Japan continues to aggressively expand its balance sheet. However, the increase in the national sales tax from 5% to 8% last April seems to have done more lasting damage to growth than expected. Worse, another increase in the sales tax to 10% is planned for October 2015. Japan, more than many nations, needs spending austerity not more tax increases.

4. The US economy is still performing very well – the Purchasing Managers Index's (PMI) and other leading indicators have remained positive, employment and income is rising at a moderate pace, GDP is growing at a modest but comparatively good pace of about 2%, and inflation is low. Exports are only 13.5% of GDP and the trade gap is less than 3% and declining. Risk from weak foreign economies is limited. New regulations are slowing growth, but at least Federal spending has fallen from 25% of GDP to 22%, thus releasing resources to the private sector.

5. Bond yields in Europe and Japan have been lower than in the U.S. for some time but the drop in European yields relative to US yields was especially dramatic this year. From about the middle of August, the Euro has gone into a steep decline as capital has shifted from low yield Europe to (relatively) higher yield U.S. The Yen has also fallen steeply versus the dollar reflecting the aggressive action by the BOJ and the low domestic yields.

Concluding Points:

1. The declining prospects in Europe and Asia, along with the steep rise in the dollar's F/X value, create a risk to U.S. corporate earnings growth (about a third of S&P 500 earnings come from overseas, including Canada, Mexico and South America). Nonetheless, the domestic U.S. economy is likely to continue to expand moderately.

2. The next meeting of the FOMC is on October 28-29 (after QE has been terminated). We expect that the recent stock market decline, as well as the negative numbers from overseas, will soften the Fed and change expectations with regard to the ultimate timing of interest rate hikes, which could be a positive market surprise. In any case, the Fed will roll bond maturities into new securities and the central bank balance sheet should at least remain stable after QE terminates.

3. There will be elections on November 4th. The Republicans are likely to take control of the full U.S. Congress. This could have a positive impact on the markets as the Republicans are perceived as more business friendly and conservative with government spending. After the Republicans took over the Congress in the mid-term elections of 1994, when Clinton was president, stocks immediately started to rise sharply.

4. "Buying on Dips" has been an excellent strategy during this Bull Market and the short sell-offs turned out to be good buying opportunities; as long as inflation remains low and growth is positive, stocks should do well. Year-end rallies are common and that could be what is in store during the last three months of 2014.

5. We are holding above normal cash now, but expect to invest in attractively priced and liquid stocks in the weeks ahead.
