

Can the Multiple Expansion Rally Continue?

Key economic indicators and market events for October by Joe Terranova, Chief Market Strategist



As the third quarter winds down, the S&P 500® (SPX) has risen nearly 16% year to date, the NASDAQ is up over 25%, and the Russell 2000® Index is up over 15%. Much of this year's equity rally has been on multiple expansion, starting last fall into the first quarter, and from the second quarter into the third quarter. In order to avoid a correction, a P/E of 15-plus will be mandatory in the fourth quarter. I've reverted to my "guilty until proven innocent" mindset from early this year, as we are running low on favorable conditions for further multiple expansion. The fiscal cliff has the potential to evolve into a favorable condition, but that wouldn't occur until January or February, assuming a grand compromise can be orchestrated on Capitol Hill. The market continues to conduct itself in pristine technical fashion, and technical analysis will remain important throughout October. A close below 1422.38 for the SPX would signal that the bullish momentum has been neutralized and that it's time to trim back overweight positions. With this in mind, there are three key areas of focus for October: earnings first and foremost, global manufacturing data, and a clearer reading on China's economy.

October 2012

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
Sept. 30 9:00 PM: China Mfg. PMI	1 4:00 AM: European Mfg. PMIs 10:00 AM: ISM Mfg. Index	2	3 10:00 AM: ISM Non-Mfg. Index 9:00 PM: Presidential Debate	4 ECB Monetary Policy Meeting	5 8:30 AM: U.S. Unemployment	6
7	8 Columbus Day (Bond Market Closed) 2:00 AM: German Exports EU Presidency Summit* Eurozone Finance Ministers Meeting	9 Earnings Season Begins**	10 2:00 PM: Beige Book	11 8:30 AM: Jobless Claims 9:00 PM: Vice Presidential Debate	12 JP Morgan Earnings** China Trade Report	13
14	15 8:30 AM: Empire State Mfg. Survey 8:30 AM: U.S. Retail Sales Apple Earnings**	16 IBM Earnings** 9:00 PM: Presidential Debate	17 China Key Economic Data	18 8:30 AM: Jobless Claims 10:00 AM: "Philly Fed" Mfg. Survey	19	20
21	22 Caterpillar Earnings** 9:00 PM: Presidential Debate	23	24 German Ifo Business Climate 12:30 PM: FOMC Announcement*	25 8:30 AM: Jobless Claims 8:30 AM: Durable Goods Orders	26 8:30 AM: U.S. GDP	27
28	29	30	31	Nov. 1 Starbucks Earnings**		

Times shown are Eastern Time. *Indicator on calendar only. **Expected earnings release date; may be subject to change.

October indicators / events of note:

China Manufacturing PMI

China manufacturing PMI (purchasing managers' index) is released on the last day of the month. This monthly gauge of China's manufacturing sector, combined with the monthly U.S. ISM Manufacturing Index value released the next day, gives a clear picture of global manufacturing health. An index value above 50 indicates growth, below 50 contraction.

European Manufacturing PMIs

A country's PMI is a key measure of the state of its manufacturing sector. An index value above 50 indicates growth, below 50 contraction.

ISM Manufacturing Index

Issued by the Institute of Supply Management, this report provides an influential monthly measure of the health of U.S. manufacturing based on an in-depth survey of 300 manufacturing firms. An index value of 50 is the dividing line between an expanding or slowing economy. Data released is for the previous month.

ISM Non-Manufacturing Index

The index is based on surveys of nearly 400 firms from 60 sectors across the U.S., including agriculture, mining, construction, transportation, communications, wholesale trade, and retail trade. The index provides the economic backdrop for the various markets, and includes data on business activity, new orders, employment, and supplier deliveries.

U.S. Presidential and Vice Presidential Debates

Four debates are scheduled throughout October:

- > October 3: Presidential debate, Colorado
- > October 11: Vice presidential debate, Kentucky
- > October 16: Presidential debate, New York
- > October 22: Presidential debate, Florida

You should be watching:

China manufacturing PMI spilled below 50 last month, to 49.2. Some of the recent China data and seasonality would suggest that the market will be looking for the PMI to rise back above 50. Expectations are calling for a reading of around 50.2 this month, which would be encouraging and would defeat four consecutive months of contraction in this index.

There has not been a recovery in European manufacturing. PMIs for Italy, France, Germany, and Spain have all been sub-50. While Germany's PMI at 47.3 is clearly non-recessionary, PMIs for Italy, France, and Spain still are. China's weaker export data also offers evidence that investors should not be looking for a dramatic recovery in European manufacturing.

Last month, ISM manufacturing came in at 49.6. We would like to see that reading rise back above 50 this month, but my bigger concern is the composition of the ISM. I think one of the reasons why Fed policy makers were so aggressive last month was in response to the negative relationship between new orders and inventories in last month's ISM. New orders came in at 47.1 and inventories at 53, creating a negative 5.9 ratio, the lowest reading since the winter of 2009. That data is what investors need to be most focused on in this month's report.

I've been talking about the resiliency of the services side of the economy recently – non-tangible services over physical goods. Excluding the first quarter of 2012 (when services saw an uptick of 56.8, 57.3, and 56), last month's 53.7 was a more resilient reading than much of the past year, going back to April 2011. It's time to look at services again.

I disagree with the suggestion that the first presidential debate on October 3 could dramatically shift the momentum in the election. Rather, I think the collective body of debates will be important in determining what happens in the seven to ten battleground states in which President Obama currently holds a somewhat comfortable lead. The final presidential debate is in Florida, which not only has an unemployment rate well above the national average, but is a huge battleground state with 29 electoral votes. The focus in this election has to be on the electoral college.

October indicators / events of note:

ECB Monetary Policy Meeting

On October 4, the ECB holds its regularly scheduled monetary policy meeting for eurozone countries, followed by President Mario Draghi's press conference.

You should be watching:

Spanish bond redemptions will be at their highest level in October, at around 30 billion euros, much of that in longer term paper. As it turns out, Spain and France will auction bonds the morning of the ECB meeting. If there were ever a need for Spain to raise its hand for ECB assistance, I think it will happen this month. There will be added pressure on ECB President Draghi to expand on his comments, which the market viewed favorably, about the ECB being the buyer of last resort. He needs to counterbalance what the FOMC did in September and keep the euro competitive, avoiding a significant rise in the value of the euro. That will be very important to Draghi as he addresses the media following this meeting.

U.S. Unemployment Report

Private payroll data is part of the Labor Department's monthly U.S. Employment Situation report. This data gives the true employment story, is the best gauge of the economy's direction, and has the power to move markets.

I don't expect much from this month's labor report. Last month's report was discouraging, with only 96,000 jobs added to the headline number, 103,000 new jobs to private payrolls, a contraction of 15,000 manufacturing jobs, an underemployment rate of 14.7%, and the unemployment rate at 8.1%. Other than seasonal temporary courier and holiday workers, I think the books are closed on hiring for the year.

Columbus Day (Bond Market Closed)

With the bond market closed, this will be a good day to prepare for earnings which kick off late the next day.

German Exports

Germany's monthly trade report, including export/import data, is released by the Federal Statistical Office in Wiesbaden

The markets saw a 0.40% increase in German exports last month. China is a significant trading partner with Germany. Should there be a surprise in German exports this month, that may suggest we've seen the trough in contraction and demand from China that we've been waiting for.

Eurozone Finance Ministers Meeting

This is a scheduled meeting of the Finance Ministers and Central Bank Governors representing the world's 20 leading economies. It will also mark the inaugural meeting of the European Stability Mechanism board of governors.

A decision on the 31 billion euros in Greek aid will be determined at this meeting in Luxembourg. German Chancellor Angela Merkel will have a significant influence on that decision, and it will be Germany telling the markets what will happen next with Greece.

Earnings Season Begins**

Third quarter earnings season gets underway late day October 9, with Alcoa announcing earnings after market close.

I have highlighted earnings expectations for five companies in October: JP Morgan, Apple, IBM, Caterpillar, and Starbucks. With all of these companies, the importance of their earnings will provide insight to consumer and enterprise spending trends, both domestically and globally.

Beige Book

FOMC commentary on current conditions in each of the Federal Reserve's 12 districts is released two weeks prior to the next FOMC meeting.

The October 10 beige book will provide the guide and outline for the FOMC'S October 23-24 meeting. Fed asset purchases currently total \$40 billion a month, and it's important to look inside the beige book to see how open-ended these purchases will be. Certainly one should not expect them to end quickly given the Fed's aggressive statement and the weak labor market.

**Expected earnings release date; may be subject to change.

October indicators / events of note:

Jobless Claims

This weekly release by the U.S. Labor Department shows the number of individuals who filed for unemployment benefits for the first time. An increasing (decreasing) trend suggests a deteriorating (improving) labor market.

JP Morgan (JPM) Earnings**

JP Morgan's earnings release is targeted for October 12.

China Trade Report

China's monthly trade report provides important import, export, and interest rate data on the Chinese economy.

Empire State Manufacturing Survey

The Federal Reserve Bank of New York conducts this monthly survey of manufacturers in New York state across a variety of industries. Report data is for the month in which it is released.

U.S. Retail Sales

Retail sales data is released monthly by the U.S. Department of Commerce. Retail sales measure total sales receipts for durable and nondurable goods. Consumer spending accounts for two-thirds of GDP and is therefore a key element in economic growth. Each report is based on the previous month's data.

You should be watching:

The weekly jobless claims report remains important throughout October, as it was in September. As I wrote in a [recent blog](#), although temporary seasonal holiday retail and courier hiring will exist again this year, I expect the labor market will continue to be most impacted by the uncertainty surrounding the upcoming fiscal cliff. With potential spending and tax cuts looming, companies will not embark upon any substantial hiring initiatives.

JP Morgan's earnings will give us insight into the state of the investment banking and pure banking industries, the rebuild of cash, and the view from its C-suite of how they believe fiscal and monetary policy makers have acted, will act, and what they believe their intentions will be. CEO Jamie Dimon will provide an accurate assessment of whether the recovery and expansion in multiples we've seen in Q3 are warranted. Have conditions globally gotten better? Is there truly not only a housing trough but a housing rebound in place?

For two months, we've lost the momentum of double-digit growth in China exports, so this will be a focus area this month. Last month's China exports were up 2.7% year over year, compared with a year ago when China was consistently experiencing over 20% in export growth. China has not contributed to global growth as expected or been a tailwind for the equity markets. China is trying to use unconventional easing measures different from reducing the RRR and interest rates, and focusing instead on fiscal policy initiatives. We are looking for evidence of a trough in China, and the longer the market can sustain itself without the suggestion of a trough is favorable for further equity market appreciation. To use a baseball analogy, not having China contributing to global growth is like qualifying for the playoffs without your best hitter, and then getting your best hitter back in time for the playoffs.

I continue to monitor regional manufacturing. The most recent numbers for the New York area were:

- > September -10.41
- > August -5.85
- > July +7.39
- > June +2.29
- > May +17.09

Retail sales, which surprised last month, have proven to be surprisingly resilient due to the strong contribution from the services side of the economy.

**Expected earnings release date; may be subject to change.

October indicators / events of note:

Apple (AAPL) Earnings**

Apple's earnings release is targeted for October 15.

IBM Earnings**

IBM's earnings release is targeted for October 16.

China Key Economic Data

We will get a number of key data from China on October 17:

- > **Industrial production** measures changes in output for the industrial sector of China's economy, including manufacturing, mining, and utilities.
- > **Retail sales** measures total receipts at stores that sell durable and nondurable goods.
- > **PPI (producer price index)** and **CPI (consumer price index)** data are significant indicators of inflation. PPI measures the price of consumer goods and capital equipment at the producer level before they are passed on to consumers. CPI measures the price of consumer goods and services.
- > China's **gross domestic product (GDP)** growth rate provides an aggregated measure of changes in value of the goods and services produced by China's economy, which is the second largest in the world after the United States.

"Philly Fed" Manufacturing Survey

This monthly survey provides useful intelligence on manufacturing conditions within the Philadelphia Federal Reserve district and is useful as an indicator of broad manufacturing sector trends.

Caterpillar (CAT) Earnings**

Caterpillar's earnings release is targeted for October 22.

You should be watching:

We'll want to hear Apple's guidance and expectations for the December and March quarters on potential growth opportunities beyond the U.S. and China. Apple's report should also give us a sense of the demand from the emerging market consumer and the potential for the U.S. holiday season.

Last quarter, IBM cited the headwinds of Europe for a modest slowdown in enterprise spending on technology. I want to hear IBM's current positioning and outlook on these areas.

Over the last couple of months, the market has had the benefit of being able to look past some of China's economic weakness. This month, China's economic data goes back to being important and is not to be dismissed. Last month, China industrial production was up only 8.9% and retail sales were up 13.2%, both on a year-on-year basis. China industrial production and retail sales, although growing, are experiencing less than 30% to 40% of the growth the market became comfortable with in 2010 and 2011. China PPI contracted 3.5% last month, while CPI prices have remained relatively benign, an important condition for fiscal and monetary policy makers to stimulate growth back to more comfortable levels. Last quarter, China's GDP was 7.6% year over year, and its third quarter GDP will be of interest.

The most recent manufacturing figures for the Philadelphia region:

- > September -1.90
- > August -7.10
- > July -12.90
- > June -16.60
- > May -5.80

With Caterpillar, we'll look for evidence of a trough in global manufacturing conditions in its earnings and conference call. This is incredibly important because the evidence to date does not suggest that manufacturing, either globally or domestically, is going to be a significant contributor to a recovery unless a trough is in place. The services industry has been assuming the lead over manufacturing, which is quite different from what we saw in 2010 and 2011.

**Expected earnings release date; may be subject to change.

October indicators / events of note:

German Ifo Business Climate Index

This index, prepared by the Ifo Institute for Economic Research in Munich, is a leading indicator for Germany's economic activity. The index is based on a monthly survey of 7,000 manufacturing, construction, wholesaling, and retailing firms on their current business situation and their business outlook for the next six months. Results reported are for October.

Durable Goods Orders

This monthly release from the U.S. Commerce Department reflects new orders placed with U.S. manufacturers for immediate and future delivery of factory hard goods, and is an indicator of how busy factories will be to fill those orders. Data reported is for the previous month.

U.S. GDP

The quarterly GDP report, released by the U.S. Commerce Department, tracks the purchases of all U.S. goods and services in all sectors and is the broadest measure of the economy. Advance Q3 GDP will be released this month.

Starbucks (SBUX) Earnings**

Even though Starbucks' earnings release is targeted for November 1, I've included it in the October calendar as part of my focus on companies that I expect will give the best insight on consumer spending.

You should be watching:

The Ifo moderated last month to 1.4, the lowest figure since February 2010. As goes Germany, so goes Europe. Markets rose in September on the intentions of ECB President Mario Draghi, who signaled for the first time in a year and a half that "all for one, one for all" in the eurozone would be orchestrated. We're getting to the point where ECB intentions need to evolve into supportive actions. Economic data points will become more important. It's no longer about the talk of the central bank; it's about the walk, and that should start to be reflected in the figures for German manufacturing and exports to China. An improving business climate condition in Germany will be an important signal for Europe's recovery.

Excluding transportation orders, last month's durable goods report reading was -0.4%, following a downwardly revised -2.2% reading in June. I have suggested an intangible services over physical goods investment thesis. This month's durable goods report will either provide evidence for remaining committed to that strategy or indicate that a momentum shift must be cautiously gauged.

Early expectations for Q3 GDP fall in the range of 1.5% to 2%.

Starbucks, a classic growth story coming into 2012, is heavily owned with significant leverage, both domestically and in China. Last quarter, Starbucks delivered a rather disappointing message to the markets that accurately telegraphed the slowdown in both the U.S. and China.

**Expected earnings release date; may be subject to change.



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Joe Terranova is chief market strategist for Virtus Investment Partners. He was elevated to that position in June 2009, having started with the company in the role of chief alternatives strategist.

In his current role, Mr. Terranova works with Virtus' regional sales teams and the financial advisors who sell the company's investment products, providing insight into the domestic and global investing landscape and has represented Virtus as a keynote speaker for several financial institutions. He is a member of the Virtus Investment Oversight Committee.

Prior to joining Virtus in 2008, Mr. Terranova spent 18 years at MBF Clearing Corp., rising to the position of director of trading for the company and its subsidiaries. In this capacity, he managed more than 300 traders and support staff for MBF, one of the New York Mercantile Exchange's largest firms. His work was highlighted as the feature story in the June 2004 issue of *Futures* magazine.

Mr. Terranova is perhaps best known for his risk management skills, honed while overseeing MBF's proprietary trading operations during some of the most calamitous times for the U.S. markets, including the first Gulf War, the 1998 Asian Crisis, 9/11, and the collapse of Amaranth Advisors. In 2003, he was one of the first Wall Street professionals to make an early call for higher energy, natural resources, and commodity prices. In June 2008, he cautioned investors to move to the sidelines in commodities and, in March 2009, he encouraged investors to ignore the global "embracement of pessimism" and overweight equities. Before joining MBF, Terranova held positions at both Swiss Banking Corp. and JP Morgan Securities.

Mr. Terranova is a regular panelist on CNBC's highly rated program *Fast Money* and a frequent panelist on CNBC's *Fast Money Halftime Report*. He is the author of *"Buy High, Sell Higher"* (Business Plus, 2012), a book about the "new rules" of investing based on his years as a professional trader.

In 2007, Mr. Terranova and Hockey Hall of Fame player Mike Bossy established "Bossy's Bunch," a program that rewards excellence in the classroom for elementary school students.

Mr. Terranova earned a bachelor's degree in finance from the Peter J. Tobin College of Business at St. John's University in New York.

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