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MARKET COMMENTARY

With one trading day left in October, the S&P500 is up nearly 14 percent for the month. Last Thursday's 3.43 percent rise was the month's best day. Stocks surged on the news that European leaders reached an agreement on how to contain the region's ongoing debt crisis. Assuming that the market doesn't give back much of its gains on Halloween, the S&P 500 will have enjoyed its biggest monthly gain since October 1974. Monthly gains were also driven by increased confidence that the U.S. will not slip back into recession.

Increasing confidence in European and U.S. economies lead to a substantial rise in the value of nearly all "risk" assets, not just stocks. Last Thursday, after the European debt deal was reached, the FTSE All-World equity index was up 4.5 percent. Commodity prices rose, and the "safe-haven" dollar was sold off by the most since 2008, with the trade-weighted dollar index off by 1.8 per cent. Not surprisingly, the euro was up 2.3 percent hitting a seven-week high of $1.4219. It was the biggest single-day jump for the currency in 15 months.

While I've been quite confident that Europe would eventually put forward a reasonable plan to deal with the spiraling debt problem, the arrival of a credible plan was still very welcome news and global financial markets obviously reacted enthusiastically. European leaders hope the agreement will reverse the escalating sovereign debt crisis. While resolution of the details and implementation challenges probably could be rough as already seen by bondholders and issuers tepid support, the agreement's overall influence should remain quite positive.

The other major positive influence for the month has been the receding fears of a U.S. recession. While I've continually voiced my strong belief that another recession isn't coming, confidence that the U.S. will keep growing, albeit slowly, is growing. We've successfully navigated major potential problems such as Congress' struggles with the debt ceiling, the Greek debt crisis, and the dislocation and uncertainty of Japan's earthquake. If we haven't already gone back into recession, one doesn't seem likely in the foreseeable future.

Instead, by this stage in the recovery, pretty much every sector of the economy that affects GDP growth has recovered with the notable exception of housing. While annualized 2.5 percent GDP growth isn't inspiring, growth levels exceeded expectations and calmed fears that the U.S. was slipping back into recession. The growth rate was the fastest seen since third quarter of last year, even if it's still very low. Possibly as encouraging, investment and consumption were major growth contributors signaling increasing confidence – or at least lessening pessimism – in the economy.

Other data points highlight encouraging news. Although unemployment remains painfully high, it's slowly declining rather than increasing. Retail sales grew at the fastest pace in seven months in September, and holiday sales are projected to grow at least 5 percent over last year. Profits are also expected to be strong given lower inventories and tightly controlled costs.

Lower gas prices should also continue to help consumers as price declines put more money in consumer's pockets. If prices reach $3 a gallon by the end of November as some economists have projected, the dollar decrease from earlier in the year would add about $17 billion to the economy during fourth quarter. Lower prices not only give people more money to spend, decreasing prices usually lift consumer sentiment making them more likely to spend what they have.

Looking forward, in spite of lessening bad news, there are still many challenges that will slow economic growth. Probably first and foremost, Washington isn't going to change dramatically leaving business leaders and investors facing ongoing hostility, uncertainty and a wave of new regulatory challenges. Other risks such as sovereign debt issues, a possible harder landing in China than anticipated, and potential trade and currency wars still loom but remain very low probability events.

While equity and risk asset values should increase over time, markets will probably remain volatile, and sharp short-term price movements seem almost inevitable given likely upcoming challenges. We've moved past the first big chapter in the global debt crisis, but there's much more coming. For example, the U.S. has yet to deal with its perpetual overindulgence. The next federal deficit deadlines arrive on November 23rd, when the debt committee must offer up a plan. By December 23, Congress must approve the plan or face automatic cuts. A repeat of the summer isn't expected, but markets may be jittery.

Inflation is likely to become a much bigger issue in the relatively near future. Official inflation remains low because the calculation method in the U.S. excludes food and energy while emphasizing housing. Anyone who eats and drives has likely experienced a different reality. By 2013 or soon after, annual inflation could easily hit 5-6 percent or higher. Unfortunately, high inflation will likely hit even if growth remains anemic. Stronger growth could force levels higher. Higher inflation will probably continue for years given the government's debt load and easy monetary policy. Unfortunately, the problem continues to worsen with the two parties showing no ability to eliminate annual deficits and reduce debt.

In spite of the potential challenges, and possibly even because of them, I believe various risk assets – whether domestics stocks, foreign stocks, commercial real estate, commodities, private equity or higher yielding debt – present attractive buying opportunities for individual investors. While stocks are not the bargain they were a month ago, valuations remain on the low side and the economic outlook continues to slowly brighten. As long as something unexpected doesn't completely derail the U.S. economy, values should bounce upwards over time. Even with recent good news, sentiment remains pessimistic keeping prices depressed.

As important, with inflation likely coming down the road, assets with strong appreciation potential and the ability to excel during times of inflation probably become more valuable in a portfolio. Our likely future probably requires a very different investment approach than employed decades ago. For instance, possible inflation potentially makes bonds and other "safe" assets a risky investment given the threat to purchasing power. Increasingly sophisticated use of various risk assets probably provides investors the best combination of returns and purchasing power maintenance.

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