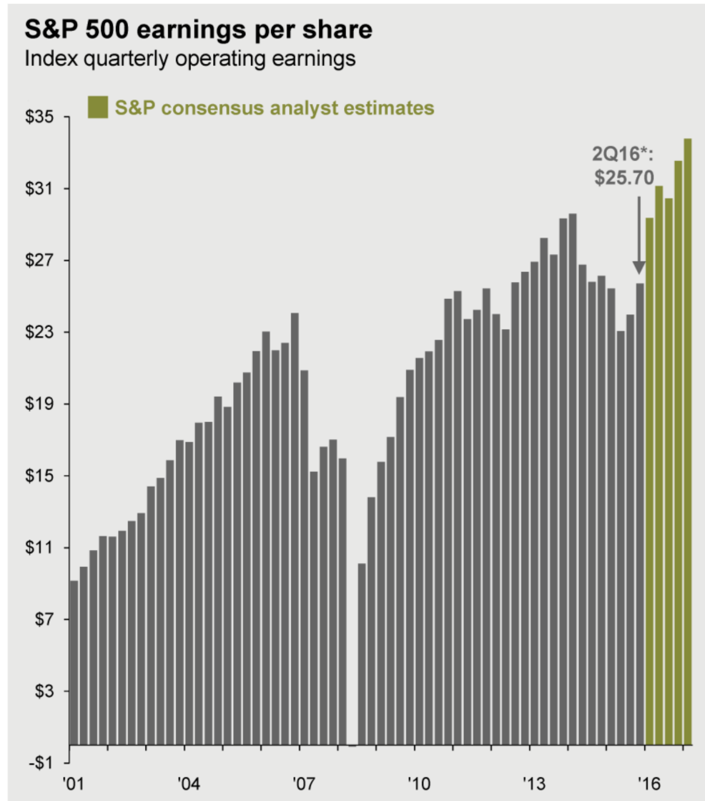
After almost of two years of trading in a fairly narrow range, with only a few double-digit declines that didn't last long, the S&P 500 broke out to the upside in the first two weeks of the third quarter. Unfortunately this momentum didn't have much energy as the S&P 500 essentially moved sideways with even less volatility the rest of the quarter. But this market activity is better than it sounds because the advance was broad based, led by areas of the stock market that had already been through a bear market. The S&P 500 put in a solid performance of +3.85% but was eclipsed by small and mid-capitalization stocks and international stocks which posted gains of 6% or higher. While we continued to hold some cash for protection we benefited by emphasizing out-of-favor sectors that rebounded nicely.

The stock market continues to be at a crossroads with risks and rewards seemingly in balance. Usually a flattening of the yield curve and falling interest rates are a sign that an economic slowdown or recession is likely. However, as we've commented several times in the past we are in uncharted territory where past road maps may be faulty guides. Global economic data has surprised to the upside. The latest data releases confirm that the Chinese economy has regained its footing. A new index prepared by the Bank of Japan reported its economy expanded 2.4% in 2014, rather than falling 0.9% as the official data showed. In the US there are signs that the rebound from the Great Recession is finally reaching middle income consumers. The Census Bureau reported that real median household income jumped 5.2% between 2014 and 2015. This marked the first gain since the eve of the global financial crisis in 2007.

World central bank munificence is alive and well. Balance sheets continue to expand and interest rates remain suppressed. The problem for equities with this strategy is that policy options are limited in the event of a negative shock. But for now markets seem confident that a recession is not imminent.

Valuations for stock indices are elevated but reasonable given the interest rate environment. **Future gains for stocks are going to have to come from the ability of companies to grow earnings. Again here the outlook is mixed but there are expectations for improvement (chart).** Profits soared relative to GDP for years after the financial crisis, but there are signs of wage inflation which could hit profit margins. In addition, TrimTabs Investment Research reported recently that stock buyback (a driver for higher earnings) announcements by U.S. companies sank to $115.0 billion in the third quarter, the lowest level in nine quarters.

Corporate profits



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management

However, as the *Financial Times* recently opined: "But there is a sense in which earnings are improving. In markets, it is the rate and direction of change that matters, as the previous outright level of earnings should already be reflected in prices. A fall of "only" 2.8 per cent represents an improvement after four successive quarters in which the rate of change worsened." Importantly, earnings are expected to rise nicely in the fourth quarter as the drag from falling energy prices reverses.

We remain cautiously optimistic and are very encouraged that a broad group of stocks did well last quarter. Many of the stocks we own are well below their recent highs and should perform well over the long term. However, we will be on the lookout for increased volatility. **We know that volatility tends to cluster so an uptick would suggest it wise to become more active in portfolios with an eye towards raising cash to preserve capital.**

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