Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST

US Markets and Economy: US stocks rebounded in August from a late July selloff, with the S+P 500 reaching the milestone level of 2000, and the Dow Jones returning to 17,000. The NASDAQ Composite Index rallied strongly for the month, reaching its highest level (4600) in 14 years, and moving closer to its all-time high set in 2000. The NASDAQ has now tripled from its 2009 low of 1500. The main driver of the rally is still easy money. The Fed is winding down QE, with a likely end in October, but short-term interest rates remain at zero for now, while long-term rates have fallen to 2.5% for 10-year Treasuries and 3.2% for 30-year Treasuries. With inflation subdued, and likely to remain so, stocks are still the only game in town: many safe blue-chip companies with growing earnings have dividend yields equal to or greater than the 10-year safe yield on bonds. US stocks and bonds are also still seen as a safe haven for flight capital from Europe and the Middle East. With the US economy growing at a moderate and sustainable pace, corporate earnings can continue to grow, providing even more of a forward push to equity prices. Although the housing sector in the US is showing signs of a slowdown in the growth of prices, sales, and construction, the rest of the US economy is showing increasing strength. At the end of August, the US Commerce Department revised upward its estimate of GDP growth for the April-June quarter. The new higher 4.2% rate is one of the strongest since the last recession, and was broad based. The report showed that business investment was particularly strong, including increases in inventories, and plant and equipment. Exports also showed strength. With consumer optimism at high levels too, it is likely that the economy is finally on a sustainable growth path, which will enable the Fed to gradually reduce its monetary stimulus. **While Wall Street often swoons at the prospect of rising interest rates, strong economic growth and rising corporate profits can keep the market on its feet**.

World Markets and Economy: The story in Europe is much less benign. Russia continues to foment civil war in eastern Ukraine, and many European countries justifiably fear that Vladimir Putin may have more territorial ambitions. Increases in economic sanctions against Russia, which may be all the West is willing to do now to punish the Russians, will hurt European economies much more than the US economy. Reductions in trade could not come at a worse time for Europe, where sluggish growth could be turning into another recession. Even worse, inflation is now so low in much of Europe that fears of deflation have grown. **Deflation is just as bad for an economy as rapid inflation.** When prices are expected to fall, consumers and businesses hold back from purchases, putting downward pressure on economic growth. At the same time, debtors are hurt because the real burden of their nominal debts increases as prices fall. European policymakers will have to work hard to prevent this Japanese-style scenario of stagnation/deflation (which lasted 20 years in Japan) from taking hold in Europe.

In spite of the weak economic outlook in Europe, continental stocks followed the US lead and rose for the month, with broad-based gains from Athens to Paris to Frankfurt. The threat of deflation drove yields on European bonds to levels unthinkable a few years ago: Greek 10-year government bond yields fell below 6%, and safer countries like Germany saw 10-year yields fall below 1%. Even Portugal, an economic “basket case” a few years ago, can now borrow 10-year money at just over 3%. These low rates do ease the fiscal burdens on Europe, and also have driven down the exchange value of the euro, which should eventually help stimulate exports and economic growth in the Eurozone.

Markets in the Americas have followed the US higher. Canadian stocks have outperformed the US market, with the TSE Index reaching all-time highs in August. The TSE is now up over 15% for the year. South of the border, the news has also been good: Mexican stocks have hit new highs for the year, and Brazil’s Bovespa has broken 60,000 for the first time. Argentine stocks reached new highs, even though Buenos Aires is in technical default on some of its bonds.

Smaller Asian markets also rallied for the month, led by Indonesia, which has had a mostly successful and fair election. Both Indonesian and Thai stocks hit new highs, up almost 25% for the year already. The larger stock markets in Asia also had a good month. India leads the pack, with gains for the year approaching 30%, as the euphoria over the election of Modi continues. Although China was flat for the month, stock prices are holding well above their lows for the year. Japan gained for the month, although Tokyo stocks are still down a bit for the year. As Japan struggles to end two decades of deflation and stagnation, it is well to remember that the Nikkei stock average is still down by 2/3 compared to its high over 20 years ago.

OUTLOOK: In the short term, the path of least resistance is still up, as very low interest rates in the US and Europe make stocks look attractive. The market will certainly “correct” as it moves higher, but long-term investors should ignore the unpredictable short-term twists and turns in stock prices.