Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – FEBRUARY

US Markets and Economy: The US stock market shrugged off a bad January and recovered all the ground that it had lost in the previous month. By the end of February, stocks, as measured by the S+P 500 Index, had reached new all-time highs. (The more popular Dow Jones Average did not, but, with only 30 stocks, it is not as representative a measure of the US market.) The stock market surged even though the economic news was mixed at best. Fourth quarter US GDP growth was revised downward to only 2.4% (from 3.2%), suggesting the US economy is still not firing on all cylinders. Bad weather in much of the US in February will certainly slow the economy further in the first quarter of 2014. Housing, which has been one of the strongest drivers of US growth in the last two years, is also showing signs of a slowdown, with home price growth flattening in much of the country, and new construction and existing home sales weaker because of the bad weather. Yet investors were heartened by testimony from the new leader of the US Federal Reserve, Janet Yellen. She suggested that the Fed was going to continue to reduce the monthly amount of Quantitative Easing (QE), but that she (and the Fed) were open to reconsidering the "taper" of QE if the economy really did slow markedly. This was enough to convince investors that the Fed would support the economy (and thus the stock market) in 2014. In Wall Street slang, this will become known as the "Yellen put," which in English means that investors can bid up stocks knowing the Fed will come to the rescue if the economy and the stock market show significant weakness.

The Fed has a lot of room to maneuver because inflation, at 1%, remains stubbornly low in the US. Since the Fed has an unofficial target of 2% inflation, it can further stimulate the US economy without fear of a substantial (and dangerous) pickup in inflation. Some of the members of the Fed's FOMC (Federal Open Market Committee) are inflation "hawks" who would rather see the Fed be less stimulative, but the FOMC, run now by a monetary "dove," is unlikely to even consider raising short-term interest rates before 2015.

World Markets and Economy: Much of the world rallied in tandem with the US market in February. Europe was particularly strong, with many countries' indexes hitting new 12-month highs, as more evidence appeared that the Eurozone was beginning to pull out of its recession. More speculative markets like Greece, Portugal, and Italy (with another new leader) rallied strongly, but Germany and France also logged strong months. Italy, which seemed politically and financially paralyzed by the antics of former Prime Minister Berlusconi, is now ahead 30% in the last 12 months. Portuguese stocks are up 25% in the past year. Interest rates on Italian and Spanish bonds have also been falling, as confidence in a European recovery spreads to sovereign debt markets. Portugal is on schedule to exit its €80 billion "rescue" plan in May, and is preparing to sell new 10-year bonds to investors. Ireland has completed its exit from its "rescue" by the "troika" of the IMF, the European Commission, and the ECB. While unemployment remains extremely high in many of these countries, the worst of economic austerity may be over.

Latin America stocks, represented by the Big Three of Brazil, Argentina, and Mexico, did not follow the US lead in February. Brazil and Argentina still face domestic economic and financial crises which have resulted from poorly chosen policies. Inflation in Argentina exceeds 25%, and the peso is falling. Mexico is in the midst of important reforms (such as opening up its oil monopoly to foreign investment), but there is little enthusiasm for stocks, which are down 10% over the past year.

The big markets in Asia did not keep pace with the Americans and Europeans either. Japan, which had sharp gains in 2013, driven by the easy fiscal and monetary policies of Abenomics, is down 10% this year after a weak February. China, whose economy is still one of the fastest-growing in the world, continued its multi-year bear market. Chinese stocks are down 10% for the year, and near their lows reached last summer. Some of the weakness in these two markets reflects the rising political tension in Asia, as China flexes its military muscles, while Japanese leaders also stoke the fires of nationalism. China proclaims its desire for a "peaceful rise," but many Chinese, Japanese, and Koreans have not forgotten the horrors of World War II.

OUTLOOK:

The US stock market has fully recovered from its January selloff, but investors must realize that corrections like January's could crop up again at any time, for domestic or international reasons. The academic evidence clearly shows that stock investors are generously rewarded for holding stocks for the long run, but part of that reward goes only to those investors who have the patience and discipline to "stay the course," even when markets are volatile.