



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY

US Markets and Economy: US stocks reached record highs in July, with the Dow Jones Average reaching the 17,000 milestone, and the broader S+P 500 inching closer to 2000. The celebrations were brief, however, since the month was marred by a sharp decline on the last day of trading, with the Dow dropping over 300 points. The decline on the 31st wiped out the gains for the month, making July the first down month for stocks since January. The cause was certainly not the latest GDP report, which showed strong 4% real growth for the US economy in the second quarter, with inflation remaining low. The selloff was probably not tied to further unrest in eastern Ukraine, or even the imposition of new sanctions against the perfidious Russians. The most likely cause was a small hint that the US Fed might have to start its monetary tightening plan sooner than the middle of 2015. Even though the public statement after the July Fed meeting gave no indication of any change to the zero-interest rate policy, a late-July report on the Employment Cost Index for US businesses showed a higher-than-expected increase. If labor costs were to accelerate this year, the Fed would have to begin raising interest rates sooner, to head off a potential increase in inflation above its acceptable range of 2-2½%. **The decline in stocks suggests that the stock market will be very sensitive going forward to any unexpected change in the Fed’s monetary stance.** Janet Yellen, the Fed chief, still believes that the US labor market has lots of slack. Even though unemployment is close to 6%, millions of Americans are still not counted as unemployed even though they would like to work. This “reserve army” should keep a lid on wages, and thus on price inflation. Since there is little inflationary pressure coming from raw materials prices (oil prices actually fell in late July), the majority of the Fed’s Open Market Committee (FOMC) is still lined up behind Yellen’s plan to wind down Quantitative Easing, while keeping short-term interest rates at zero well into 2015. There are inflation hawks on the FOMC who fear that easy money will spark a return of inflation, but so far they have been spectacularly wrong, and they remain a small minority on the FOMC.

The rest of the economic news in July was very good: employment gains have been strong, at well over 200,000 a month; the size of the US budget deficit continues to shrink in both absolute terms and as a percentage of GDP, and US corporate earnings for the second quarter have grown faster than expected. Americans are beginning to spend more, and take on more debt again, after years of necessary deleveraging. All this good news could have unsettled the bond market, but longer-term interest rates remained very low, with the US 10-year note yielding less than 2.6%.

World Markets and Economy: European markets did far worse in July than the US. The Russian meddling in eastern Ukraine, with tragic human consequences, has also had economic consequences, with the Europeans finally adding teeth to their sanctions. Germany has a lot to lose if the Ukrainian crisis gets worse, and their stock market fell almost 8% for the month. Portugal was even weaker for the month, as a Portuguese bank headed for bankruptcy. Greece, Spain, and Italy, the other most heavily indebted Eurozone countries with weak banks, also fell in sympathy. The other economic news in Europe was not so negative: there are more signs of a nascent, if weak, economic recovery in countries like Spain. Yet the long shadow of the Russian bear to the east, and the reminder of weak banks at home, can easily overwhelm good economic news.

North and South American markets did far better than the US in July. North of the border, the Canadians logged solid economic growth, with the Canadian central bank promising to keep interest rates extremely low. Canadian stocks responded by rising all month to new highs. The TSX is now up over 13% for the year. South of the border, both Mexico and Brazil rallied to new highs in July, with Brazil outperforming the US for the year. Argentina sold off after a partial default on its bonds, but recovered by the end of the month.

Asian stocks were also strong, led by a resurgent China. Data on Chinese provinces' GDP suggest that the growth slowdown is over and the economy is gaining steam, especially in the central and western parts of the country. Shanghai-Shenzhen share prices spiked upward by almost 10% for the month, erasing all of the year's losses and then some. Japan rallied modestly for the month, Indonesia reached new highs after the completion of their elections, and India also pushed higher on further optimism that Modi can put the Indian economic engine back in high gear.

OUTLOOK: In the short term, the path of least resistance is still up, unless the Fed surprises the markets with a change from its easy money regime, or the crisis in Ukraine spirals out of control. The selloff at the end of July in the US market is a timely reminder that the path upward may not run smooth.