Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY

US stocks chugged ahead in May, reaching one all-time high after another, with the Dow Jones and the S+P 500 indexes ending the month at records. The NASDAQ rallied too, although it ended the month below its 2014 high of 4371, and still well below its all-time high of 5000 set in 2000. Although the rise so far this year has been tepid compared to last year's meteoric advance, it is still an impressive achievement for a bull market which began in March 2009 with the Dow at 6500 and the S+P at 700. **A perusal of the frightening headlines in the dark days of early 2009 demonstrates once again that investors who keep their heads when others are losing theirs will be handsomely rewarded in the long run**.

Stocks were driven higher this month in part because there are more signs that the American economy is picking up speed from a slow winter (first quarter GDP growth was actually revised to a decline), which should bode well for corporate profits, which have recently been growing slowly. At the same time, the Federal Reserve shows no signs of willingness to raise short-term interest rates before 2015, even though the so-called "taper" of Quantitative Easing (QE) will end on schedule later this year. The Fed has lots of room to maneuver with its easy money policy because there is still slack in the nation's labor market, which keeps a lid on wage increases, and thus labor costs for businesses. The slack is not well-measured by the "headline" unemployment rate, since this rate disguises the fact that many unemployed workers have given up looking for work, even though they still want jobs. These workers, who are not counted as unemployed, will surge back into the labor force as market conditions improve. In addition, the rate of inflation in the US remains very low at about 1%, which is well below the Fed's implicit target of 2% price growth. **Some economic commentators and even FOMC members claim that the Fed's QE and ballooning balance sheet mean that rapid inflation is right around the corner, but these "inflationists" have been conspicuously wrong for years**. Banks are not lending out all the reserves that they have. If bank lending were to suddenly fuel a pickup in inflation, the Fed under Janet Yellen has all of the tools and experience and determination it needs to bring prices back under control. The Fed is no doubt more concerned that the economy will continue to grow at a subpar rate, as it has in recent years. In this scenario, which is bullish for stocks, the Fed is likely to hold off even longer on interest rate increases. One reason the pace of economic growth may indeed stay low is that the US housing market, which has roared back from calamity, is taking a breather. Home price growth is slowing and home construction activity is still below normal levels. Since home prices are so crucial to the net worth and economic outlook of the average American household, weakness in the housing sector could well translate into weakness in the growth rate of the overall economy.

World Markets and Economy: Conditions in Europe are not nearly as benign as the US. The European economy is struggling to grow at all. Unemployment remains high in many countries, and is still at Depression levels in countries like Greece and Spain. Prices are falling or barely rising in much of Europe, which means that the European Central Bank (ECB) must worry about the specter of deflation, which can be just as punishing to an economy as rapid inflation. The Japanese economy, which is only now shaking off the shackles of two decades of stagnation and falling prices, is a good example of the perils of deflation. For heavily indebted Europe, falling prices have the pernicious effect of making the real value of the debt burden higher. In the worst cases, like Greece, the debt/GDP ratio has ballooned even as the Greeks have shrunk their outsized fiscal deficits with wave after wave of austerity. Although there are still signs that European growth is returning, slow growth in the heavily indebted countries does not bode well for political stability, given that the populace will only suffer so much austerity. The surprising strength shown by the far-right and anti-Europe parties in the recent European elections is a potential warning sign. The European situation is made worse by the military adventurism of Russia, which has been described as a “gas station masquerading as a country.” But turning the pumps on or off, or raising or lowering the price, can affect all of Europe. The Russian stock market was hit hard after the Crimean takeover, but, in spite of worldwide condemnation and more sanctions, Russian stocks rallied sharply in May, erasing most of their March-April losses. European stocks, led by Germany and England, also rallied for the month, with the German and British markets reaching new highs for the year.

In Asia, Japanese stocks rallied for the month (the economy is surviving the latest tax increases), and Thailand gained even though the country suffered yet another military coup. Chinese stocks were flat to down, plumbing the lows of their multi-year bear market. China represents the ultimate disconnect between the economy and the stock market, with Chinese real GDP continuing to rise at 7% per year (a doubling every 10 years), while the Chinese stock market seems determined to halve every 10 years. China’s weak stock market is also a demonstration that ordinary investors will flee a market that appears to be rigged for insiders.

OUTLOOK: In the short term, upward momentum could continue to carry markets higher. But Wall Street is still a two-way street, and sharp corrections are a normal part of any bull market.