The Reilly Report:

2014 MID-YEAR REVIEW AND OUTLOOK

World financial markets rallied strongly in the first half of 2014 led by strong performances for US stocks, which rose to new all-time highs, (Figure 1) and US bonds, which also rallied, driving long-term interest rates lower (Figure 2).

Figure 1: **S+P 500 Index**

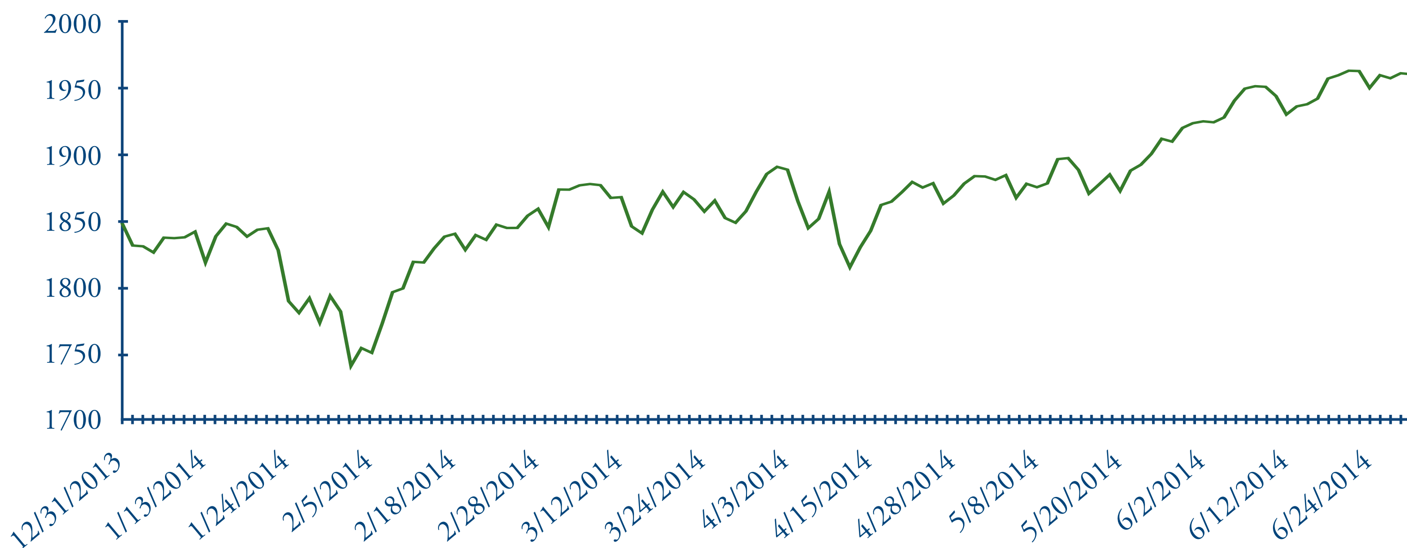


Figure 2: **US 10 Year Interest Rate**

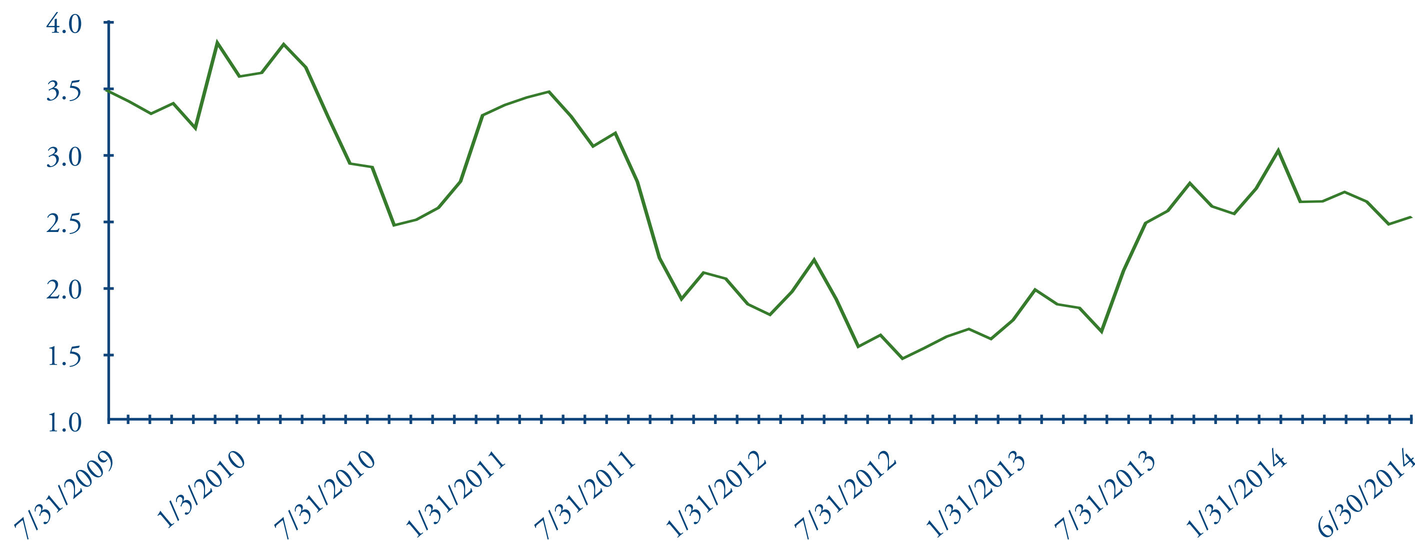
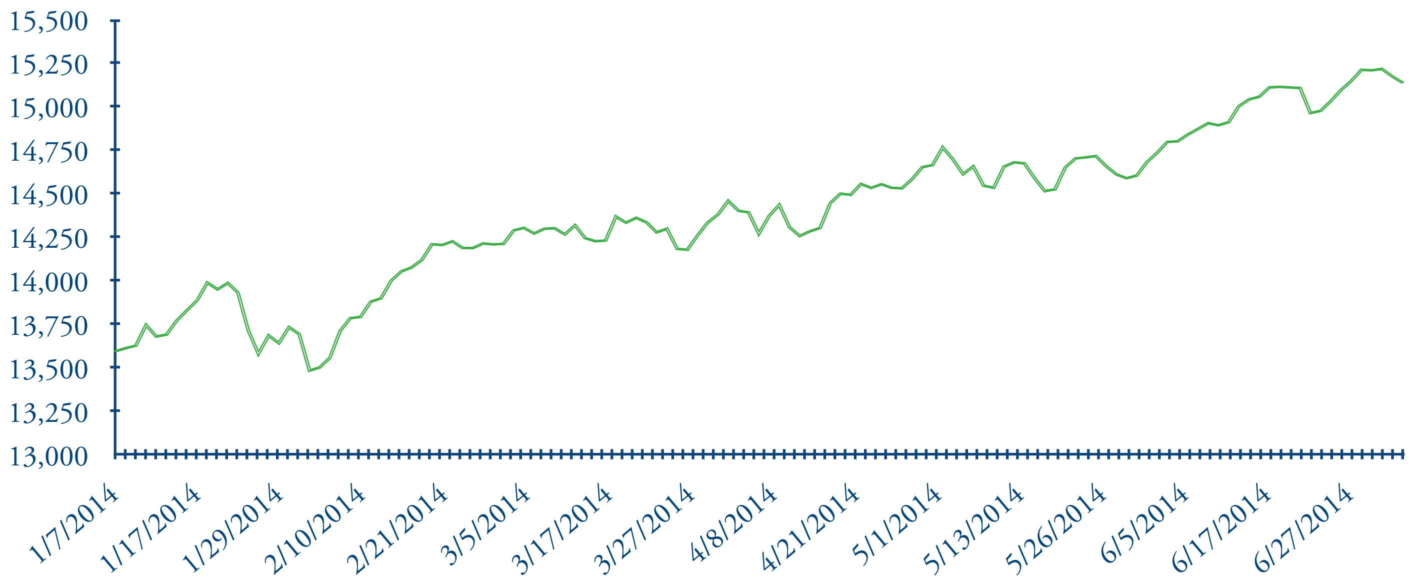


Figure 3: **Toronto Stock Index**



Many other stock markets advanced around the world, from Canada in the Americas (Figure 3) to almost all of Europe (Figure 4), and even parts of Asia (Figure 5 and Figure 6). The only laggards in stocks have

Figure 4: **European Stock Index**

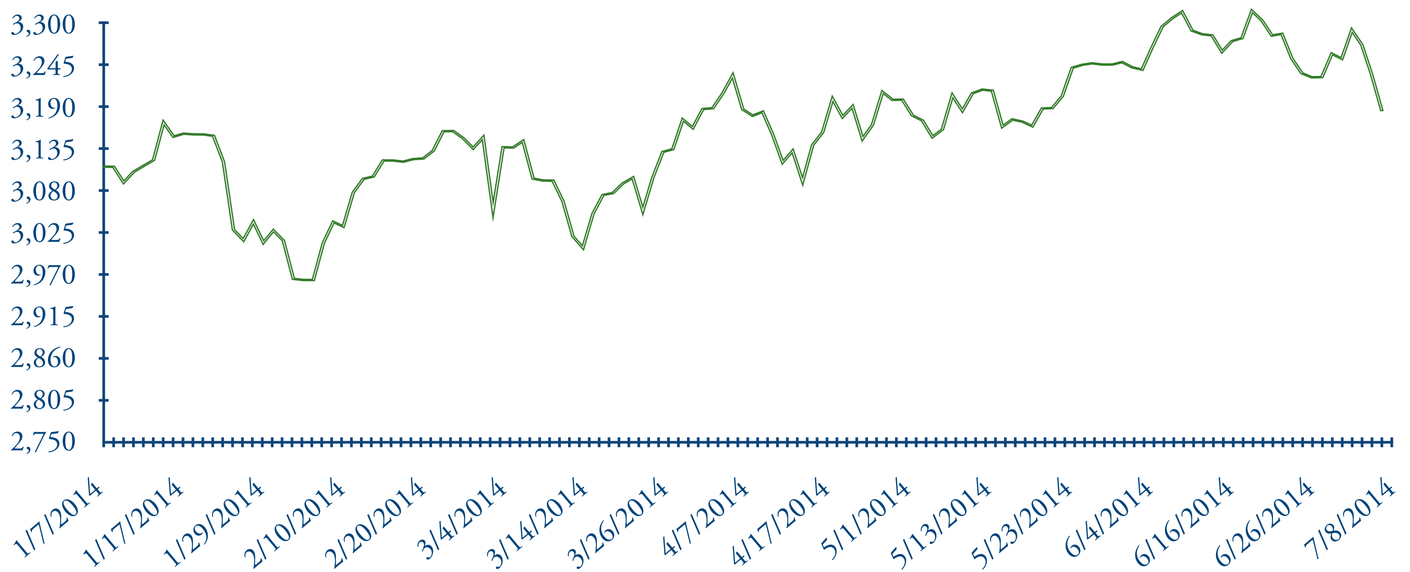
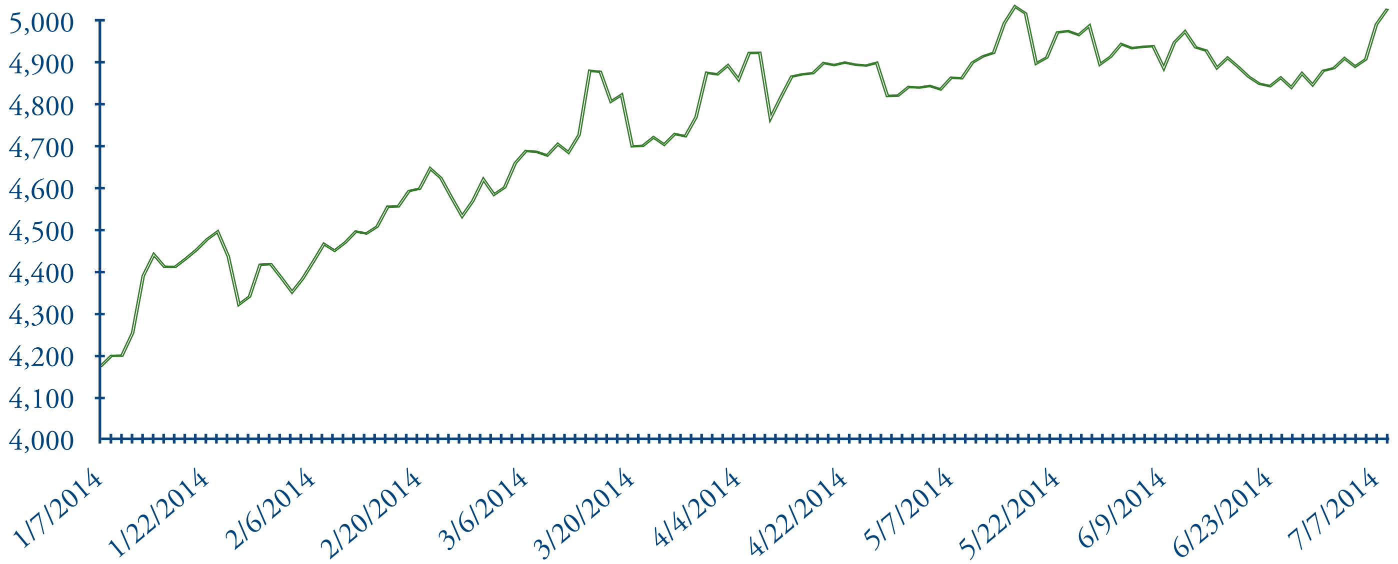
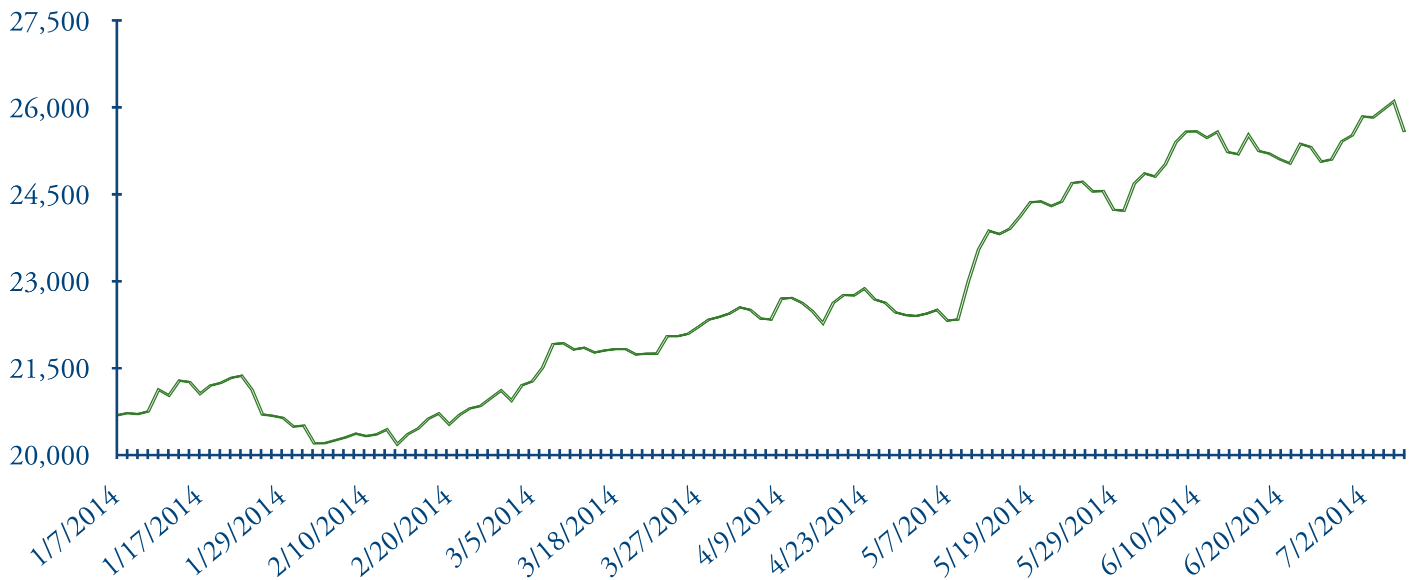


Figure 5: **Indonesia Stock Index**



been Japan (flat for the first half) and China (still locked in a long-term bear market). The worldwide rally in bond prices was even more impressive, with 10-year government bond interest rates falling in

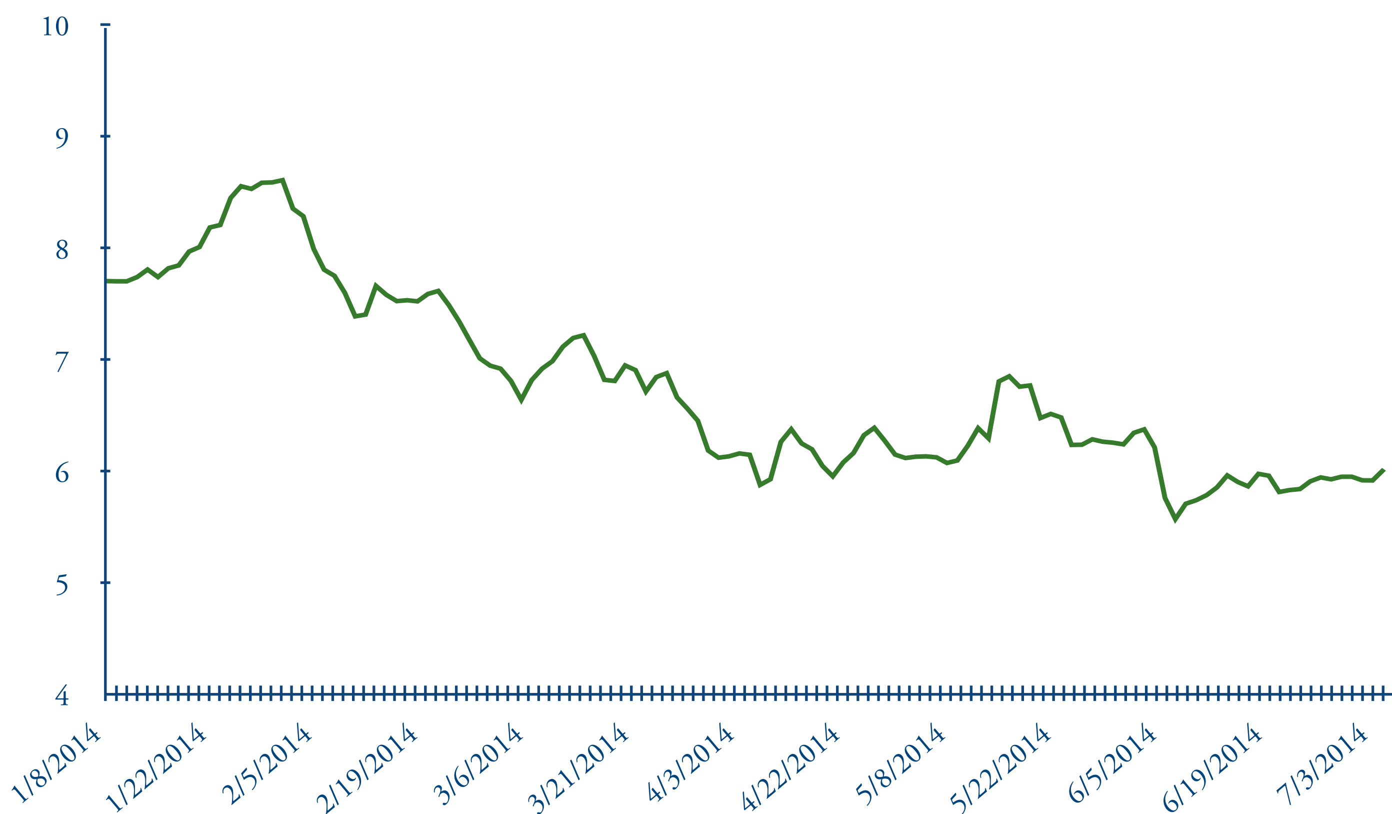
Figure 6: **India SENSEX**



many countries. The declines were especially sharp in heavily indebted Greece (Figure 7) and Italy (Figure 8). The Italian 10-year yield is now below 3%, even though Italy's government debt is now 130% of Italian GDP and rising.

The driving force behind this worldwide surge in bonds and stocks has been expansionary monetary policy, with the US (the Fed) and Eurozone (ECB) central banks keeping their reference interest rates near zero. At the same time world economic growth remains positive, even strengthening, while

Figure 7: **Greece Ten Year Bond Yield**



inflation remains unusually subdued in much of the developed world. This benign environment allows both bonds and stocks to rally in tandem. Although international politics could have derailed these impressive rallies, the invasion of Crimea, civil war in eastern Ukraine, sanctions against the acquisitive Russians, and a spillover of the Syrian civil war into Iraq have had little effect on financial markets, even though this political instability has driven the price of crude oil almost 10% higher this year. Even Russian stocks recovered all their first-quarter Crimean losses by the middle of the year.

Figure 8: **Italy Ten Year Bond Yield**

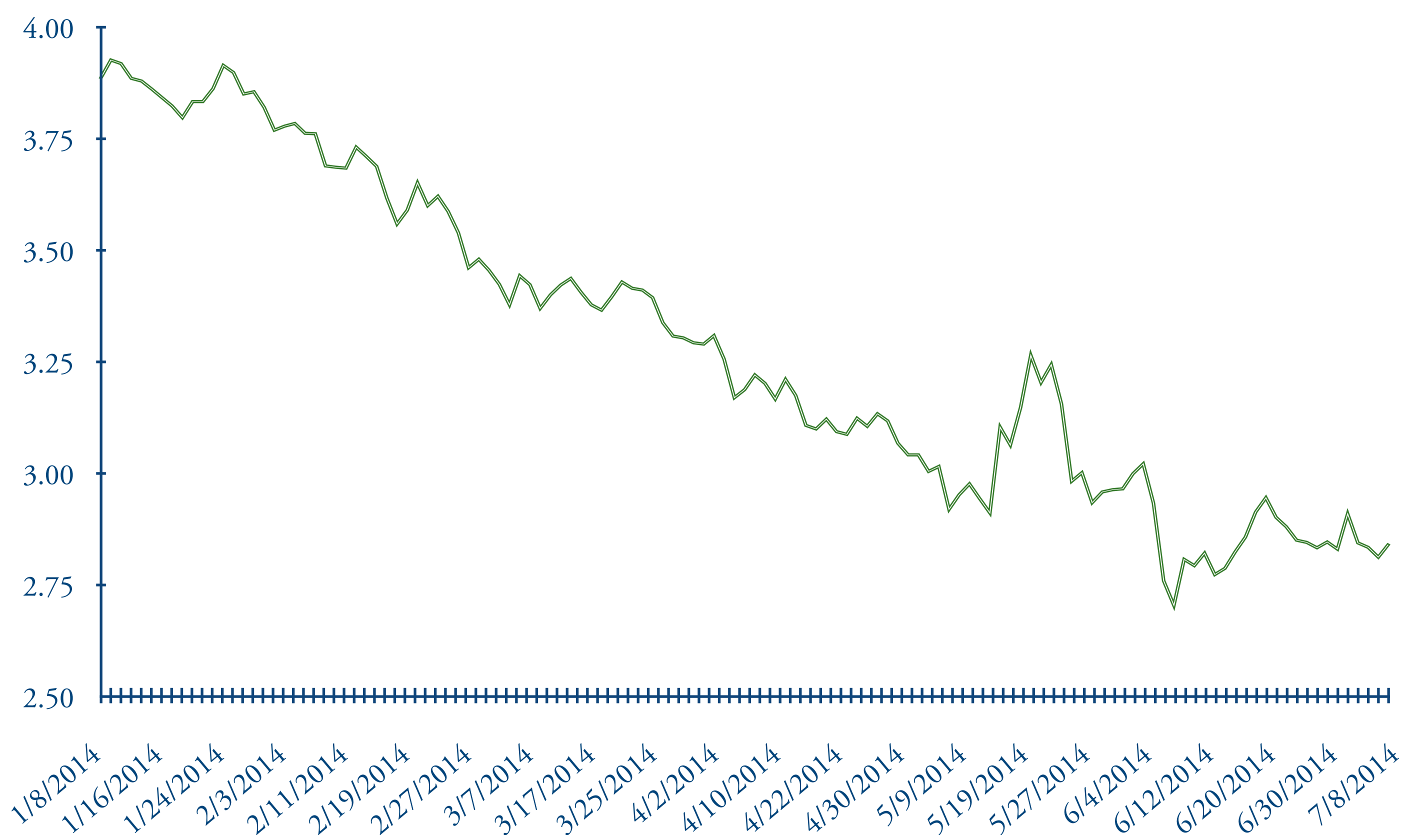
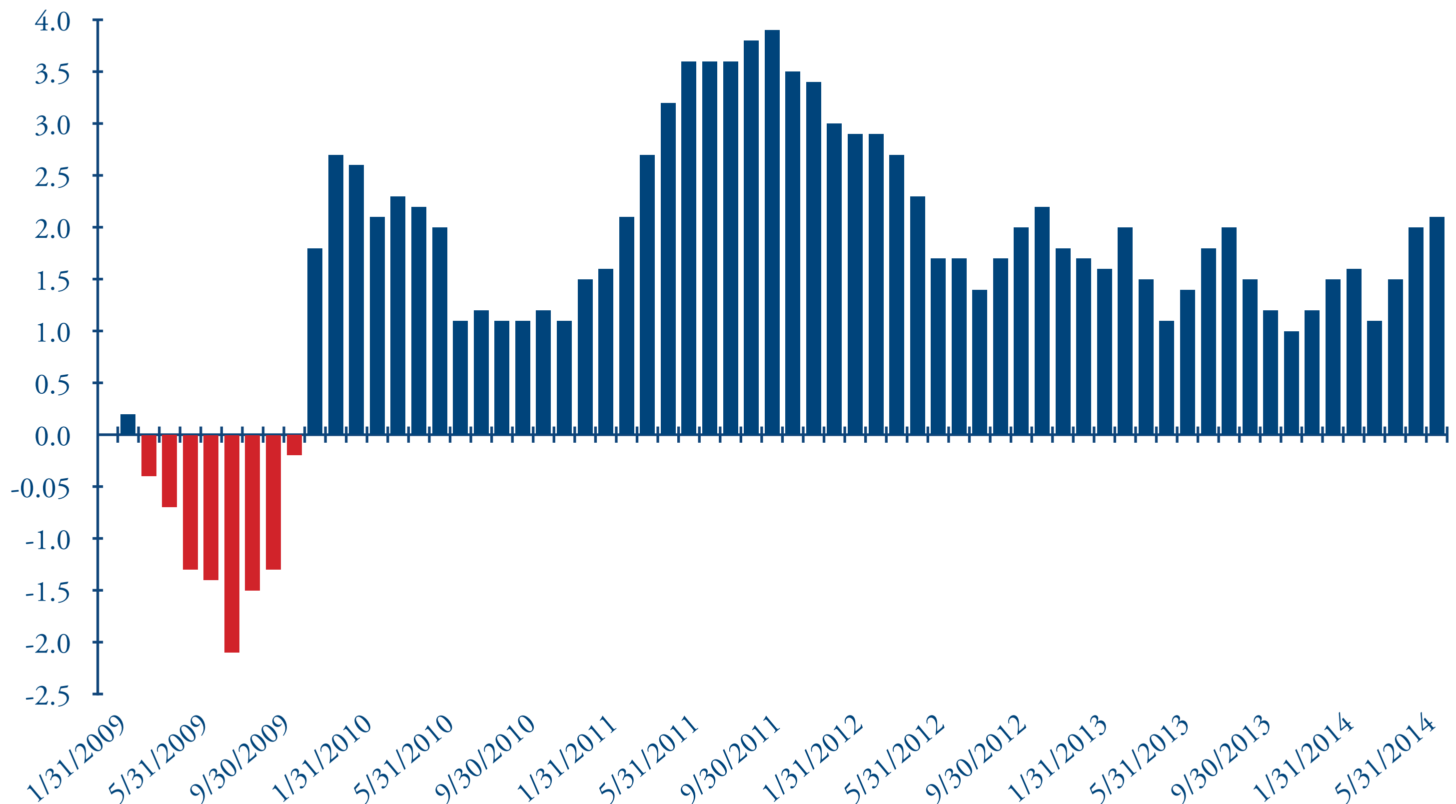
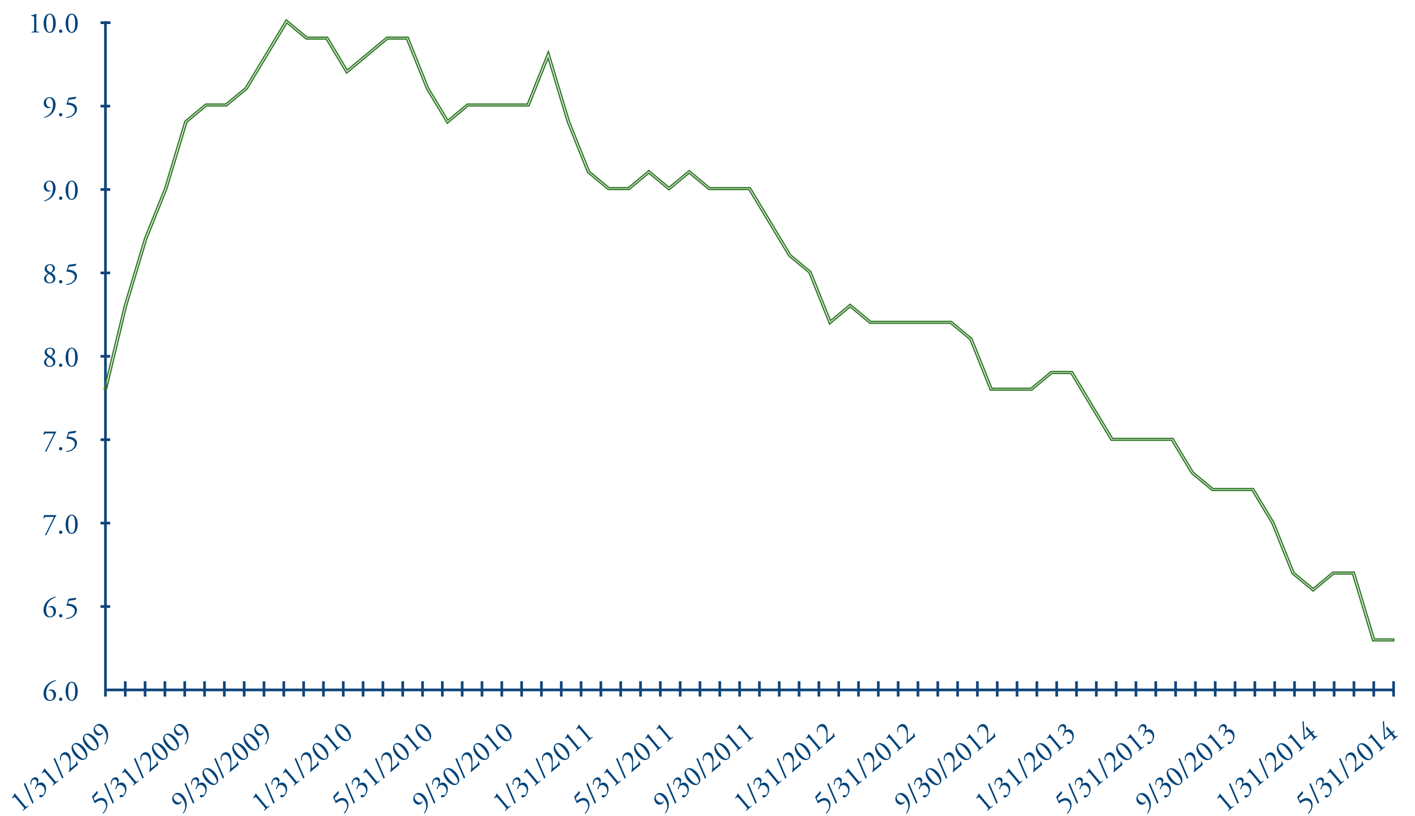


Figure 9: **US Consumer Price Index**



The rationale for Fed and ECB expansionary monetary policy and zero short-term interest rates remains clear: the US and most European economies are still operating well below their potentials, even though the economic recovery is now in its 6th year. With inflation benign (Figure 9) or even too low for the central banks (deflation is as economically undesirable as rapid inflation), policymakers can concentrate on expansionary policy. The simplest measure of the slack in an economy is the level of unemployment. In the US, the standard measure of unemployment has been dropping steadily toward 6% (Figure 10), and many economists believe that US "full employment" will be reached at around 5% unemployment. In a dynamic economy like the US, there will always be some unemployment because new workers are searching for jobs, some existing workers are quitting in search of better jobs (these two are called

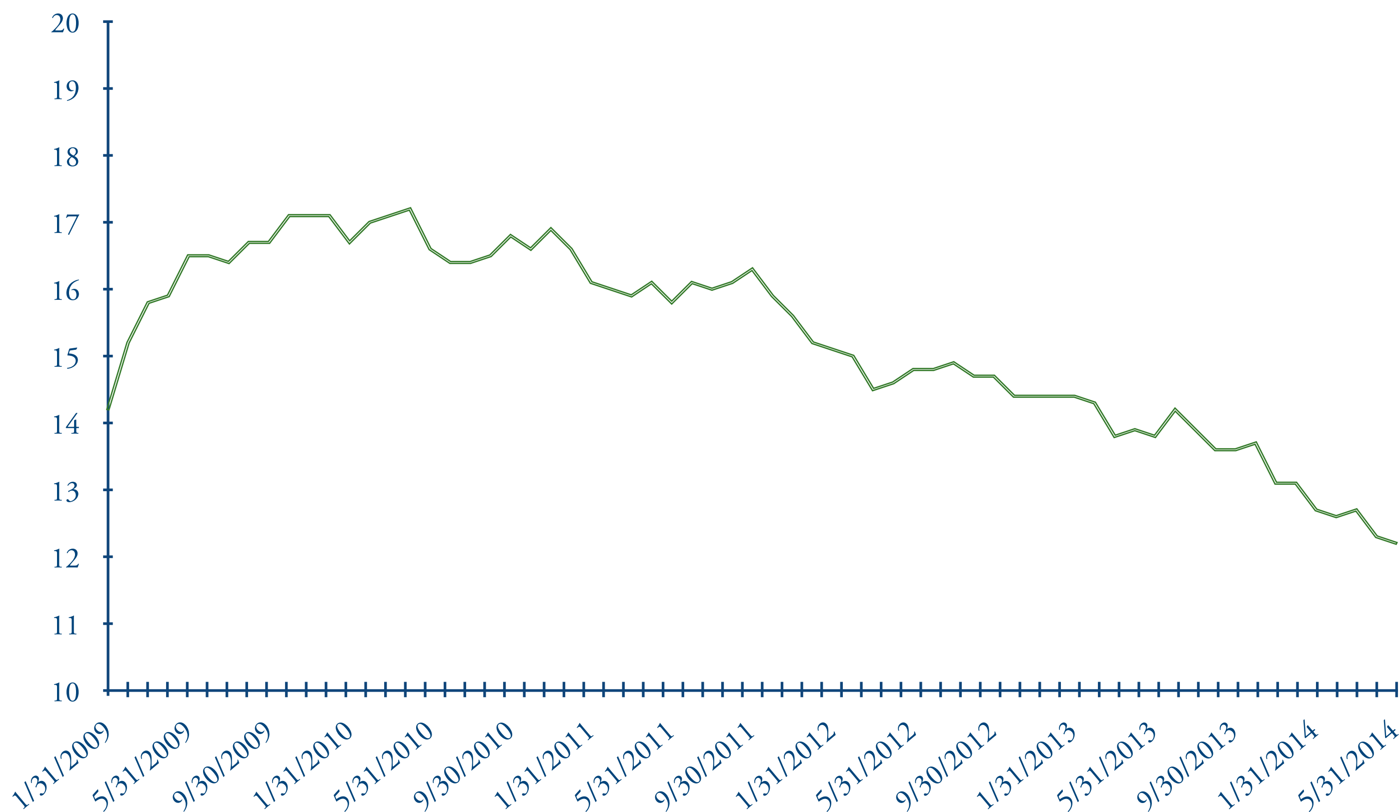
Figure 10: **US Unemployment Rate**



"frictional" unemployment), and some workers have skills which are no longer in demand (this is called "structural" unemployment). These two categories could easily add up to 5% unemployment, so any attempt by the Fed to drive unemployment below this level would lead to rising wage inflation as employers have to offer higher wages to fill vacancies. Accelerating wage inflation can then lead to faster price inflation, which is anathema to responsible central bankers. In recent decades, many economic recoveries have been derailed by central bankers attacking rising inflation. Some economists have been warning for years now that expansionary monetary policy will very soon breed rapid inflation, but they have been continuously and dramatically wrong because they have underestimated the economic slack in the world economy.

The US labor market no doubt has much more slack than is revealed by the "headline" unemployment rate. Millions of American workers want to work but have given up looking, and millions more have been working part-time even though they would prefer full-time. When these workers are added to the "headline" unemployment rate (Figure 11), the full extent of labor market slack is clear. In Europe, where recovery from recession has been much slower (France, England), or even nonexistent (Greece, Spain), the level of headline unemployment (Figure 12) is still in double digits. Thus the ECB has even more room to maintain extremely low interest rates. The central bank has now used this policy latitude to set a negative interest rate on reserve deposits of its member banks, and to offer cheap loans to banks that agree to lend the funds to the private sector.

Figure 11: **US Unemployment: A Broader Measure**



Much of the rest of the world has to set interest rates with an eye on the US and Europe. In a country like Brazil, for example, rising local interest rates (relative to the US) will bring in lots of “hot” money searching for higher yields. This capital inflow often drives up the value of the local currency, which would hurt Brazilian exports and employment. Driving down local interest rates can lead to a declining currency (as hot money leaves), which usually increases the prices of imports and feeds into inflation. (Both phenomena have occurred in Brazil in recent years.) Thus many countries with large trade sectors (exports plus imports) cannot set interest rates independently of the US and Europe, giving the Fed and the ECB even more control over world interest rates.

Figure 12: **12 EURO Zone Unemployment 2009-2014**

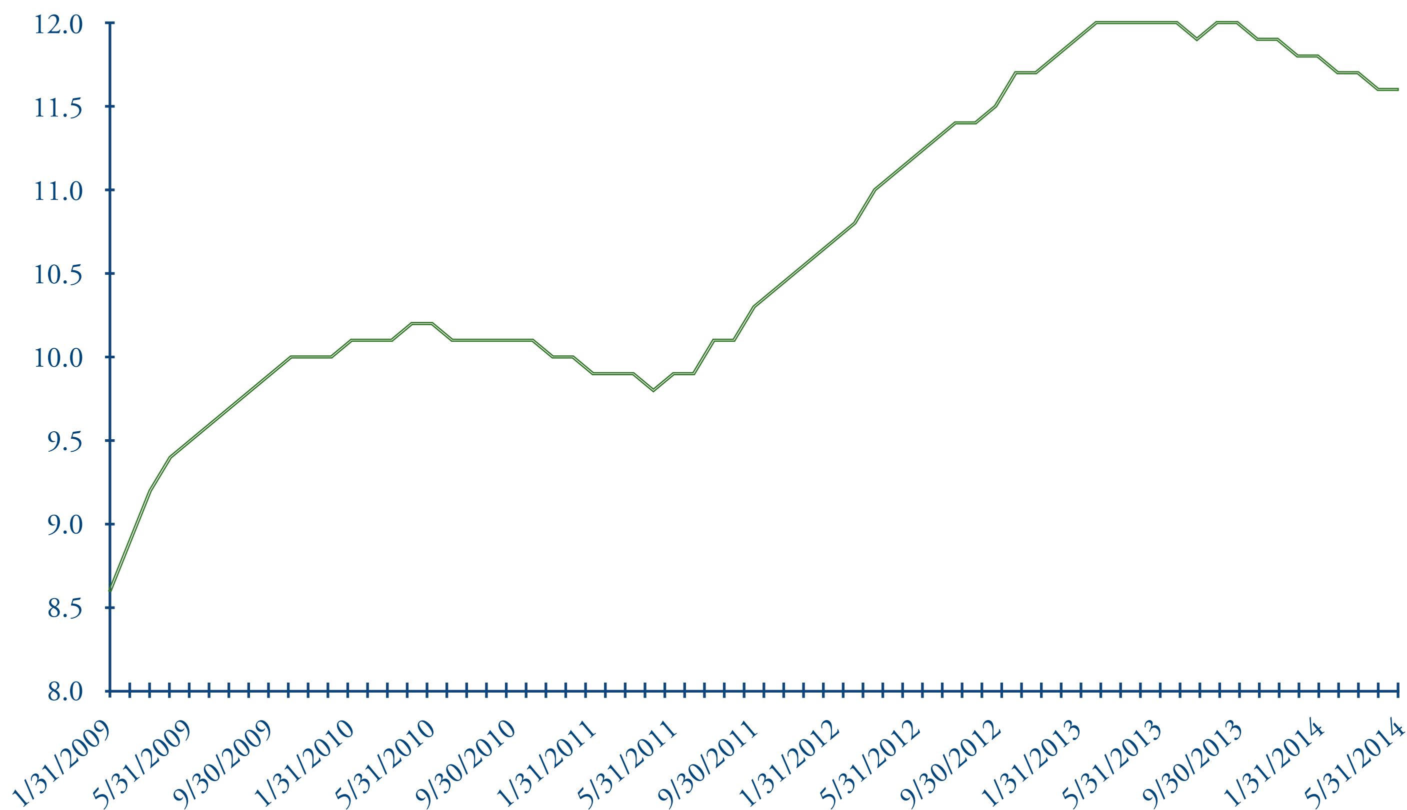
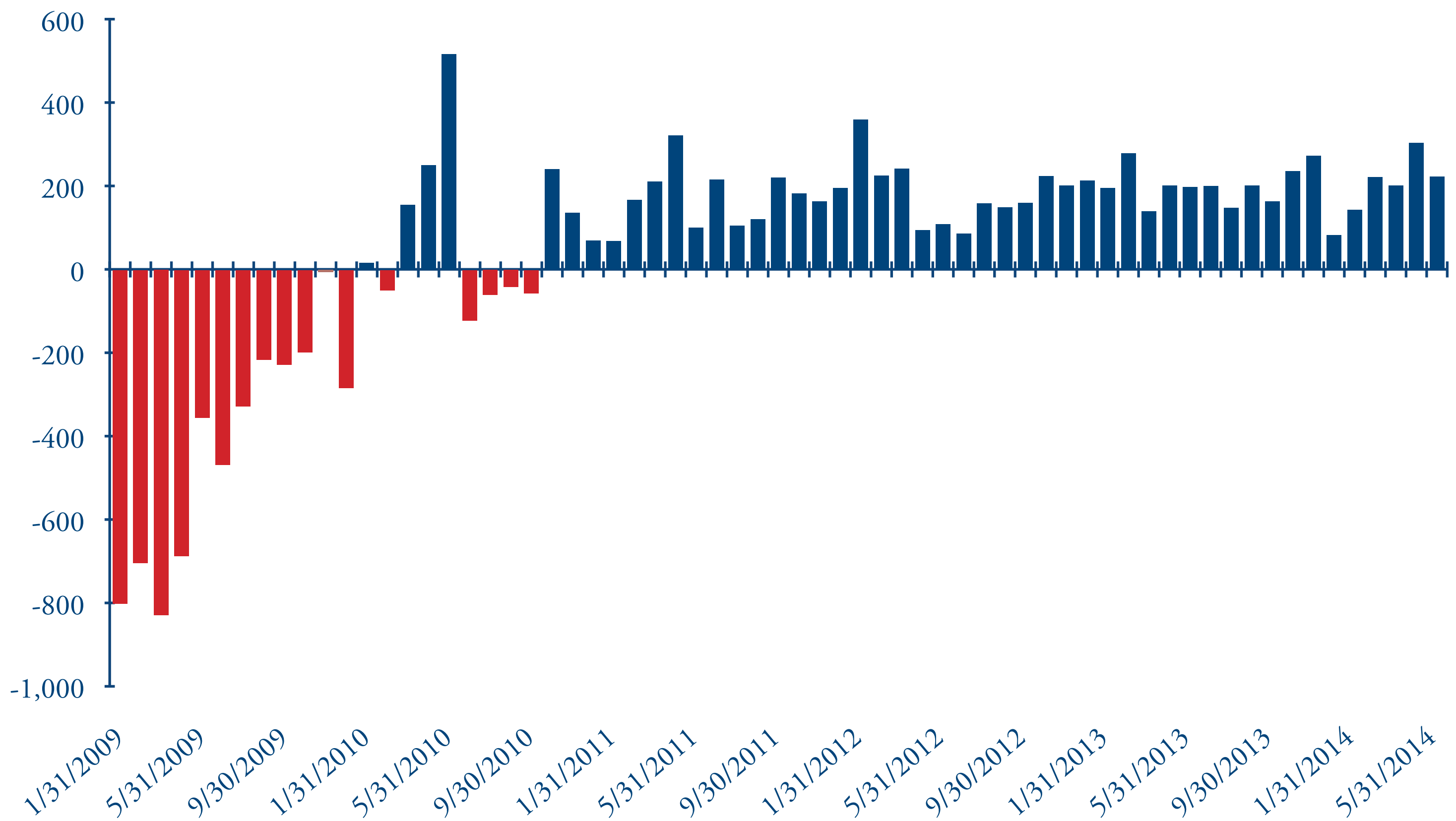


Figure 13: **US Total Employment (in 000's)**



The US Fed has also stuck to its expansionary guns because economic growth in the US remains subpar. The first quarter of 2014 witnessed an actual and substantial shrinkage in real GDP, although monthly employment gains throughout the first half suggest that economic growth will resume in the remainder of the year (Figure 13). Overall growth is now being held back by some weakness in the US housing sector, where double-digit home price increases and expanding new home construction have begun to slow down to a more sustainable pace of growth. In addition, American businesses have been sitting on a massive hoard of cash, while banks and other financial firms have kept a lid on loans with strict lending standards of the kind that were absent in the 2005-2007 credit bubble.

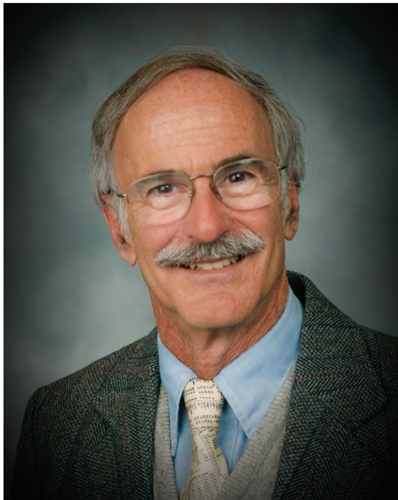
Asian economic conditions pose thornier questions for policymakers in economic heavyweights China and Japan. Chinese leaders are attempting to guide the economy onto a slower, more economically and environmentally sustainable growth path, while at the same time squeezing gently on property and credit bubbles. China's "peaceful rise" also entails freer use of the yuan as an international currency, which in turn will require freer capital flows to match the dollar and euro reserve currencies. Achieving all these goals in a state-controlled economy would be difficult for any policymakers. But China is also determined to maintain political repression at home, which alienates many citizens, and to pursue aggressive sovereignty claims in disputed areas, which alienates many of its trading partners, including Japan.

Japanese leaders have used expansionary monetary and fiscal policy to jumpstart a long-moribund economy, and have now begun the process of structural reform, the "third arrow" of the Shinzo Abe package. Corporate taxes will be reduced, labor market regulations will be eased, and the overly coddled agriculture sector will be opened to more competition. These changes may give Japan a chance to battle the Chinese economic juggernaut. Aggressive economic policy has reinvigorated financial markets in Japan, even though stock prices had a flat first half in 2014. Paradoxically enough, Chinese growth has left Chinese stocks mired in a multi-year bear market, as Chinese investors still see better opportunities in real property at home and more transparent markets abroad.

THE OUTLOOK FOR THE SECOND HALF

Easy money and low interest rates in the US and Europe will continue to be the dominant driver of most world markets. A faster pace of US economic growth in the second half of the year, combined with modest economic recovery in Europe, and low interest rates, could propel stock markets to even higher levels. At some point, however, interest rates in the US will begin to return to more normal levels, which will negatively impact bonds. In a rising interest rate environment, stocks will need growth in corporate earnings to drive prices higher. Even so, the path of bull markets is rarely smooth, so long-term investors must be prepared for the inevitable "speed bumps" on the road ahead.

About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Dan enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within the context of the global economy.

Dan was a member of the Finance faculty at San Diego State University for nine years, where he taught an array of courses including international business finance, investments, and financial literacy. For the academic year 2013-2014, Dan will be teaching full-time in the Economics Department at California Polytechnic University at San Luis Obispo. At SDSU, Dan received the International Business teaching awarded in 2012, as well as the Finance teaching award in 2007. From 1978 to 2005, Dan was a Professor of Economics at Miami University (Ohio), where he taught a variety of courses in economics. He has over 20 publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Dan has also been a consultant to the Center for Naval Analyses, and was the investment adviser to the Population Association of America for many years.

He earned his Bachelor of Arts, Masters and Ph.D., all in economics, from Yale University.

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