Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST

US Markets and Economy:

US stocks fell sharply in August, with the benchmark S+P 500 Index down more than 6%, more than wiping out the gains for the year. The declines were broad-based, and were particularly intense on August 24, when the Dow Jones Industrial Average initially declined 1,000 points, with all major indexes down over 10% from their highs. This is Wall Street's definition of a "correction." The markets did find their footing and rally later in that week, although the last day of August brought another decline.

Investors are often surprised and dismayed by the speed and extent of corrections during a bull market, but they are unavoidable. **The long-term real returns on stocks, compared to other assets, are very high just to compensate investors for the inevitable selloffs and volatility**. Investors should remember that in March 2009 the S+P was at 676. After the August selloff, the index was still at 1972, without even counting dividends.

The proximate cause of the selloff was China. The Chinese have been trying to slow their breakneck growth rate to a more sustainable level, while also transitioning to a more consumer-oriented economy. Since China has become the world's second largest economy, this slowdown has significant worldwide effects: raw materials exporters like Australia and Brazil have seen a sharp shrinkage in Chinese demand. In fact, the Chinese economy has probably been slowing much more than the official figures reveal, and this has spurred Chinese policymakers to reduce the international value of the yuan, in order to spur exports and economic growth. This devaluation set off immediate shockwaves, since it meant that many Asian countries which compete with Chinese exports would see their own exports weaken. At the same time, the bubble in the Chinese stock market burst, taking Chinese stocks down over 30%, even though the Chinese authorities intervened in an attempt to stabilize the market.

These financial and economic concerns gave US stock traders an excuse to sell, even though US economic prospects are not closely tied to China's (our exports to China are less than 1% of our GDP.) Second quarter growth in US GDP picked up sharply from the first quarter, and the outlook for the rest of the year is good. Housing is still in recovery mode, cheap oil improves consumer's spending power, and steady gains in employment have reduced the US unemployment rate to 5.3%, which is close to "full" employment. Inflation remains very low.

All this good news in the US does pose a quandary for the Federal Reserve. The Federal Open Market Committee (FOMC) must decide in September whether to begin raising short-term rates above the zero level, where they have been since the depths of the economic and financial collapse of 2008. No one, not even the voting members of the FOMC, knows whether the process of "liftoff" from zero will begin in September. There are powerful arguments on both sides of the issue, with the "doves" favoring waiting because inflation is so low, with millions of discouraged workers not yet looking for jobs, while millions of others are still working short hours. The "hawks" want to start the normalization process now, since the Fed has stated that it will start this year and should not appear indecisive, and because monetary policy acts on the economy with long lags, and finally because a ¼-point increase will still leave short rates at a very stimulative level, and negative in real terms (after subtracting inflation).

Fears that the Fed will start raising rates also contributed to the August decline, since traders have a knee-jerk reaction to any increase in interest rates (sell) just as they respond to cuts in rates (buy). **Long-term investors should remember that stocks can actually rise while interest rates are rising**.

US Treasury bond prices rallied during the most intense declines, as traders undertook a "flight to quality." However, bond investors must realize that over the next several years the most likely course of interest rates is up, which could be a strong headwind for bond prices.

World Markets and Economy:

European stocks did not have long to enjoy the tentative agreement on a third Greek bailout before the surprise Chinese devaluation dragged them down. The German DAX fell sharply, although it remained a bit higher for the year. Other European indexes also fell, with the Greek index falling sharply and approaching its low set during the previous bailout crisis. Although China hogged the headlines, Europe's economy is struggling to grow at all, even with massive QE by the European Central Bank. And the Greeks are not out of the frying pan, since the details of the $100 billion bailout must still be worked out, with another election scheduled for September.

Japanese stocks were also dragged down by the "China Syndrome," and by news that the Japanese economy shrank in the latest quarter, even with the Bank of Japan's QE program. Even with a 10% correction, Japanese stocks have been so strong this year that they are still up 5% for the year. Not so in China. The collapse of the stock bubble pulled stocks down 43% from their summer highs, and more than wiped out the gains for the year. Efforts by the authorities to prop up the market have not succeeded, and many Chinese investors, who jumped in the market this year on margin, have seen their losses magnified by leverage.

OUTLOOK: The US bull market in stocks is still intact, and corrections during a bull market often provide excellent buying opportunities. While these corrections can be sudden and sharp, long-term investors must keep their eyes on the long term, and avoid being stampeded by day-to-day volatility. As Richard Thaler, a highly-regarded University of Chicago behavioral economist has suggested, "Inhale, exhale. Repeat. Then watch ESPN."