The Reilly Report:

2015 MID-YEAR REVIEW AND OUTLOOK

US stock prices ended the first half of 2015 on a sour note, as the Greek crisis deepened at the end of June. A modest gain of 2% in the S+P 500 Index from January to late June was wiped out in the last two days of the first half of the year. (Figure 1) European stocks, which had rallied much more broadly in the first half of the year,

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

Figure 2: **EuroStoxx 50 Index**

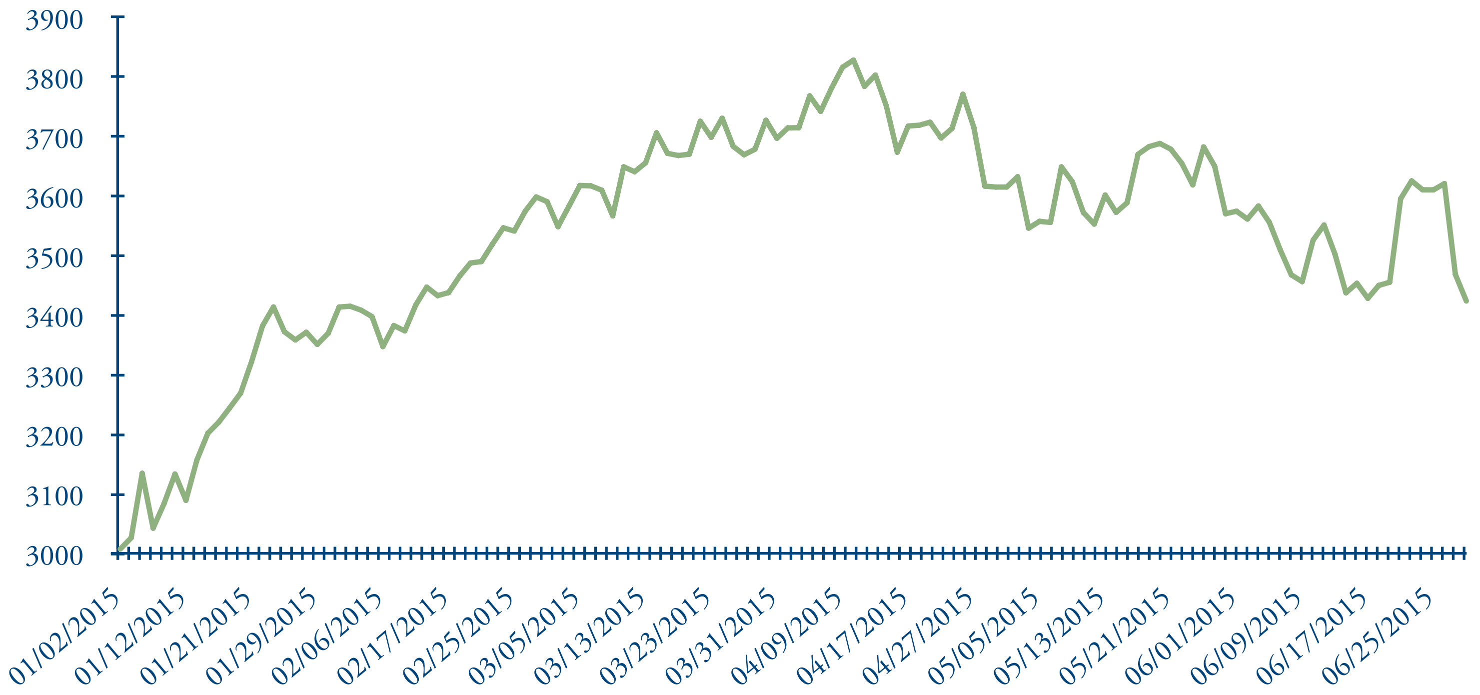
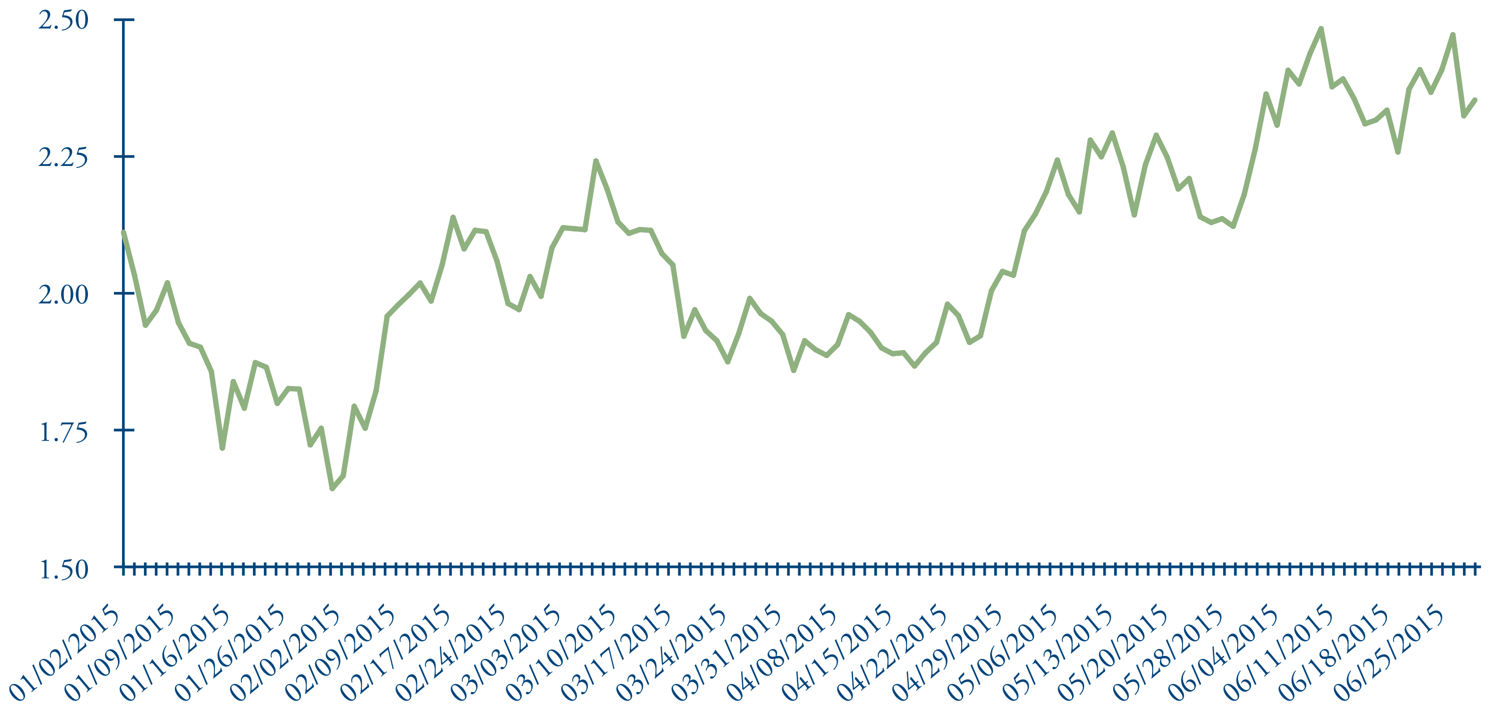


Figure 3: **Yield on 10-year Treasury Bonds**



sold off even more sharply in the final two days of June. Europe overall still managed a gain for the first half, as measured by the Eurostoxx 50 Index, a broad European index of large blue-chip stocks. (Figure 2)

US bond prices were moving lower in the latter part of the first half, in anticipation of the Fed's long-planned "liftoff" from its multi-year, zero short-term interest rate regime. But these bonds rallied strongly in the last two days of June, in a "flight to quality" which often occurs during a financial crisis. (Figure 3)

During the final weekend of June, the Greek government announced that it would close all of its banks, and the stock market, for the following week. This action was taken to stem the outflow of funds from Greek banks, as citizens lined up to withdraw Euros for redeposit outside the Greek banking system. Greek banks were being propped up by loans from the European Central Bank (ECB), one of the "troika" of lenders to Greece, which includes the IMF and the European Commission (EC).

Once the negotiations between the Greeks and the troika broke down, with the two sides unable to reach an agreement on extending loans in exchange for Greek economic and fiscal reforms, it became inevitable that there would be a default by Greece, which was unable to pay loans from previous bailouts that were coming due in July. On June 30, the Greeks officially missed their payment to the IMF, bringing them closer to a full default.

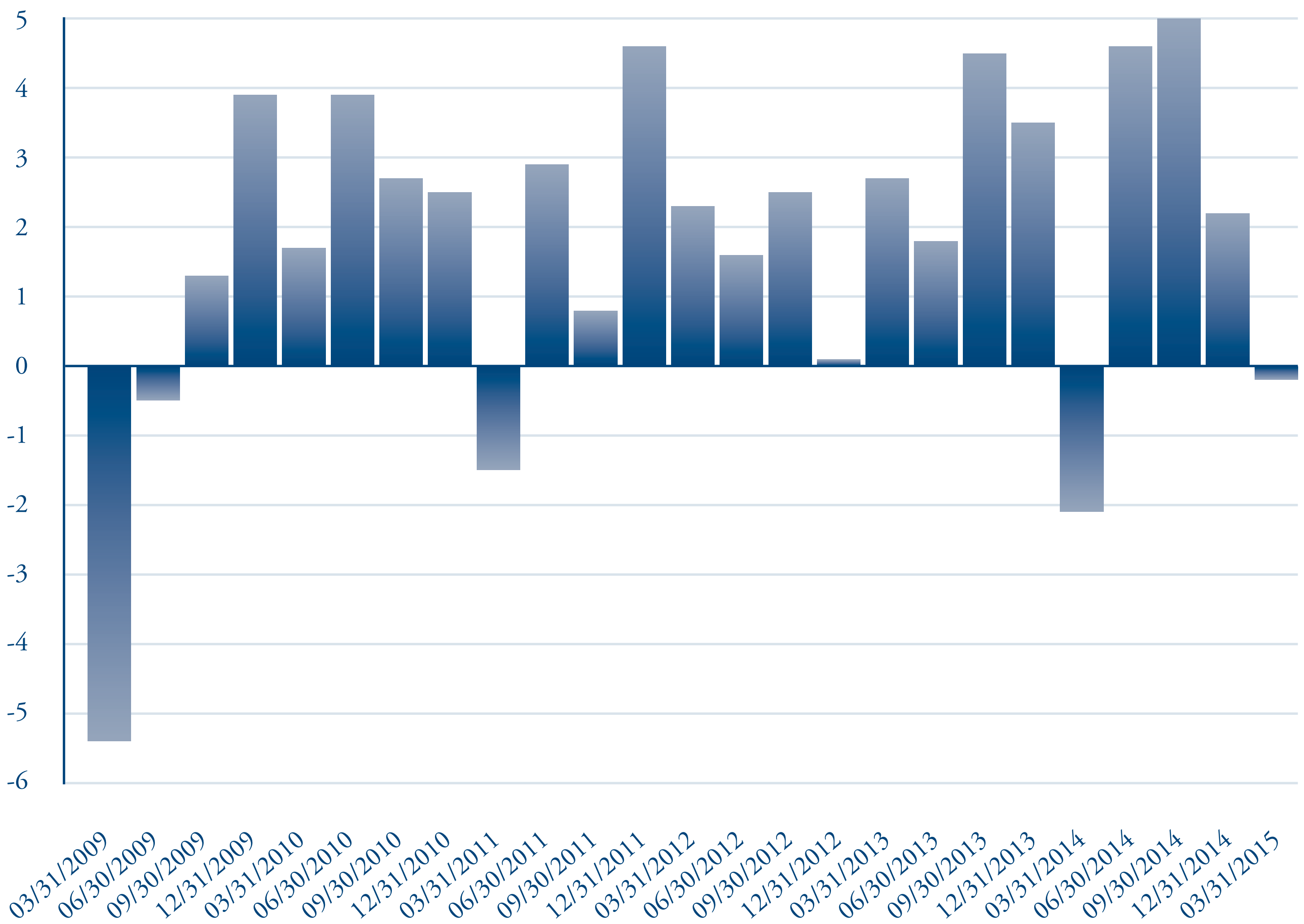
While it is unclear how the Greek drama will end, the epicenter of the crisis will be in Athens: whether or not the Greeks officially default, leave, or get pushed out of the Eurozone, or even the European Union, the bulk of the economic pain will be felt by the Greeks themselves. Their standard of living has been falling for years, and even though the economy appeared to stabilize in 2014, the level of Greek unemployment is still 25%, equal to the US unemployment rate at the lowest point of the Great Depression. As we move away from the epicenter, the shock waves will also be felt in European capitals. Much of the Greek government debt is held by the ECB, which is the European equivalent of the US Federal Reserve. The Eurozone countries, a large subset of the European Union, have no policy on leaving the Eurozone, since joining the currency union was supposed to be irrevocable. It is feared that a Greek departure would embolden other high-debt countries, like Spain or Italy, to also consider a departure. Yet it is even more likely that the pain that will be suffered by the Greeks upon departure will be great enough to convince the other high-debt countries in the Eurozone to remain.

Moving across the Atlantic to the US, the Greek shock waves will be much more reduced, with "hot money" flowing into the US dollar and Treasuries as a safe haven, and the US economy strong enough that the Federal Reserve can plan on beginning a slow and gradual increase in short-term interest rates.

Although US GDP growth in the first quarter of the year was slightly below zero (Figure 4), it is clear that the remainder of the year will show

positive real growth of 2-3%. The first quarter of the year in the US was weak in part because of bad weather and a West Coast port strike. The first quarter was also artificially weak because of the technique used to seasonally adjust the data. Another measure of overall economic activity, called Gross Domestic Income (GDI), actually showed growth in the first quarter. The US labor market is also strengthening, with monthly gains in jobs exceeding 200,000, and the overall unemployment rate falling closer to the Fed's "full-employment" target of 5-5½%. Labor market strength is also a signal to the Fed that the time to begin increasing interest rates is approaching. The Fed has stated it wants to be "preemptive," that is, it does not want to wait to raise rates until the economy is overheating, with wages and prices rising sharply, since monetary policy can take many months to have an effect.

Figure 4: **US GDP**



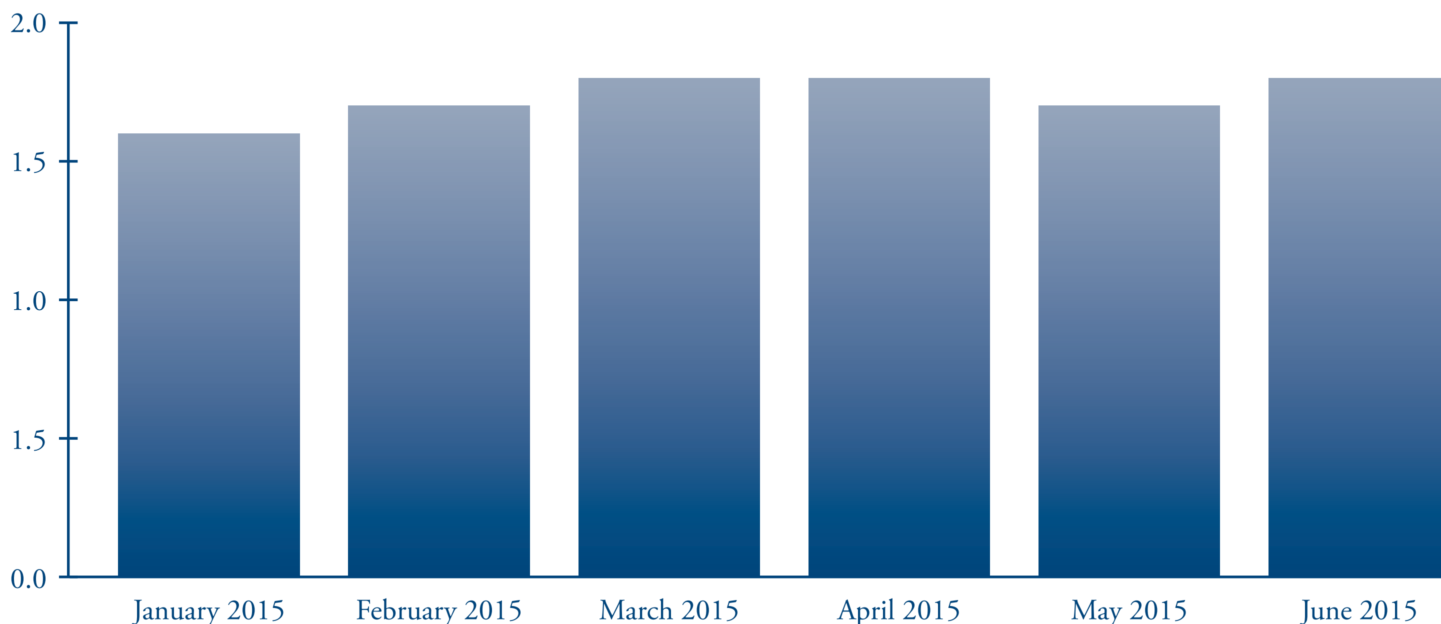
Until the latest act in the Greek drama, US stock traders were fixated on these coming increases in US short-term interest rates. Longer-term interest rates have already crept up in anticipation of these increases (see Figure 3). Yet it must be remembered that even if the US Fed increases nominal short-term rates to 1½%, which might easily take 18 months, the "real" short-term rate (nominal minus inflation) will still be at zero, which should provide a constructive environment for the economy and stocks.

Slow growth in corporate earnings will offset to some degree the continuing monetary stimulus from the Fed. Corporate earnings actually fell in the first quarter, pulled down by the effects of the sharp decline in oil prices on energy sector profits. Oil prices appear to have stabilized in recent months (Figure 5), but slow growth in US GDP, and a stronger dollar (which hurts exporters) may keep corporate earnings from growing rapidly.

Figure 5: **US Crude Oil Price**

The decline in energy prices has helped keep a lid on inflation, which remains at about 1½%, below the Fed's official target of 2%. The Consumer Price Index (CPI) has not been showing any inflation at all, but the Fed pays more attention to "core" CPI, which excludes volatile food and energy prices. (Figure 6)

Figure 6: **US Consumer Price Index**



The real excitement in stocks in the first half of the year was in Asia. The two giants, Japan and China, both witnessed roaring bull markets, with China showing classic signs of an unsustainable "bubble." (Figure 7 and Figure 8) While the Chinese leaders and the People's Bank of China (PBOC) are still trying to slow Chinese economic growth to "only" 7% per year, recent easing of interest rates and other stimulative monetary policies have spilled into the stock market, where millions of Chinese are now speculating with borrowed money. At its peak in early June, the Shenzhen was up over 50% for the year (and up over 100% for 12 months), although a sharp selloff has since reduced that gain. The PBOC has begun to tighten restrictions on margin borrowing to cool off the mania for stocks.

The Japanese Nikkei Index also rallied sharply to a new recovery high above 20,000, with stocks rising steadily throughout the first half of the year. The Japanese central bank (BOJ) has been following in the US Federal Reserve's footsteps with Quantitative Easing (QE), which floods the financial system with funds from purchases of government bonds by the BOJ. While the economy has yet to show strong growth, it now appears that the latest recession, brought on by a tax increase, is now over. With the next tax increase postponed for two years, Prime Minister Abe may finally succeed in ending Japan's two decades of economic stagnation.

Figure 7: **China Shenzhen**

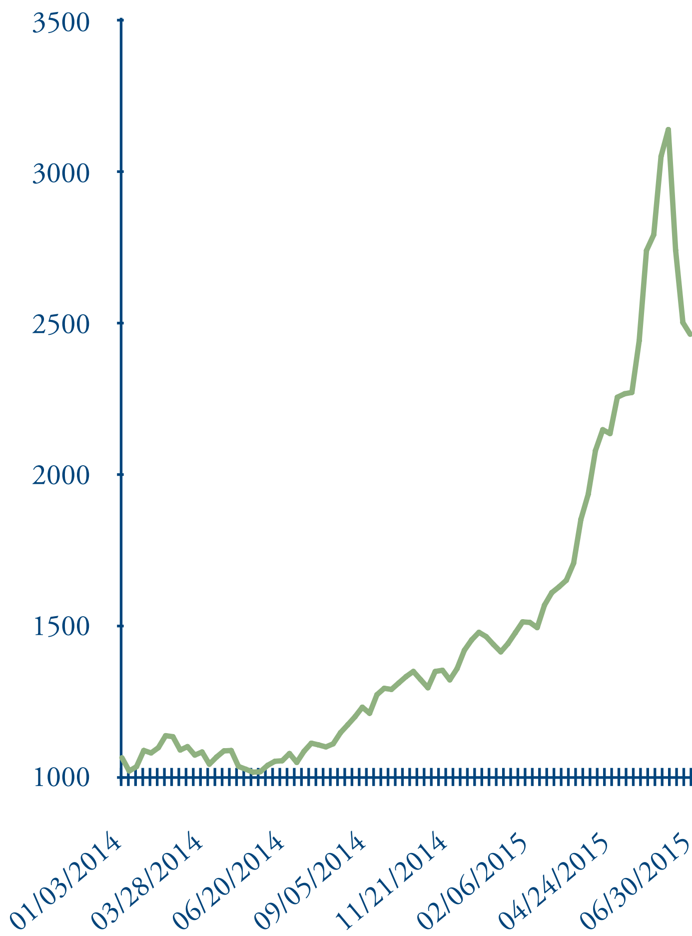
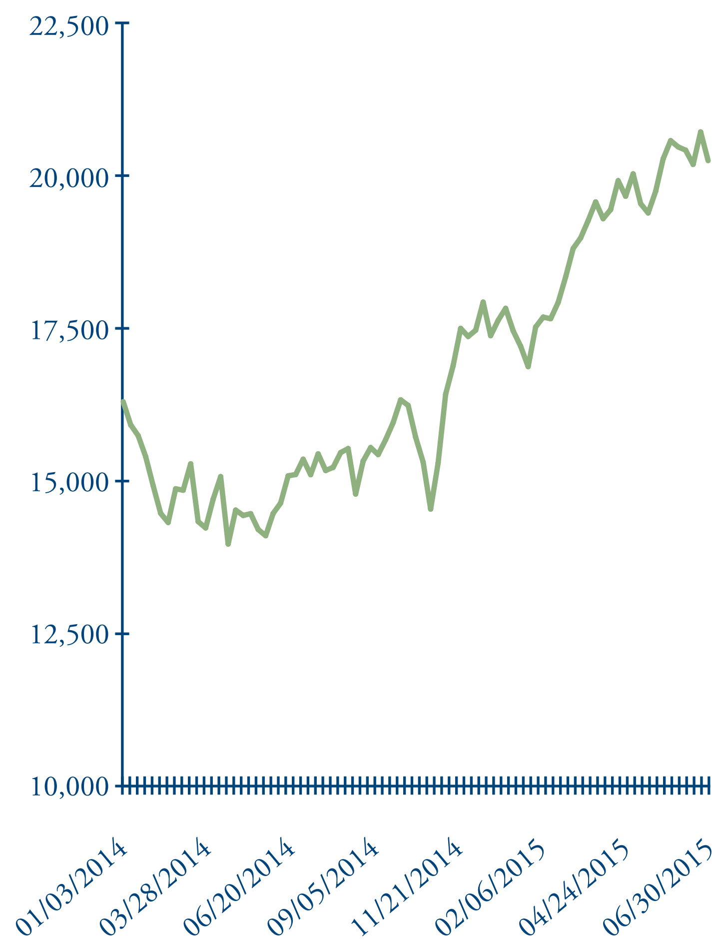


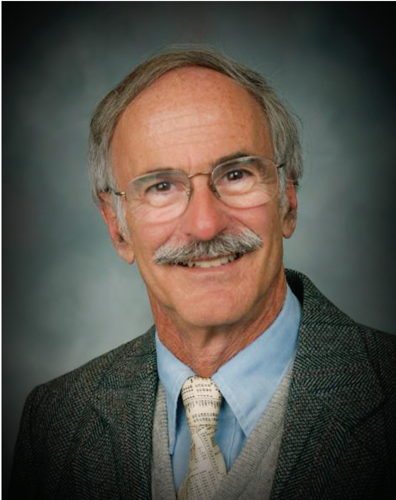
Figure 8: **Japan Nikkei**



THE OUTLOOK
FOR THE SECOND HALF

Monetary policy will remain expansionary in the US, Europe, Japan, and China, which should help support stock prices. But stock markets around the world will be buffeted by shock waves from the Greek crisis as it continues to unfold in July. Bond prices in the US will face headwinds if the Fed does indeed begin raising interest rates. Although second half gains may be harder to come by, long-term investors must have the courage to persevere through periods of market weakness.

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 has been a member of the Finance faculty at San Diego State University for many years, where he has taught an array of courses including international business finance, investments, and financial literacy. For the academic year 2014-2015, Dan is teaching full-time in the Economics Department at California Polytechnic University at San Luis Obispo. Dan received the International Business teaching award in 2012, as well as the Finance teaching award in 2007. From 1978 to 2005, he 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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