US stock prices made modest gains in the first half of the year, despite two sharp selloffs in January and June. The S&P 500 Index gained a little more than 2%, mirrored by a gain in the widely-followed Dow Jones Industrials, while the NASDAQ Index suffered a small loss. European stocks, which often follow the lead of American stocks, were noticeably weaker in 2016: a broad measure of European stocks, the European 500, fell more than 10% for the first half. The January worldwide selloff was led by US stocks, which were pummeled by three fears: first, that the US economy was headed into recession; second, that China’s economic growth rate...
was tumbling, and that their currency would also fall sharply; and third, that the continued collapse in oil prices would damage the US and world economy. All three fears were overstated, as the US economy continued to grow, the Chinese economic growth rate and currency depreciation both moderated, and oil prices rebounded. These more favorable trends, illustrated in Figures 3-5, helped power a strong worldwide rally in stock prices which lasted until the Brexit vote on June 23rd. Most economists agree that the surprise British vote to leave the EU will damage both British and European economic growth, with more modest economic effects in the US. Stock prices got this one right, with US stocks recovering after two days of dramatic losses, while European stocks remained justifiably weak. The British pound also swooned given that London could lose its status as a world and European financial center, and the British economy could even fall into a recession. The fall in British stocks reflected these concerns.
The level of economic uncertainty and political turmoil in the United Kingdom and the European Union remained high at the end of the first half: would Scotland vote to leave the UK in order to stay in the EU? Would Northern Ireland follow them? Would England be able to negotiate an arrangement with the EU that would preserve much of their access to European markets? And who would lead Britain through this murky period? These questions could hang over Europe like a dark cloud for many months.

The economic outlook for the US, by contrast, is clearer and brighter: extremely low interest rates will continue to promote economic growth, which will remain slow, but steady. Economic weakness in Europe will have only a modest economic effect in the US, with US export growth held back by a strong dollar.

The US Federal Reserve has kept short-term interest rates in 2016 near zero, after increasing them by one-quarter percent in December. The Fed has been willing to maintain its aggressively easy monetary policy in part because inflation has remained well below its target of 2%, while economic growth remains sluggish. Even with an expected rebound in the second quarter to 2.5% growth, 2016 is likely to be another year of slow growth. While it is somewhat puzzling that the US economy has not responded more vigorously to monetary stimulus, it is much more puzzling that the strength of the labor market has not generated more wage and price inflation. Continued gains in employment have driven the US unemployment rate below 5%, which has historically been associated with rising wages and prices. This “Phillips Curve” inverse relationship may yet reappear in 2016, but until it does, the Fed is in no hurry to raise short-term rates. The economic uncertainty and weakness emanating from Europe will also encourage the Fed to keep short rates low. At the same time, US long-term rates have fallen even further this year, with US Treasury yields approaching all-time lows near 2%. Some of this decline in yields is a result of hot money fleeing Europe and negative interest rates. One extreme example of this phenomenon is the recent foray of the German 10-year bond yield into negative territory. Bond investors are in effect paying the German government to hold their money for 10 years! Whether sustainable in the long term or not, these very low long-term interest rates have created even more capital gains for bond investors, while further supporting US economic growth.
The Fed must also keep a sharp eye on the strength of the dollar, which will slow export growth, and also keep inflation in check, since a strong dollar makes imports cheaper. In many ways this strength does the work of interest rate increases, which means the Fed can wait even longer to raise rates if the dollar stays strong.

For stock investors, the downside of slow growth and low inflation in the US is slow growth of corporate profits. This creates a tug-of-war between extremely low short- and long-term interest rates (bullish for stocks) and low or no growth in corporate profits (bearish for stocks). So far, the bulls have been gradually winning this battle, amid occasional sharp yanks by the bears from events like Brexit.

The Japanese economy and stock market provide cautionary notes to the US tug-of-war scenario which the bulls are winning here. The Japanese economy has been stagnant for decades, and recent growth has continued to disappoint. Economic weakness has forced the Abe government to postpone a second scheduled increase in the national sales tax, since the first increase caused yet another recession in Japan. When the Japanese under Abe decided to attack economic weakness with the double barrels of easy money (both negative interest rates and Quantitative Easing) and expansionary fiscal policy (budget deficits approaching 10% of GDP), the stock market responded with a powerful bull market which drove the Nikkei Index above 20,000 last year. Yet the economy has failed to respond, and now the Nikkei is mired in a bear market, down 20% this year. Japan’s economy may be the poster child for the resurrected economic theory of “secular stagnation,” which argues that economic growth will remain slow in the developed world indefinitely. This theory is hotly disputed in the US, and was proven wrong after World War II. But if it turns out to be true this time, interest rates and inflation could remain very low for many years.

Stagnation is not the problem for the Chinese economy. Although real economic growth has slowed to 6.5%, this is still one of the highest rates in the world, and it now applies to the second-largest economy in the world. The real questions for the Chinese are:

1. Can the growth rate be managed at this level
2. Can the economy make the transition toward consumption and away from export and investment
3. Can the yuan be stabilized
4. Is the current leadership up to the task?

The answers to these questions are vitally important to US and world investors, since the Chinese import massive quantities of raw materials, and export massive quantities of heavy industrial products like steel. When Chinese growth slows, it immediately impacts economies like Brazil and Australia which export to China. When China steps on the export pedal to maintain growth, it sells steel at low prices around the world, inflaming trade tensions and increasing worldwide protectionist sentiment, including the Brexiteers and the US populists. China now produces fully half of the world’s steel output, and if demand at home is not sufficient, it must be exported to maintain economic growth. Depreciation of the yuan is a classic way to stimulate growth, but the surprise decline in the yuan last year, and fears of further declines in January of this year, each created financial shock waves which spread around the world. It is still an open question whether the Chinese can safely rein in their fire-breathing economic dragon.

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 European stock prices, and to a lesser extent, US stock prices, will have to contend with the aftereffects and uncertainty of the Brexit vote. US stock prices must also contend with slow growth in the economy and in corporate profits. Bond prices in the US will have difficulty gaining even more ground, although the low yields in the US still look enticing compared to the negative yields in parts of Europe. Although second half gains may in the end be as modest as the first half, stock investors should expect that the recent pattern of sharp selloffs and recoveries will recur, as the tug-of-war between slow growth and low interest rates continues.
About Dan Seiver:

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

Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

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