The Reilly Report:

THE REILLY REPORT: 2017 MID-YEAR REVIEW AND OUTLOOK

The bull market in US stocks celebrated its 8th birthday with a strong rally to new all-time highs in the first half of the year. The rally was powered by technology and health care stocks, with the NASDAQ leading the way with a 14% gain, while the Dow Jones Industrial Average and the S+P 500 Index both logged respectable gains of over 8%. With dividends added, the S+P 500 has already matched in the first half of the year its average annual total return over the last 90 years. Even more impressive, the first-half rise was not punctuated by any sharp selloffs, with declines limited to no more than 2%, on only two occasions. The rally was exceptionally broad-based, with only the telecom and energy sectors declining sharply, as oil prices remained weak.

S+P 500

2,500
2,400
2,300
2,200

1/3/17 1/13/17 1/26/17 2/7/17 2/17/17 3/2/17 3/14/17 3/24/17 4/5/17 4/18/17 4/28/17 5/10/17 5/22/17 6/2/17 6/14/17 6/30/17

NASDAQ Composite Index

6,500
6,250
6,000
5,750
5,500

1/3/17 1/13/17 1/26/17 2/7/17 2/17/17 3/2/17 3/14/17 3/24/17 4/5/17 4/18/17 4/28/17 5/10/17 5/22/17 6/2/17 6/14/17 6/30/17

Dow Jones Industrial Average

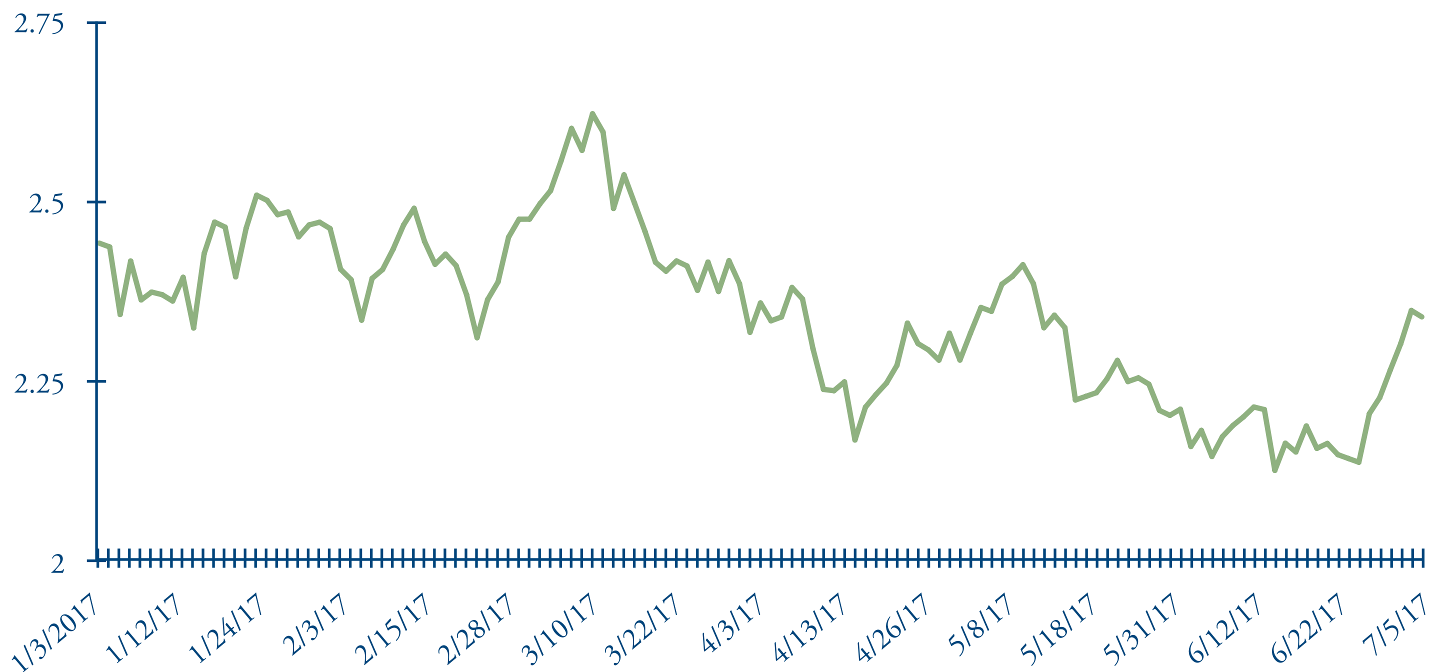
22,000
21,000
20,000
19,000

1/3/17 1/13/17 1/26/17 2/7/17 2/17/17 3/2/17 3/14/17 3/24/17 4/5/17 4/18/17 4/28/17 5/10/17 5/22/17 6/2/17 6/14/17 6/30/17

The bull market is now the second longest in history, at 100 months, exceeded only by the 1990-2000 bull market which lasted 113 months. What fundamental factors have powered the bull so far this year? First, corporate profits were strong in the first quarter, showing a gain of 12% over 2016's first quarter, for the second straight quarter of substantial growth after a "profits recession" of five quarters. The consensus outlook for the rest of the year is for profits to continue to grow at a 10% annual rate. Built into this forecast is an assumption that the Trump administration will achieve its goals in terms of health care reform, tax reform, and deregulation, all of which should drive corporate earnings higher, and thus provide still more fuel for a stock rally.

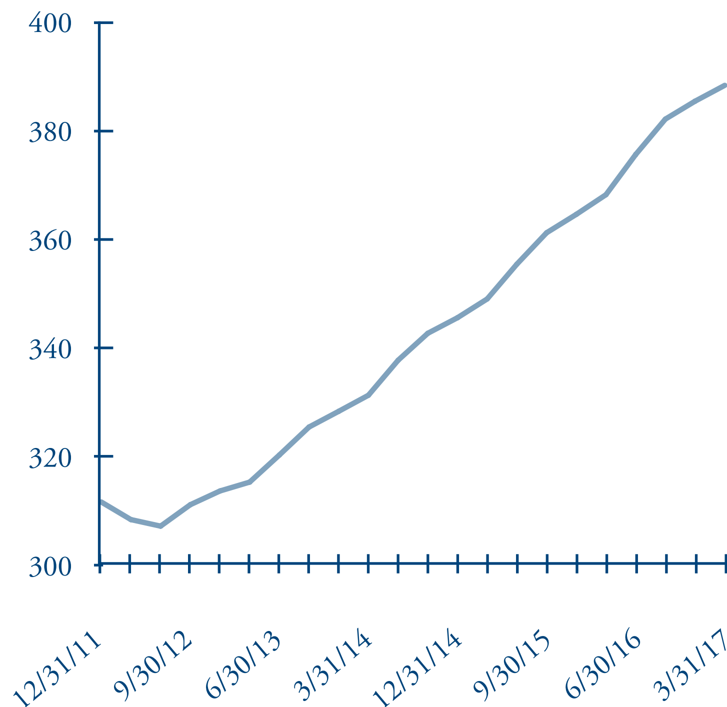
Second, monetary policy remains accommodative, meaning that the Federal Open Market Committee (FOMC) is still providing monetary fuel for a stock rally. Even though the FOMC did raise its nominal overnight benchmark Fed Funds rate by ¼% in both March and June, to a current range of 1% to 1¼%, this rate is still below the current rate of inflation of 1.6%. This means that the real (nominal minus inflation) Fed Funds rate is still below zero. The Fed has also hinted that this sensitive short-term rate may not exceed 1½% by the end of the year, meaning that the real Fed Funds rate will stay negative all year. Even more impressive, longer-term interest rates have fallen in 2017 even though short rates have been nudged up. The US 10-year Treasury rate has dropped this year from 2.45% to 2.30%. This decline not only drives bond prices higher, but makes stocks, which yield about 2%, and which compete with bonds for investors' money, even more attractive. In fact, if we factor in a rate of inflation of 2%, which is the Fed's target rate, the real 10-year interest rate is very close to zero. These low rates also stimulate economic growth

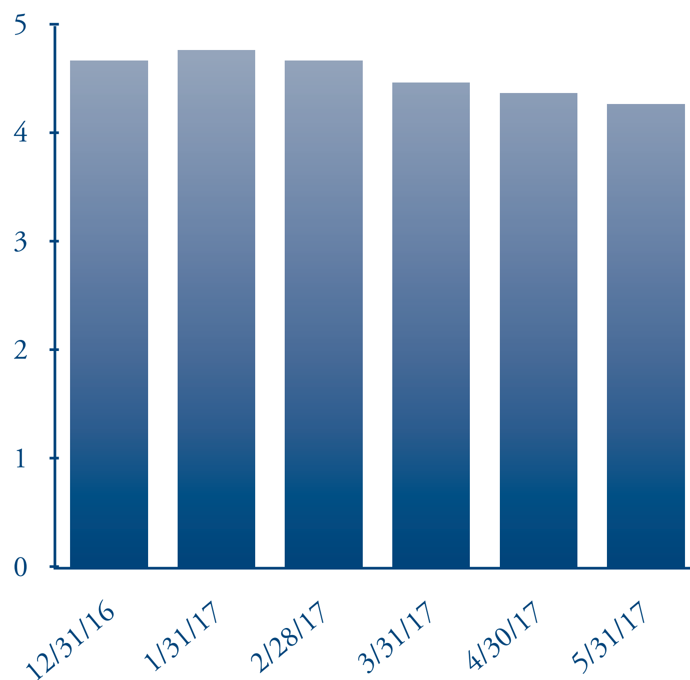
US 10-Yr Treasury Yield



(and thus corporate profits) by keeping the cost of borrowing low for consumers and businesses. For home refinancing, 30-year fixed-rate mortgages hovered around 3.85% at the end of June, while corporations with top credit were borrowing for 30 years at 4.5%. These low interest rates have fueled a continued rise in US home prices, and encouraged US corporations to borrow $750 billion in the first five months of 2017, up 45% from 2016.

The outlook on US interest rates may be even more favorable than the consensus forecast, since several FOMC members have suggested in public statements that the Fed might consider not raising rates again this year. Their reasoning may be that, with inflation still below the Fed's target, and the economy growing slowly, the Fed can continue to push the economy forward with very low rates. Indeed, the revised first-quarter real GDP growth for the US was very slow at 1.4%. This growth is expected to pick up in the rest of the year, however, with the Wall Street forecast for the second quarter of about 3% growth. What has clearly surprised many FOMC members, and many economists, is that wage and price inflation has remained low even though the US unemployment rate has dropped to 4.3%, its lowest level in 16 years. Under normal textbook conditions, this rate is low enough to force businesses to raise wages to attract workers, and then pass those higher wage bills on to consumers in the form of higher prices. The FOMC's "doves," who are more concerned with employment growth than inflation, may thus win the day in 2017, which will make the monetary environment even more favorable for US stocks. Although the

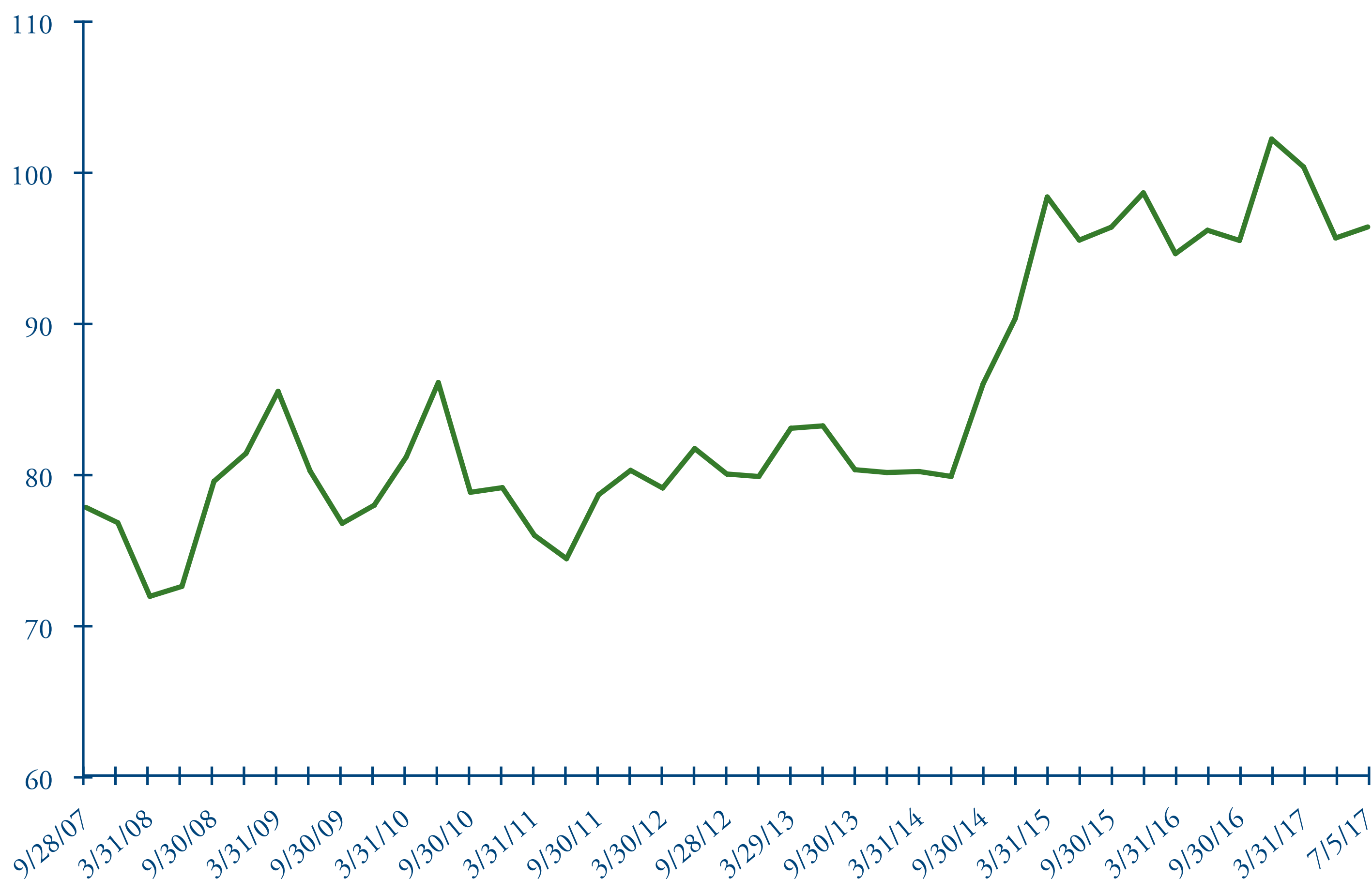




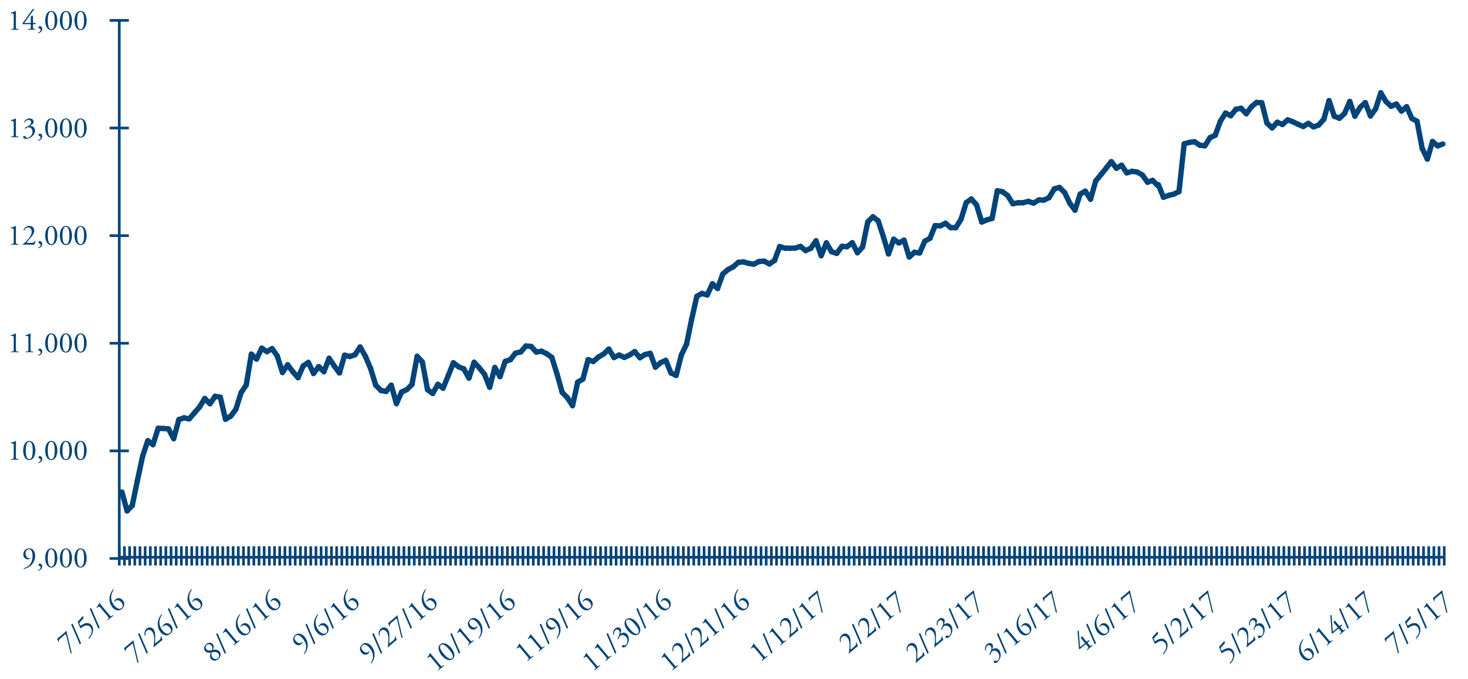
trade-weighted dollar remains historically strong, it fell 6% gradually throughout the first half of 2017, as currency traders decided that US interest rates would rise very gradually in the US this year, making the currency a little less attractive to "hot money" flows. A bit of weakening for the dollar is welcome news to US exporters, who will thus face a bit less of a currency handicap when competing with the rest of the world's exporters.

Monetary conditions are certainly favorable for stocks in most of Europe and Japan, too, where short-term nominal interest rates remain negative, a development that most economists used to think was well-nigh impossible. But it is not just short rates. At the end of June, the German government 5-year bond was yielding -0.23%, and the Japanese government 5-year bond was yielding -0.07%. As one would predict, this extraordinary monetary ease has driven the German stock market (DAX) up 27% in the last 12 months, and the Japanese market (Nikkei) up 28% over that time.

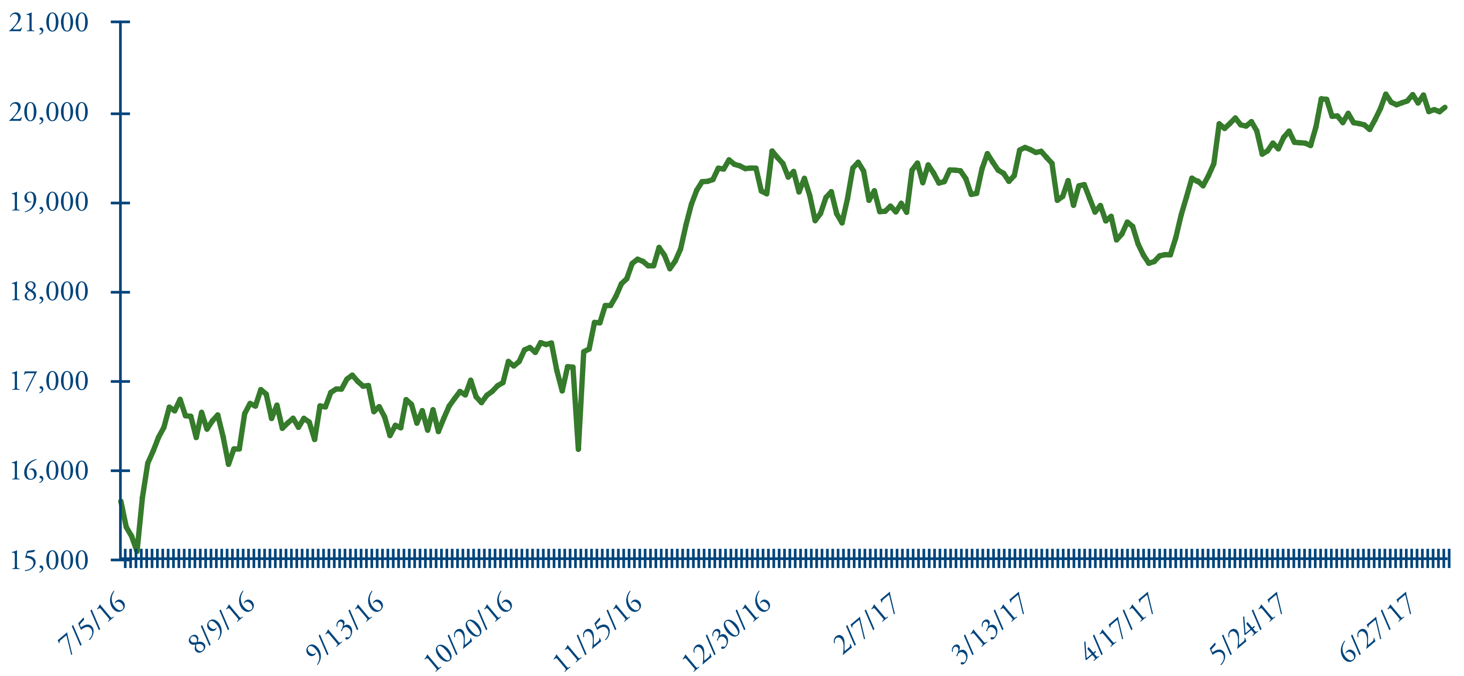
US Dollar Index



DAX



Nikkei



The power of easy money, driven in part by Quantitative Easing in both Europe and Japan, and further supported by very stimulative fiscal policy in Japan, may finally be sufficient to end stagnant growth in Europe and Japan. Historically low levels for the euro and yen (the counterpart to historical strength in the US dollar) have also stimulated exports from these regions. The EC (European Commission) estimates that GDP growth in the euro region will reach 1.7% in 2017. The OECD (Organization for Economic Cooperation and Development) estimates that economic growth in Japan may reach 1.4% in 2017, with corporate profits at record-high levels, and inflation very low, even though the unemployment rate in Japan is now below 3%.

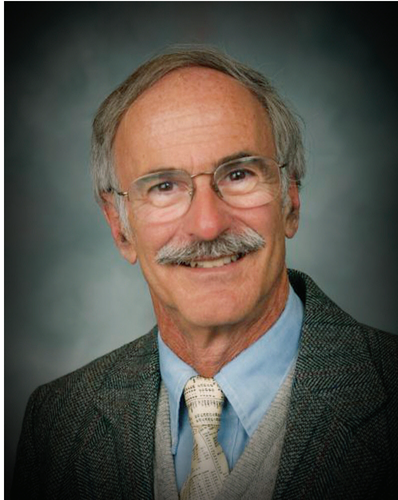
This sunny picture for the Eurozone and Japan is not mirrored by developments in the UK, where some of the fallout from last year's Brexit vote has hit the economy. First quarter growth was very slow at 0.2%, and the falling pound has driven inflation above 2%, as imports become more expensive. The Bank of England is close to raising interest rates to combat rising inflation, and this prospect held the FTSE Index to a subpar 2% gain for the first half of the year.

The economy in China continues to grow in excess of 6% a year based on official reports, although Chinese economic statistics may be overstating the growth rate. While this is a welcome slowdown from previous years of breakneck 10% growth, the level of debt (both public and private) in China has reached a worrisome level, and Moody's in May downgraded China's government debt to A1 from Aa3. (By comparison, the US rating is three notches higher.) In spite of the slowdown and rating downgrade, Chinese stocks rose 10% for the first half, in part because they will be part of the MSCI world Index for the first time, and in part because the Chinese government is likely to keep monetary conditions easy before the major Party Congress in the fall of 2017, when there will be significant leadership changes.

THE OUTLOOK FOR THE SECOND HALF

Monetary policy will remain expansionary in the US, Europe, Japan, and probably China, which should help support stock prices around the world. Bond prices in the US may have difficulty gaining even more ground, although the above-zero yields in the US are superior to negative yields in Europe and Japan, especially if the dollar were to gain more ground against the euro and the yen. With growth slated to pick up speed in the US and perhaps even Europe and Japan, and inflation nowhere in sight, the path of least resistance for US and most world equities is up.

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 context of the global economy.

Dan 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. Dan was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

Dan is the editor and publisher of The PAD System Report, an investment newsletter. He earned his Bachelor of Arts, Masters and Ph. D., all in economics, from Yale University.

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