Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – May

US Markets and Economy:

The long US bull market in stocks got back on track in May. Led by small stocks (the Russell 2000 was up almost 5% for the month to a new all-time high) and tech stocks (the NASDAQ rallied 5%) the broad market averages gained modestly, with the S+P 500 up around 2%, moving closer to its all-time high set early in the year. The gains were not achieved without brief selloffs, which have become common in 2018. The upward pressure clearly comes from a sharp acceleration in corporate profit growth, which has been fueled by the recent tax cuts. Further upward pressure comes from an apparent acceleration in US economic growth, although official GDP data for the April-June quarter will not be available until the end of July. The Atlanta Fed, which publishes its own estimates for current-quarter GDP growth, now expects the growth rate of real GDP to accelerate to 4.8%, which would be an outstanding number rarely achieved since the Great Recession ended in 2009. More evidence that the economy is beginning to fire on all cylinders is that the May growth in US employment (released June 1) showed strong monthly growth of 233,000 jobs and an unemployment rate of 3.8%, the lowest in decades. Even wages are rising a little faster, as the growth is being shared among more of the population. In spite of this growth, inflation remains tame at just about the Fed's target of 2%. These statistics describe a "Goldilocks" economy, with almost all the economic data "just right."

So where do the selloffs come from? In the Goldilocks story there are, appropriately enough, three bears. We ascribe the role of Papa Bear to the threat of a world-wide trade war, which almost all economists believe would be a major negative for all economies, and financial markets. If we review the relevant economic history of the 20th century, one of the proximate causes of the Great Depression was the passage by the US Congress of the Smoot-Hawley Tariff, which raised tariffs sharply on all of our trading partners, provoked retaliation, and leading to a near drying-up of world trade. (Almost all leading economists implored the Congress to not pass Smoot-Hawley.) Today, the threat of a trade war with China, and our allies Canada, Mexico, Japan, and Europe, has led to one-day selloffs, followed by rallies on the hope that cooler heads will prevail.

Mama Bear is played by the Federal Open Market Committee (FOMC), which is set to raise short-term interest rates by ¼-percent at its June meeting. Markets do worry that the FOMC might increase its pace of gradual rate increases if inflation picks up above the Fed's target of

2%, but the Fed's current thinking is that there is no reason to rein in the Goldilocks economy, which heartens financial markets.

Baby Bear is played by the Italians, the Spanish, and Europe in general. A one-day selloff in the US market was ignited by fears that a new Italian government might consider leaving both the Eurozone and the EU. Once these fears were allayed, US markets recovered nicely.

Any of these bears could again frighten US financial markets, but by the end of the month, all three seemed ready to sit down with Goldilocks for a nice bowl of hot porridge, with US stocks poised to move higher still.

World Markets and Economy:

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, rallied in the first part of the month, only to fall sharply as the Italians struggled to form a government. The net loss for the month was about 3%. Italian stocks led the way down, falling about 10% for the month, and Italian bonds were also weak, with yields on the 10-year bond rising from 1.8% to 3%, before a rally at the end of the month. (One of the great mysteries of the world bond market is that Italian bonds yield less than US bonds.) Troubles in Italy, where the new government will be composed of a right-wing and a left-wing populist party, were reinforced in Spain, where the government of Rajoy fell, with the Socialist Party now in control. Adding to Europe's troubles was a comment by a European Central Bank (ECB) member that it was time to wind down Quantitative Easing, which historically has fueled sharp rises in financial markets. These developments could keep Europe's stocks on the defensive in upcoming months.

Japanese stocks also fell in May. It appears that the Japanese economy contracted in the January-March quarter, which would break a streak of positive quarterly growth. Exports were weak, and the Japanese also face the possibility of US trade barriers on autos and a trade war with the US.

OUTLOOK:

The long-term path for US stocks remains upward, as a strengthening economy can further boost soaring corporate profits, while US monetary policy remains benign. This sunny outlook of course does not mean that brief squalls (as in May) will not continue to pop up, with Europe likely to be a source of instability. Long-term investors must, as always, stay the course.