THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – DECEMBER

US Markets and Economy:

US stocks stumbled to a weak close in December, which resulted in a nearly flat year for the S+P 500 and the Dow. (The NASDAQ recorded a small yearly gain.) For the month, the S+P 500 Index fell over 2%. The weakness in December, historically one of the strongest months of the year, may have been a result of the Fed's first increase in interest rates in many years. The increase was small (0.25%) and well-anticipated, but Wall Street may have become so accustomed to zero short-term interest rates that any increase was viewed negatively.

The positives of the increase were clear: the FOMC was signaling that the US economy was strong enough to grow even with slightly higher nominal short-term rates, which are still negative in real terms (after subtracting inflation). The negatives were also clear: with Europe and Japan still struggling, higher rates in the US should further increase the strength of the dollar, which hurts the earnings of America's multinationals. With S+P earnings already pulled down by weakness in the energy sector, the outlook for earnings growth in 2016 becomes even more clouded.

Yet the economic news for the month overall was good, with employment rising strongly again in November, unemployment steady at 5%, and inflation dormant at 1.5% (without food or energy) or 0% (with food and energy). While some further interest rate increases are likely in 2016, the stock market may be overlooking this good news. With inflation so low, the Fed can afford to raise rates very gradually. With wages still rising very slowly at an unemployment rate of 5%, the Fed may conclude that we have not reached "full" employment, a rate of unemployment that could set off wage inflation and then price inflation. With the dollar still strong, lower import prices should also contribute to lower inflation. Thus the Fed has the opportunity to keep monetary policy expansionary for at least one or two more years, which, with low inflation and a growing economy, is usually constructive for stock prices.

World Markets and Economy:

European stock markets outperformed the American market even as Europe remained in the economic doldrums. Although European shares fell in December, the Eurostoxx 600, a broad measure of European equities, rose over 5% for the year, once again showing the long-run portfolio benefits of geographic diversification. The same disconnect between stocks and economic growth appeared in Japan, where the Nikkei gained over 10% for the year, even with a down December, while the Japanese economy once again flirted with recession. In both Europe and Japan, the central bank is desperately following the US Fed's playbook with massive rounds of Quantitative Easing (QE), in addition to zero or negative short-term interest rates. But monetary policy may not be enough. The Japanese economy probably still needs the reform of labor and product markets promised by Abe. The Europeans are held back by lack of a unified fiscal policy. In the US, California, a rich state, does not fret about the fact that West Virginia, a historically poor state, receives twice as much in federal spending as it pays in federal taxes. In Europe, almost everyone in Germany frets about the fiscal assistance flowing to Greece. European policymakers must also contend now with a tsunami of migrants and the threat of domestic terrorism.

The Chinese stock market managed to gain in December, and rose 10% for the year. Volatility was extreme, however, with a 40% drop occurring in the summer. This collapse roiled world markets, as did the Chinese surprise devaluation of the yuan in August. Both of these events were driven by the sharply slowing growth rate of the Chinese economy, but it is impossible to know just how great the slowdown has been. The Chinese believe that the accuracy of economic statistics must take a back seat to politics. In any case, the slowdown continues to have repercussions among China's big trading partners, like Brazil. After a weak December, Brazilian stocks fell over 10% for the year, while inflation rose, the currency plummeted, and an unpopular president faced impeachment. In Argentina, however a new leader began to unwind the poor policies of his predecessor, and the Merval Index rose sharply after his election. Economic policy does matter.

OUTLOOK: US stocks took a well-deserved breather in 2015, and could muster another rally in 2016 as economic growth continues with low interest rates. While a strong dollar could further crimp earnings of US multinationals, domestic growth may be strong enough to boost profits. The outlook for the economies of Europe and Japan is less promising, but their stock markets may again disconnect from the economy, as in 2015. Perhaps the biggest cloud on the world economic horizon is China, the second largest economy, which is in the throes of a major slowdown. Tremors from China could once again roil markets around the world.