THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – DECEMBER

US Markets and Economy:

The “Trump Bump” continued in December, with US stocks breaking all-time records. The Dow Jones Industrial Average came within a hairsbreadth of piercing the 20,000 level, while the S+P 500 broke 2200 and the technology-heavy NASDAQ Index broke 5500. The post-election rally was very broad-based: the Russell 2000 Index of smaller-capitalization companies also reached an all-time high in December, more than tripling its 2009 bear-market low.

The fuel for the rally is still based on several anticipated trends in 2017 and beyond. First, economic growth will accelerate in 2017, as higher government spending on the military and infrastructure will be combined with across-the-board tax cuts on businesses and households, which will stimulate business investment spending and personal consumption spending. (Consumers are already reporting more confidence in the economic outlook for next year.) Second, repeal or weakening of government regulations and regulators of all kinds will further increase business profits. Third, the Supreme Court vacancy will be filled by a pro-business judge which will create a more business-oriented legal climate. These changes could lead to a sharp increase in corporate profits, which could give new life to the long bull market, driving stocks still higher in the years ahead.

The biggest raincloud in this sunny outlook is the Federal Reserve itself. The FOMC is quite likely to raise short-term interest rates several times in 2017, since the economy in November 2016 was fast approaching what most economists describe as “full” employment: an unemployment rate of 4.6%, less than half the peak rate in 2009. Steady growth in employment of close to 200,000 net new jobs per month has continued to chip away at what economists call “cyclical” unemployment, which only exists because the economy is not producing at its potential. Even at potential, however, millions of Americans are either between jobs, or searching for the first time, or are unemployed because their skills do not match the requirements of vacant positions. All of this so-called “natural” unemployment exists in any healthy dynamic market economy. What concerns the FOMC, and most economists, is that if the economy grows beyond its potential, pushing the unemployment rate below the “natural” rate, wage inflation and therefore price inflation will pick up steam, as businesses compete to hire from a shrinking pool of available workers. This "overheating" is analogous to running an automobile at a higher RPM than the red line on the tachometer.

Since the Fed's dual mandate is to promote maximum employment growth consistent with price stability, any signs of a further pickup in inflation will cause the Fed to tap the monetary brakes with more frequent increases in short-term interest rates in 2017. As the composition of the Fed becomes more conservative in 2017 with new Trump appointments, it is likely that the Fed will become even more hawkish about the potential for inflation. While stocks can certainly rally while interest rates are rising, very low short-term interest rates have often fueled powerful stock market rallies. Longer term interest rates have already jumped significantly since the election, suggesting that bond traders are anticipating an increase in inflation in 2017, and higher short-term interest rates.

Higher interest rates in the US could also spur further rises in the exchange value of the US dollar. Many billions of dollars of "hot" money seek both safety and high returns, which may drive further capital flows into the US, putting upward pressure on the dollar. The downside of this strong dollar is that US exporters will have a harder time selling abroad, which will weaken the demand for US goods and services.

World Markets and Economy:

European stocks surged upward across the board in December, driven in part by the US rally, and in part by further quantitative easing (QE) by the European Central bank (ECB). The ECB announced that its QE program would extend to at least the end of 2017, buying €60 billion of bonds every month. **Nominal short-term interest rates are still negative in Europe, and as seen time and again, very easy money is catnip for stocks**. As noted above, these interest rates drive hot money to the US dollar, weakening the euro and thus improving prospects for exporters in Europe. The collapse in the British pound since Brexit has done the same thing, and British stocks, particularly large multinationals, have surged. Even Italian stocks rallied very strongly, in spite of the resignation of Renzi after he lost a referendum on governance changes, and amid further worries about the financial health of Italian banks, which are burdened with nonperforming loans.

Japanese stocks also rallied sharply in December, to the highest levels of the year. Again, this rally is in response to extremely aggressive monetary ease, expansionary fiscal policy, and a sharply falling yen, which should stimulate exports. The Bank of Japan will continue to buy government bonds at the rate of almost $700 billion a year, keeping the 10-year yield at about zero. With signs that the Japanese economy may actually be growing, led by exports, it is once again possible that Japan will break out of its decades-long economic stagnation.

OUTLOOK: The US bull market finished 2016 with a powerful two-month rally to all-time highs. Since January is often (but not always) one of the strongest months of the year, the path of least resistance for US stocks is still upward. The rally in Europe may be harder to sustain, as political uncertainty in Europe and weak economic growth in the Eurozone could hinder stocks. If Japan has really turned the corner on economic growth, the rally there could even pick up steam.