THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JANUARY

US Markets and Economy:

US stocks fell hard in January, although a sharp rally at the end of the month cut into the losses. The selloff seemed to be driven by three factors: most importantly, there were signs that US economic growth was slowing again. Economic data for December, released in January, showed that retail sales were weak, businesses reduced inventories, and industrial production fell. Some economists even forecasted that fourth quarter US GDP growth would be zero. Since corporate profits are strongly influenced by the state of the economy, this was cause for concern. It is likely, however, that any slowdown in US growth will be temporary. The economic expansion, which began in 2009, has had numerous quarters of slow or no growth. Each slowdown has been followed by a resumption of the growth trend. Other data, such as employment growth, remain strong; consumer optimism remains high; and the housing sector, which was ground zero for the last recession, continues its multiyear recovery in both prices and new construction. Federal Reserve monetary policy is still strongly expansionary, with short-term interest rates near zero.

China's economy and stock market were the second big factor behind the US market's January blues. There is no doubt that the Chinese economy is slowing sharply after decades of breakneck growth. The size of the slowdown is controversial, however, since official statistics may be obscuring the extent of the slowdown. Since China's economy is now the second largest in the world, many countries that rely on exports to China, like Australia and Brazil, are directly impacted. Since the Chinese currency has also weakened further, countries that compete in world markets with Chinese exports, such as Vietnam, Thailand, and other Asian nations, either must let their currencies fall or risk losing export markets. At the same time, the bubble in Chinese stocks, which peaked in the summer of 2015, has continued to deflate, with Chinese stocks dropping another 20% in January. While these developments should have little direct effect on the US economy (our total goods exports to China are well below 1% of our GDP), the uncertainty about the extent of the slowdown in China, and doubts about the ability of the Chinese leadership to steer the economy onto a sustainable growth path, have weighed on financial markets around the globe.

The third big factor behind the decline was a further sharp fall in the world price of oil, which fell as low as $30 a barrel during January. (As recently as July 2014, the price was $100 a barrel.) While this is certainly a heavy blow to oil-export-dependent economies like Russia, Venezuela, and Saudi Arabia, this would normally be good news for oil-importing countries like the US. Standard economic theory suggests that a lower oil price keeps inflation low at the same time that it gives consumers the equivalent of a tax cut every time they fill up with cheap gasoline. This combination should spur GDP growth. Markets have chosen to focus instead on the effects of the oil price decline on companies in the energy sector. There is no doubt that energy firms from the oil giants to the small frackers have been hurt. But, at the same time, the auto companies are selling record numbers of cars and trucks, and the airlines are earning large profits.

Near zero inflation, and flows of hot money seeking the relative safety of US Treasuries combined to drive up the price of US bonds, and drive down interest rates. Stock investors holding high-quality bonds as part of a diversified portfolio had their stock losses cushioned by these bond gains.

World Markets and Economy:

European stock markets were dragged down by the same factors pulling US stocks down. Germany, in particular, relies on China for a significant percentage of its exports. Europe is also struggling to return to sustained economic growth, an elusive goal even with an aggressively expansionary monetary policy.

The rally in world stock markets at the end of the month was a direct response to another easing of monetary policy in Japan. The Bank of Japan (BOJ) surprised markets by reducing its reference interest rate below zero. Japanese stocks, which had been falling sharply in January, reversed course with a powerful rally which spilled over to the US and Europe. The European Central Bank (ECB) has already driven short-term rates below zero to stimulate economic growth. Neither the ECB nor the BOJ has yet found the magic formula to rekindle economic growth, but financial markets do like easy money.

OUTLOOK: US stocks got off to a bad start in January, but the bull market remains intact unless stock prices fall further in the rest of the year. The US economy is still growing, and the beneficial effects of cheap energy should still stimulate economic growth without inflation, giving the US Fed the opportunity to keep interest rates low this year. This scenario is still positive for stocks, but events in China could once again act as a damper on investors' sentiments.