Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JUNE

US Markets and Economy:

US stocks declined in June, pulled down at the end of the month by the escalating financial crisis in Greece. The Greeks were unable to make a payment due to the IMF, one of the three creditors of the Troika (ECB, IMF and EC) which has bailed out Greece several times in recent years. In the last days of the month, the Greeks closed their banks and financial markets to stem the bank withdrawals by Greek citizens and businesses fearful of a full-fledged default and exit from the Eurozone ("Grexit"). The troika was unwilling to extend its deadlines for a new bailout agreement and the Greek government was unwilling to accept the terms of the existing bailout agreement. Prime Minister Tsipras called for a Greek referendum vote on July 5th, which may mean no progress on a bailout deal will be made before then.

Although Greek debt crises and the threat of Grexit have repeatedly but temporarily pulled down US stocks, the US economy has been little affected. Although first quarter US GDP growth was revised to show almost no change, it is quite likely that the rest of the year will show much more respectable real growth of 2-3%, regardless of events in Europe. June data on housing, retail sales, consumer sentiment, and many other indicators show that the US recovery has underlying strength. The continuing strength in the housing sector is especially welcome: rising home prices improve American household balance sheets, and stimulate more new home building, which generates additional construction employment and incomes. Even a rise in mortgage interest rates in June has not dented housing demand.

Mortgage rates may continue to trend upward as the US Federal Reserve (Fed) moves closer to "liftoff," the start of short-term interest rate increases which will, after several years, return rates to "normal" levels. The Fed looks likely to begin liftoff in September, although the pace will certainly be slow and gradual, with real rates (nominal – inflation) still below zero well into 2016. The pace could be even slower if the US economy unexpectedly stumbles as a result of the Greek financial implosion. The Fed also has a lot of wiggle room on raising rates since inflation remains below the Fed's target of 2%. Although overall CPI inflation in June was almost zero, the underlying, or core rate of inflation after removing volatile food and energy, is running closer to 1½%. On the other hand, the labor market remains strong. Employment growth for May (reported in June) was very strong, and employment for June (due in early July) should also be strong. With unemployment (5.5%) at the top of the Fed's range of 5.0-5.5% for "full" employment, the FOMC may decide to start raising short-term rates well before inflation reaches their target of 2%. Monetary policy takes many months to affect the real economy, and the Fed does not want to let the economy overheat.

World Markets and Economy:

The story in Europe in June was Greece, Greece, Greece. Although European stocks were holding up well early in the month, the Greek crisis pulled them down sharply at the end of the month. While there is still time to pull Greece back from the abyss of full default and expulsion from the Eurozone, which is what all major players desire, the failure of negotiations increases the risk of implosion. The Greek economy would be devastated by a departure from the Euro, with living standards falling even further. The banking system would collapse without help from the Troika. These effects would spread to the rest of Europe, with much of Greek debt held by European institutions like the ECB. Since the Eurozone has no contingency for departure of a member, European stocks will be subject to further volatility as the crisis unfolds. The European economy is struggling to increase its anemic growth rate, and the Greek drama acts as a further brake on growth.

Asian markets have been relatively immune to the events in Europe, with Japanese stocks bulling their way to new recovery highs in the month. The Chinese market, however, outshone all others, with a continuing surge that bore all the hallmarks of a bubble: rapidly rising prices, extreme valuations (many small Chinese stocks were trading at 100 times earnings), and lots of public buying with borrowed money. By the end of June, Chinese stocks began a sharp descent that could continue regardless of events in Europe. The PBOC, the Chinese central bank, has little experience with stock market bubbles, and is preoccupied with slowing the Chinese economy to a sustainable growth rate of 7%, but not slower.

OUTLOOK:

US stocks lost their yearly gains at the end of June, driven down by the Greek crisis. The crisis will be resolved in the second half of the year, which should allow US stocks to resume their bull market, although the shock waves from events in Greece could continue to buffet all financial markets. European stocks will be under more pressure, however, since the Europeans will be more directly affected by events in Greece. Asian markets should be the least affected, although the overheated Chinese market may continue to correct its excesses. US bond prices may be especially volatile as the "flight to quality" pushes them higher, while the approaching liftoff to higher short-term interest rates in the US exerts downward pressure.