Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY

US Markets and Economy: American stocks made small gains in May, adding to modest gains recorded so far this year. Stocks are being held back by uncertainty over Federal Reserve monetary policy, conflicting signals on US economic growth, and continued fears that the stalled negotiations between Greece and its creditors will end in a European financial crisis and Greek exit from the Eurozone. **Wall Street's obsession with the timing of the Fed's first interest rate increase (called "liftoff") obscures the fact that short-term rates will remain extremely low for the rest of 2015 and probably well into 2016**. FOMC members have said as much. Several, including Chairwoman Yellen, have made public statements suggesting they expect rates to be increased very gradually from zero. In addition, the Fed has repeatedly stated that it will be "data-driven," meaning that any signs of slowing economic growth will make the upward path of interest rates even flatter. It is possible that the revised figure for first quarter GDP growth (-0.7%) is indeed a harbinger of another economic slowdown, but this is unlikely. At least two special factors dragged down growth early in the year: horrendous weather in the nation's east and northeast regions, and lingering effects of a West Coast dock strike, which disrupted trade and supply chains. It is also clear that the Commerce Department's seasonal adjustment algorithm unduly suppresses the figure for first quarter growth. **An alternative measure of the nation's output, which adds up all the incomes generated by production (called Gross Domestic Income or GDI), actually showed growth greater than 1% in the first quarter.**

Most forecasters expect GDP growth to pick up to a respectable 2-3% for the remaining three quarters. Corporate profit growth, however, may not reach even those levels. The decline in oil prices has dragged down profits in the energy sector, and the rising dollar has hurt overseas earnings of US multinationals, since their foreign currency earnings are worth less when converted to dollars. Slow growth in the economy and profits has not slowed down the boom in mergers and acquisitions, which also boosts stock prices, since takeover targets command significant premiums over their recent market prices. The M&A fever is strong enough that even a fictitious bid for Avon Products (apparently from a Bulgarian shyster) temporarily drove that stock higher until Avon denied the story, although the stock remained above its pre-“offer” level.

The continuing stalemate in Greece still casts a shadow on the stock market. No one knows whether the Greeks or their lenders will cave in and reach an agreement in time to stave off a default. No one knows what would happen to financial markets if a default occurred, and the Greeks left the Eurozone. While all parties expect a compromise agreement, and all parties state that it is best if Greece stays in the Eurozone, both sides have drawn “lines in the sand” which do not overlap. **Markets in the US, and Europe, will be jumpy until this uncertainty is resolved.**

World Markets and Economy: Europe’s economy may be bottoming out and beginning to grow. Some credit is due to Mario Draghi, whose European Central Bank (ECB) is pursuing Quantitative Easing (QE) with determination. European stock indexes were flat for the month, because good news on the economy was offset by increasing uncertainty about Greece. Government bond yields actually increased for the month, even though QE continues. Even the Swiss 10-year bond is now yielding above zero, since an economic recovery in Europe, if it does take hold, will mean a return of inflation (rather than deflation) and an eventual end to the ECB’s QE. The outcome of the Greek debt negotiations could easily trump all other factors affecting European stocks and bonds, though.

Asian stock markets had another good month in May. The Nikkei Index pushed well above 20,000, a level not seen in many years. Although the Japanese economy has yet to show sustainable growth, the injection of funds via QE has been enough to push stocks higher. The real excitement in stocks, however, is in China. The Shanghai Shenzen 300 Index broke the 5,000 level in May, and shows no signs of slowing down. This index is now up a whopping 150% in the last 12 months. The People’s Bank of China (PBOC) has been easing monetary policy in an attempt to keep the economic growth rate from falling below 7%. At the same time, the PBOC has failed in its attempt to cool speculation in the stock market, which may be forming a bubble. Millions of ordinary Chinese are opening brokerage accounts, and beginning to speculate in stocks. At the end of May, in one week, Chinese investors opened 4.4 million new brokerage accounts. Chinese are now allowed to have as many as 20 accounts, and many investors are opening new accounts to increase chances of getting in on hot new IPOs. The riskiest Chinese stocks are rising the fastest. Although the inevitable bursting of this bubble will hurt Chinese investors, it is unlikely to generate shock waves in other parts of the world. But a bursting of the Chinese stock bubble would still be another useful cautionary tale for long-term investors, who must resist the Siren Song of “get-rich-quick.” Slow and steady wins the race.

OUTLOOK:

US stocks can add to their cautious gains this year, driven by continued low interest rates, and a recovery in economic growth. But markets could weaken if the Greeks do default. That scenario is unlikely, but a first rise in US short-term interest rates is very likely. Rising rates will present a much more difficult environment for bond investors, and Wall Street stock traders may increase stock volatility too, as the era of zero rates comes to an end in the US.