THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – NOVEMBER

US Markets and Economy:

US stocks fell sharply in the first half of November, but a strong rally in the second half of the month retraced all of those losses. The pattern for November has been repeated all year: sharp rallies have alternated with sharp selloffs, so that after 11 months, stocks are just about where they started the year. The pattern for the month and year reflects the economic crosscurrents in the US and world economies, and the uncertainties about the future course of US monetary policy. FOMC members spent much of the month preparing the financial community for "liftoff," the first increase in US short-term rates in many years, but uncertainty about 1) the exact timing of the first interest rate increase, 2) the timing and extent of rate increases in 2016, and 3) the effects of these increases on the US and world economy, kept markets from sustaining either rallies or selloffs. By the end of the month, it was quite clear that the Fed was ready to raise rates by 0.25% at its mid-December meeting. It was also quite clear that the Fed intended to follow a gradual path of increases in 2016, which could leave short-term rates below 1% for most or all of 2016. This would still represent strongly expansionary monetary policy, but after nearly seven years of absolute zero rates, combined with multiple doses of Quantitative Easing (QE), many on Wall Street are still skittish about the prospect of positive and rising interest rates.

While daily gyrations caused by this skittishness of traders are of little concern to long-term investors, the rate of economic growth in 2016 does have major import for stock prices. The outlook here is good, especially compared to Europe and Japan. The US economy continues to grow at a steady pace between 2 and 2.5% in real terms, while the labor market continues to recover, with unemployment holding at 5% while monthly job gains continue at 200,000 per month or more. Wages have also been rising at a little more than 2% annually, which is slightly above the inflation rate of 1.5%, after taking out the effects of volatile food and fuel prices ("core" inflation). This steady growth should not be derailed by modest interest rate increases in 2016, which will still leave real (after adjusting for inflation) short-term rates below zero at the end of 2016.

The FOMC can safely follow such a leisurely pace of increases because inflation has remained quite tame even though the labor market has gradually approached "full" employment. At "full" employment, further growth has historically triggered sharper rises in wages, which then feed into business costs and eventually prices, often necessitating a bout of “tight” money by the Fed to keep inflation contained. One reason inflation has remained so tame in recent years is that the international value of the dollar has been rising. Rate cuts in Europe, Japan, and even China, combined with expected rate increases in the US, have made dollar assets more attractive, thus pushing up the exchange value of the dollar. This rise in itself helps keep inflation low, since it makes the prices of imported goods cheaper in dollars. It also acts a mild brake on US growth, since it makes our exports look more expensive in other currencies. This braking effect of the rising dollar means the Fed can follow an even slower path of rate increases, since each increase’s effect is slightly magnified by the dollar’s rise.

Once Wall Street traders become acclimated to the new regime of gently rising but still low interest rates, the volatility on Wall Street may subside, although the reality of slow growth in corporate profits in 2016 will act as a headwind for the bull market in 2016.

World Markets and Economy:

The mirror image of the dollar’s rise is the fall in the exchange value of the euro and the yen. Economic growth in Europe has been painfully slow, while unemployment in the Eurozone has remained stuck above 10%, while inflation is so low to arouse fears of Japanese-style deflation. The European Central Bank (ECB) is engaged in a massive program of QE, and has kept short-term interest rates below zero. Banks must pay for the privilege of keeping reserves at the ECB. In theory, this should encourage more bank lending and expansion, and also drive down the euro to stimulate exports, but these “lagged” effects have yet to jumpstart the Eurozone economy. Not surprisingly, the EUROSTOXX 50 Index, a “Dow Jones” of Europe, limped to a small gain in November (which was quickly wiped out in early December).

The Japanese economy also continues to struggle after two consecutive quarters of negative GDP growth, even though the Abe government continues with its own aggressive program of QE and also fiscal stimulus. According to all the economics textbooks, expansionary monetary policy combined with expansionary fiscal policy and a weak currency should drive an economy to grow. While the Japanese stock market rallied in November as a direct result of continuing easy money, Japan’s GDP is forecasted to rise only about 1% in 2016.

The Chinese economy is faring better than Japan’s, but the slowdown in growth in China has been substantial. Official statistics understate the extent of the slowdown, which may have reached 4% real growth. While this number is strong by world standards, it is a sharp decline from the many years of 10+% real growth. Since China’s economy is now the world’s second largest, a slowdown here has ripple effects on all the resource-exporting countries supplying China with raw materials, like Australia and Brazil.

OUTLOOK: US stocks may still be the best game in town. A strong dollar both reduces returns in other currencies, and reflects better economic growth prospects here vs. Europe and Japan. With monetary policy remaining stimulative in the US, the bull market could remain intact for yet another year.