The Reilly Report:

THE REILLY REPORT: 2018 MID-YEAR REVIEW AND OUTLOOK

The bull market in US stocks rolled on in the first half of 2018, although the net gains for the first six months of the year were relatively small. The broad-based S+P 500 Index rose less than 2% (not counting dividends). The technology-heavy NASDAQ Index was the strongest of the major indexes, rising almost 9%, while the venerable Dow Jones Industrials actually lost nearly 2%. The outperformance of the NASDAQ was driven by new-tech companies like Apple, Facebook, Amazon, and Google (now Alphabet), while the Dow was held back by "old" industrials like GE, which was in fact kicked out of the Dow in June after over 100 years in the index.

S+P 500

2,900
2,800
2,700
2,600
2,500

12/29/2017 01/08/2018 01/16/2018 01/23/2018 01/30/2018 02/06/2018 02/13/2018 02/21/2018 02/28/2018 03/07/2018 03/14/2018 03/21/2018 03/28/2018 04/05/2018 04/12/2018 04/19/2018 04/26/2018 05/03/2018 05/10/2018 05/17/2018 05/24/2018 06/01/2018 06/08/2018 06/15/2018 06/22/2018 06/29/2018

NASDAQ
Composite Index

8,000
7,500
7,000
6,500

12/29/2017 01/08/2018 01/16/2018 01/23/2018 01/30/2018 02/06/2018 02/13/2018 02/21/2018 02/28/2018 03/07/2018 03/14/2018 03/21/2018 03/28/2018 04/05/2018 04/12/2018 04/19/2018 04/26/2018 05/03/2018 05/10/2018 05/17/2018 05/24/2018 06/01/2018 06/08/2018 06/15/2018 06/22/2018 06/29/2018

Dow Jones
Industrial Average

27,500
26,500
25,500
24,000
23,500
22,500

12/29/2017 01/08/2018 01/16/2018 01/23/2018 01/30/2018 02/06/2018 02/13/2018 02/21/2018 02/28/2018 03/07/2018 03/14/2018 03/21/2018 03/28/2018 04/05/2018 04/12/2018 04/19/2018 04/26/2018 05/03/2018 05/10/2018 05/17/2018 05/24/2018 06/01/2018 06/08/2018 06/15/2018 06/22/2018 06/29/2018

Figure 4: ***Corp Profits*** *($ billion)*

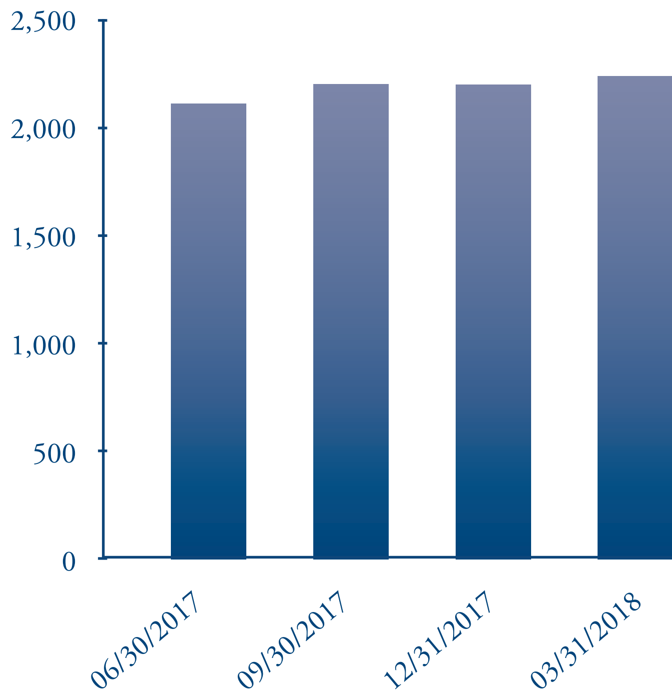
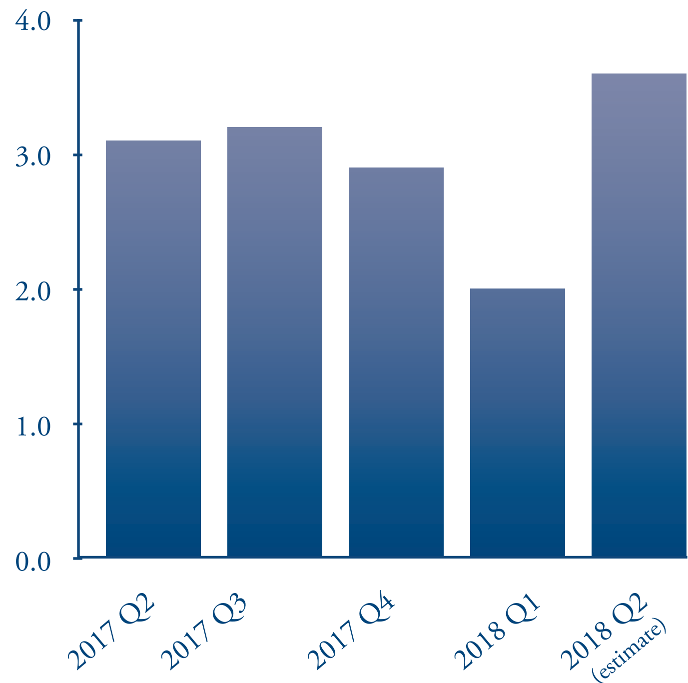


Figure 5: ***US Real GDP*** *(% change at annual rate)*

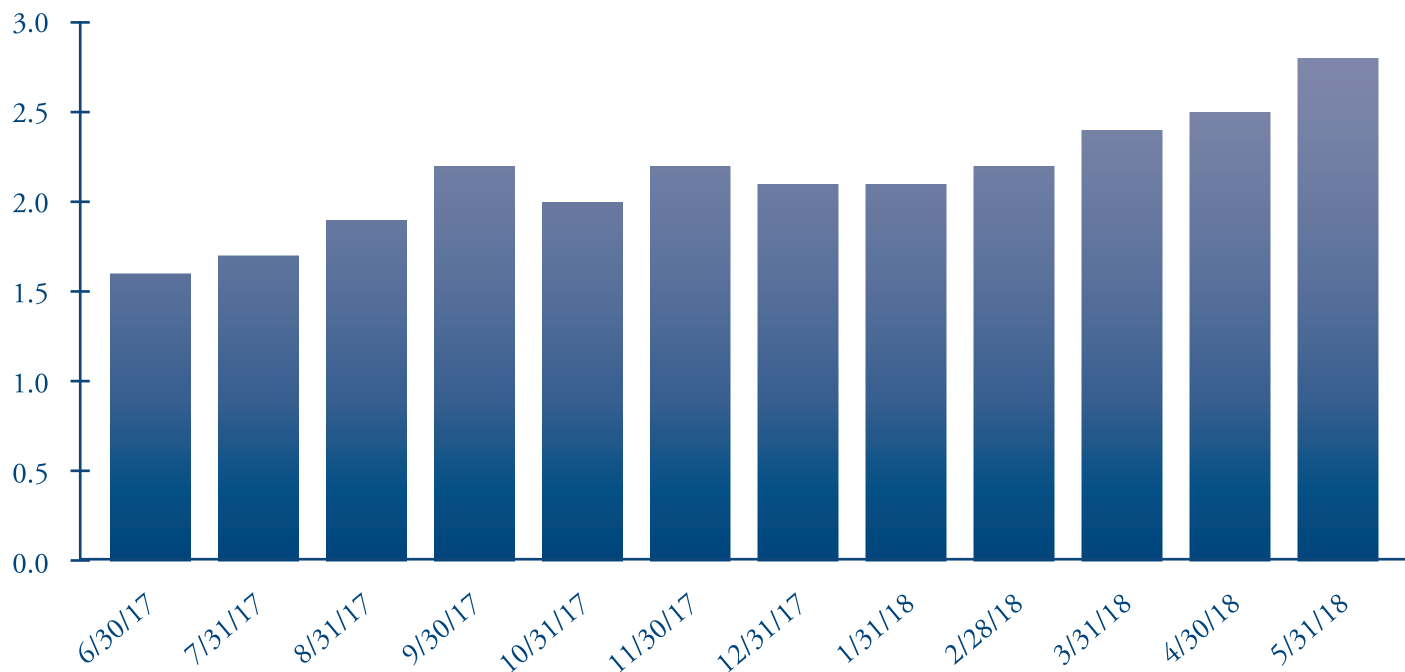


The small gain in the S+P 500 masked a first half which was much more volatile than 2017's smooth and steady rise. After a sharp rise in January to new all-time highs, stocks fell sharply in February, in their first 10% correction in over two years. The proximate cause was a sudden fear that wage inflation was rising, which could lead the Fed to raise interest rates more sharply than previously planned. Although stocks recovered almost as quickly as they fell, each rally has been stopped in its tracks by renewed fears of a trade war between the US and its major trading partners. Rising labor costs or a trade war would be much more costly to "old" Dow industrials like Boeing and Caterpillar, while the NASDAQ's fast-growing Amazon and Facebook seem impervious to both.

Yet all US stocks are benefitting from a sharp rise in corporate profits driven by reductions in corporate taxes and stronger economic growth. Corporate profits rose almost 20% in the first quarter of 2018, to over $2.2 trillion, and are expected to continue rising sharply for the rest of 2018. At the same time, US economic growth may be speeding up, with many estimates for second quarter (April-June) real GDP growth of 3.5-3.8%, much stronger than the 2-3% rates logged during recent years.

In a bit of a positive surprise, inflation remains relatively tame, although it has picked up this year to over 2%, based on the Consumer Price Index. (The Federal Reserve's preferred measure of inflation is running at only 2%, since it excludes

Figure 6: ***CPI*** *(year over year % change)*



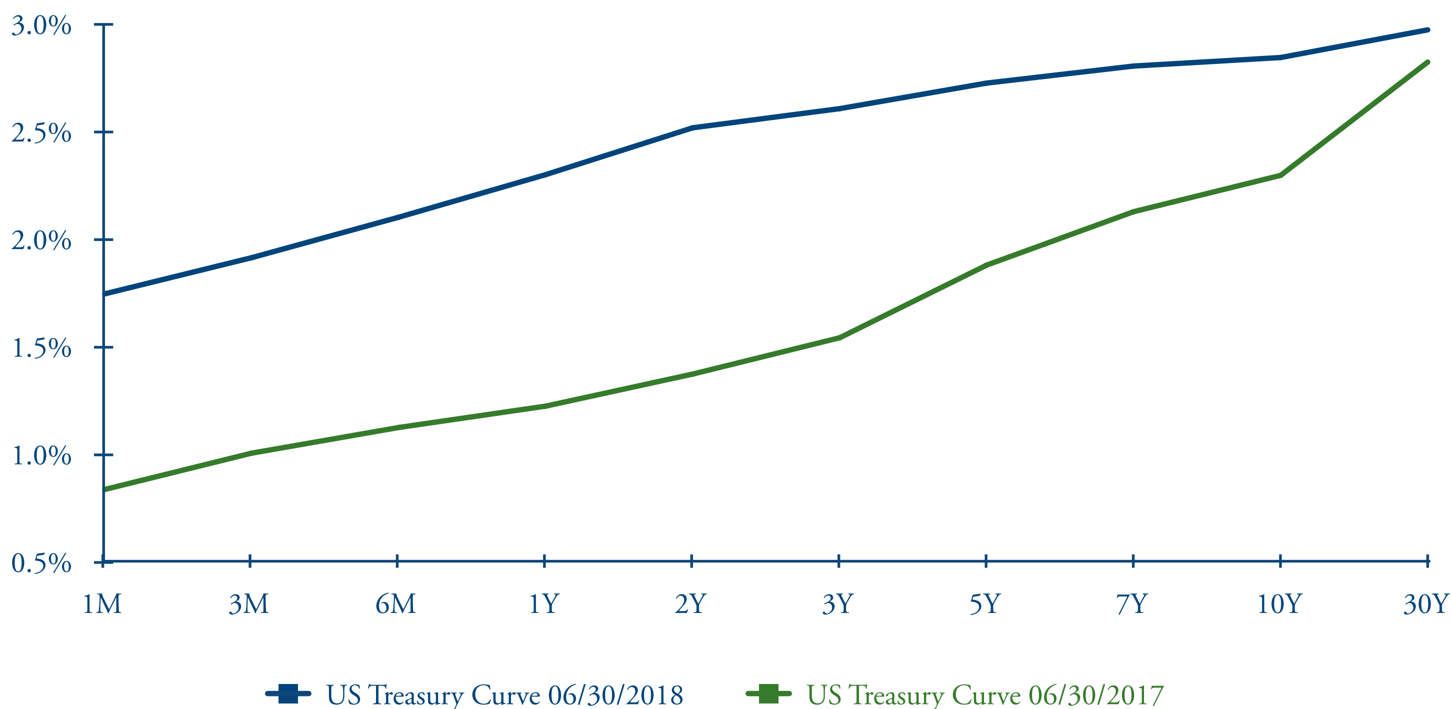
food and energy.) Wage inflation, which has also picked up a bit this year, is still relatively tame, even though the US unemployment rate dropped as low as 3.8% in May, the lowest rate in decades. While many economists would have expected such a "tight" labor market to lead to more wage inflation, it seems for now there are enough potential workers reentering the job market in the US for companies to expand employment without wages rising significantly.

These economic trends provide the upward pull for stock prices. This year, however, we have seen a "tug-of-war," as fears of 1) trade wars and 2) rising interest rates have exerted downward yanks on stocks. President Trump has long complained that international trade flows are "unfair," and that the US is "losing" on trade with its main trading partners because we import more than we export, especially vis-à-vis China. One solution to this problem is to create barriers to other countries' exports, normally in the form of tariffs, which impose a tax on goods coming into the US. So far the US has imposed tariffs on steel and aluminum imports, and is in the process of imposing more tariffs on a variety of goods from our main trading partners, including China. Our partners have imposed tariffs on our goods in retaliation, in particular, targeting red states (Kentucky bourbon) and companies previously praised by President Trump (Harley-Davidson motorcycles). This tit-for-tat game, which is still in the molehill stage, could turn into a mountain if all parties continue to retaliate until the world has a full-scale trade war. Almost all economists agree that full-scale trade wars result in net losses for all trading countries

(even though protected industries gain) and these losses could be big enough to reduce corporate profits for exporters and/or speed up inflation, as domestic goods increase in price in response to tariffs. These outcomes could create a headwind for stocks in the second half.

Problem two: even though interest rates are rising very slowly at the short end of the "yield curve," as the Fed gradually reduces monetary accommodation, Wall Street traders still fear that the Fed could decide to raise rates faster over the next 12 months. This could happen if inflation were to pick up speed in the second half of the year and breach the Fed's 2% target on the upside. If the US economy is really close to "full

Figure 7: ***Yield Curve***



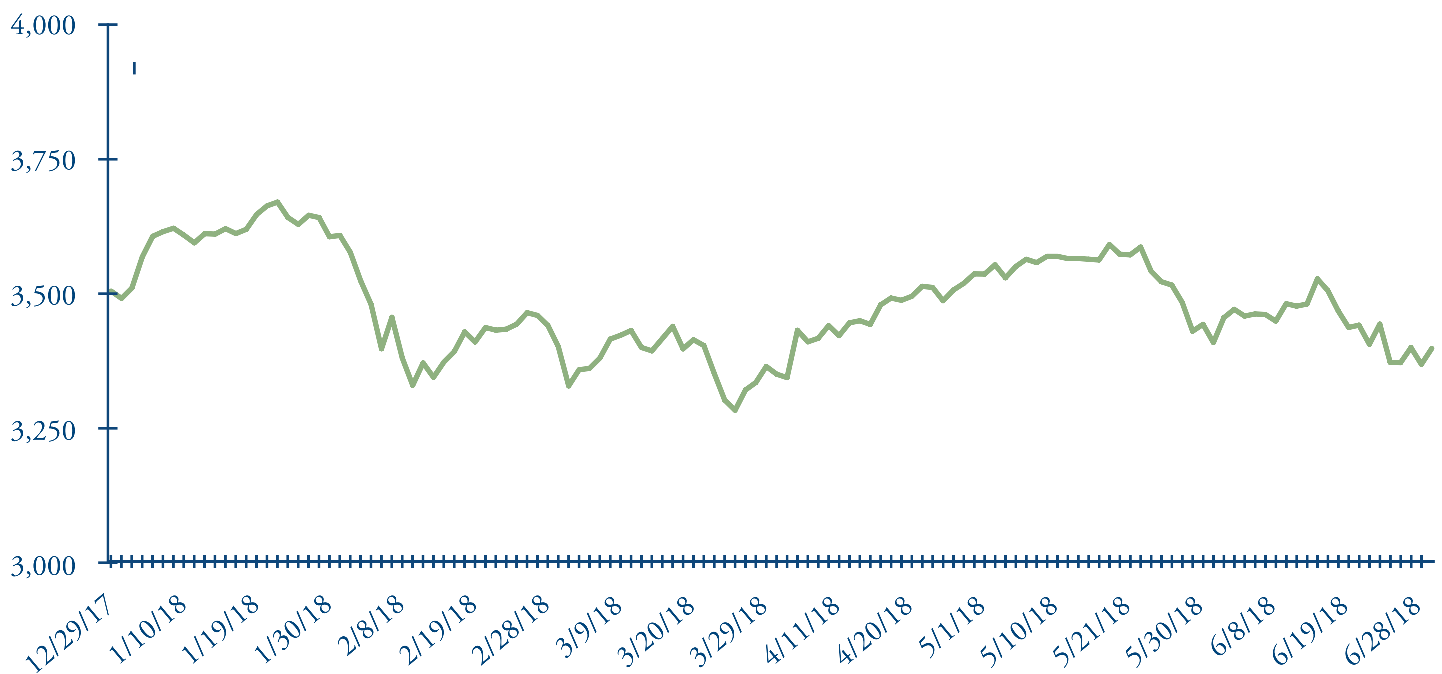
employment" at 4.0% unemployment, it is still possible that wage and price inflation could pick up in the second half of the year, although many economists who have been predicting this outcome for some time have been repeatedly disappointed. The Fed itself believes that unemployment could fall as low as 3.5% this year, without inflation rising above their target. Yet the Fed could still have an itchy trigger finger in the second half of the year because the new guy in charge (Powell) may want to show that he will be tough on inflation, in order to keep the Fed's inflation-fighting credibility. (Every central bank wants the public to be sure that monetary policymakers will keep inflation low.) The FOMC may also have a bias toward inflation-fighting (vs economic growth) since the current committee has more regional Bank Presidents (5) than Board of Governors

(3) members. Historically, Bank Presidents tend to lean more toward inflation-fighting ("hawks") than promoting growth ("doves"). It may be many months before the FOMC is back at full strength, and some of the proposed nominees to fill the four vacancies on the Board of Governors are well known as inflation hawks.

Some nervous Wall Street traders also note that the Fed's tightening so far has made the US Treasury yield curve flatter, that is, long rates have hardly budged while short rates have risen. If short-term rates were to rise above long-term rates (called an inverted yield curve), past history would suggest that there would be an increased danger of recession at some point in the future. The bulls can counter this argument by pointing out that the yield curve can flatten without inverting, and that rising short-term rates could eventually push up long-term rates somewhat, preserving the upward-sloping yield curve for years into the future. So the tug-of-war continues.

Monetary conditions are still favorable for stocks in most of Europe and Japan, although the European Central Bank (ECB) has announced plans to end its Quantitative Easing (QE). When the US Fed announced an end to QE, there was a temporary selloff in stocks (called the "Taper Tantrum") which then quickly led to another leg up for the long bull market. European stocks may not be so lucky though, since economic growth is slowing, and Europe has even more to lose from a trade war with the US. The German DAX Index fell almost 5% for the first half, partly reflecting trade worries for Europe's export powerhouse, but the big blue-chip measure for Europe, the EUROSTOXX 50, dropped only 3½%. Another fear is that the ECB

Figure 8: ***Euro Stoxx 50***

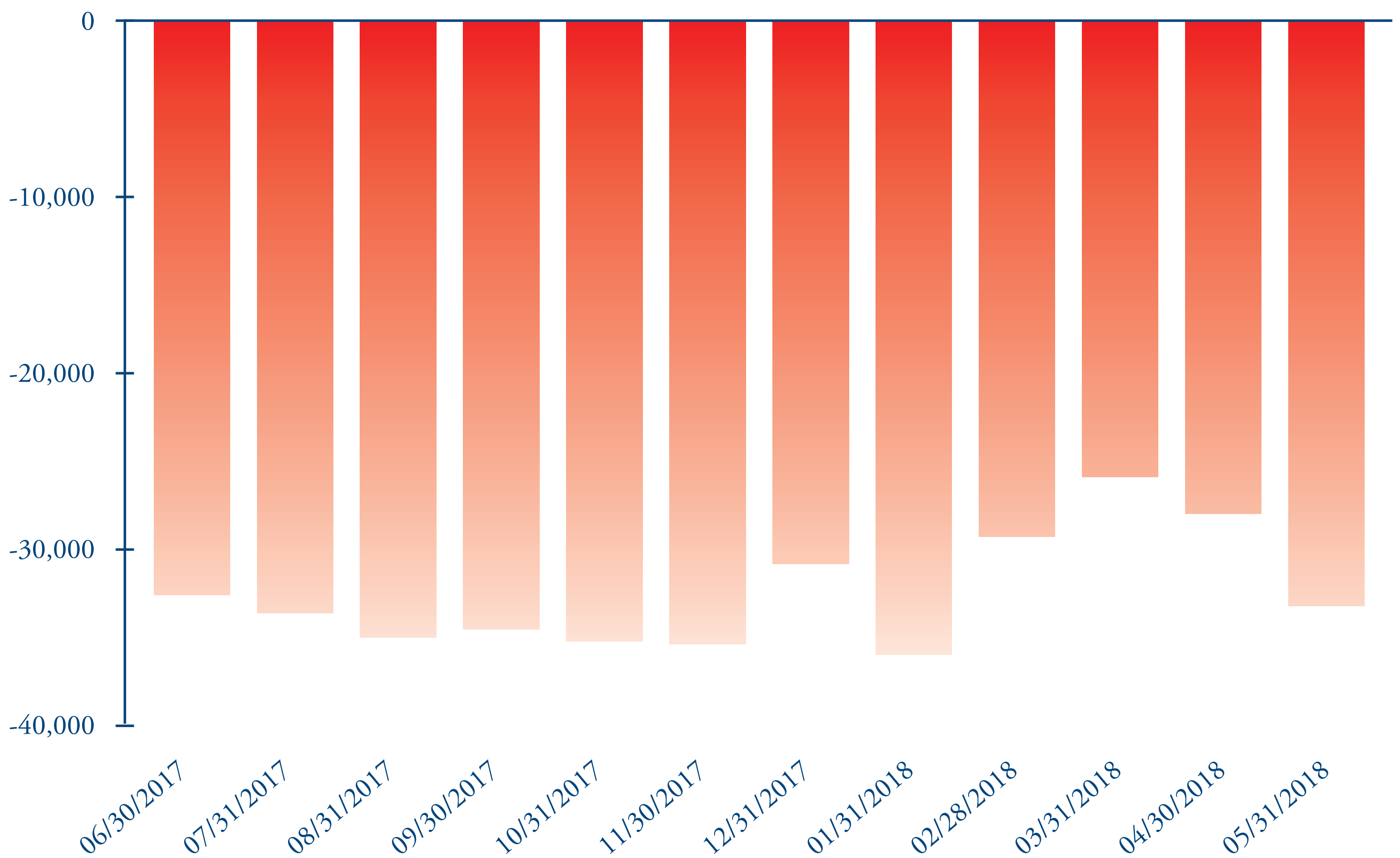


may not be able to provide enough monetary stimulus for the European economy if a full-scale trade war develops. Europe must also contend with the political uncertainty of Chancellor Merkel's shaky coalition government, and Italy's bizarre left-right populist coalition government, high debt, and weak banks. Italian stocks fell over 10% from their peak in early May to the end of June.

Japanese stocks also fell for the first half, with the Nikkei down around 2%. The Japanese rely heavily on exports too. At the same time, Japanese growth stalled out in the first quarter, with a small decline in real GDP after almost two years of steady, albeit, slow growth. While the economy is expected to recover in the second quarter, the cloud of a trade war will hang over Japanese stocks, even with continued monetary and fiscal stimulation.

The economy in China continues to grow at around 6%, but it is possible this rate will decline this year as the Chinese try to restrain bank lending and deal with the possibility of a trade war with the US. The Chinese do run a large trade surplus with the US, which President Trump seems determined to shrink with tariffs. These twin problems of slowing growth and trade battles have caused Chinese stocks to shift into reverse, with the Shenzhen Index falling 20% from its peak this year, in what is the standard definition of a bear market.

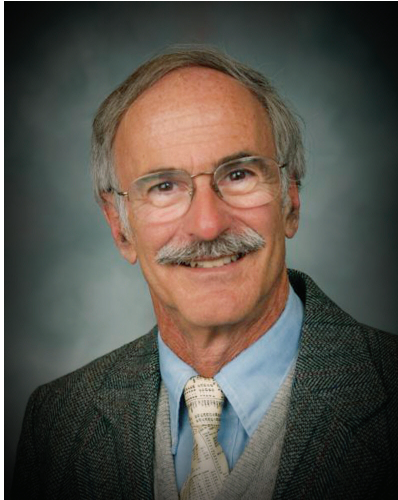
Figure 9: ***US Trade Balance with China*** *($ millions)*



THE OUTLOOK FOR THE SECOND HALF

Monetary policy will remain modestly expansionary in the US, Europe, Japan, and probably China, which should help support stock prices around the world. With corporate profits soaring in the US while economic growth speeds up, US stocks can continue to gain ground, although fears of a trade war and rising interest rates could make the path upward volatile and rocky, as it was in the first half of the year. European and Japanese stocks may periodically lag behind, since growth is not as strong in Europe or Japan, and both Europe and Japan have even more to lose from a trade war with the US.

About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Daniel enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within context of the global economy.

Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

Daniel is the editor and publisher of The PAD System Report, an investment newsletter. He earned his Bachelor of Arts, Masters and Ph. D., all in economics, from Yale University.

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