Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – SEPTEMBER

US Markets and Economy:

US stocks had another flat month in September, but the bulls remain firmly in control. Every selloff has been followed by a rally which restores the lost ground. In September, the first selloff (400 points on the Dow) was in response to a suggestion by an FOMC (Federal Open Market Committee) member that interest rates could be raised at the September FOMC meeting. Stocks in 2016 have been supported by extremely low interest rates, and thus traders fear even the smallest increase. When it soon became clear that the Fed was unlikely to raise rates at the September meeting, stocks promptly recovered their losses. The second selloff came at the end of the month after it was reported that Germany's Deutsche Bank (DB) might be in financial trouble. US regulators are seeking $14 billion in fines from the bank for alleged misbehavior during the world's housing credit bubble. After assurances from the bank, and stories that the actual fine would be much smaller, both DB stock and the US stock market recovered.

Both selloffs are reminders that the stock market climbs a "wall of worry." When one of these worries is accentuated (short-term rates may rise) traders rush to sell stocks, and then, when the fearful calm down, traders rush to buy again. Psychiatrists would call this bipolar disorder, and recommend medication, but this short-term outlook is standard practice on Wall Street. Long-term investors realize that eventually the Fed will slowly raise short-term rates as the economy continues to recover, but interest rates are likely to remain low for some time. Economic growth in the US is still slow by historical standards, and may not even reach 2% in real terms this year, even after seven years of recovery from the Great Recession. With inflation extremely low, the Fed has the luxury of waiting, and can raise rates very slowly. It is likely that the Fed will raise short-term rates ¼-point in December, and FOMC members will try to prepare skittish traders for this upward nudge. If the economy continues to plod ahead, the Fed may engineer a few more "nudges" in 2017, but short rates could easily remain below 1% for most of the year. **This is accommodative monetary policy, and it is a strong support for stocks.**

The second brief selloff was sparked by worries of another "Lehman Brothers" moment for financial markets, and revived memories of the financial cataclysm of 2008. But Deutsche Bank is not Lehman Brothers, an investment bank which was mismanaged into a titanic bankruptcy. Banks in the US are much stronger now and less leveraged than they were before the last crisis, and they are better regulated. All have passed "stress" tests which show they can survive adverse economic conditions.

World Markets and Economy:

What is true, however, is that European banks are not as healthy as American banks, the European economy is not as healthy as the American economy, and the European Central Bank (ECB) must continue to pursue massive "Quantitative Easing," and negative nominal interest rates, to stimulate a weak European economy. Europe must also confront the costs of British exit (Brexit) from the European Union, which will likely take place over the next two years. The exact timing of the exit is still unclear, and the extent of the economic losses is not yet known. Surprisingly enough, British stocks have rallied strongly since the shock of the Brexit vote, and the FTSE 100 is again challenging its 2015 high of 7000. Much of this gain must be put down to the fall in the British pound, which has sunk more than 10% since the Brexit vote. A weak pound will stimulate exports, which should drive the economy forward. Currency depreciation (the Euro is also weak) often leads to inflation, but there is little sign of inflation anywhere in Europe. At the other extreme, the Italian stock market was weaker than the rest of Europe, largely because the weak Italian banking sector is still burdened with bad loans (15-20% of all loans), and Italian bank stocks have been in their own bear market this year. Many bank loans are construction- or property-related, and housing prices are still falling in Italy.

Economic weakness also persists in Japan. In spite of heroic efforts by Abe, the economy continues to stagnate and deflation has not been vanquished. Wildly expansionary fiscal and monetary policy has yet to jumpstart the Japanese economy. The persistent weakness has taken a toll on the Japanese stock market, which had responded strongly in the early days of fiscal and monetary stimulus. In September, Japanese stocks ended the month with a thud and they remain in a bear market, more than 20% below their 2015 bull-market high.

OUTLOOK:

The US stock market is holding on to its gains for 2016: The S+P 500 Index is ahead a very respectable 7.8% for the year on a total return basis. Stocks are historically very strong in the November-January period, which is approaching. Low interest rates around the world are also supportive of stocks. However, long-term investors are earning these handsome returns in a long bull market only by ignoring the day-to-day gyrations of skittish short-term traders, as we have seen once again in September.