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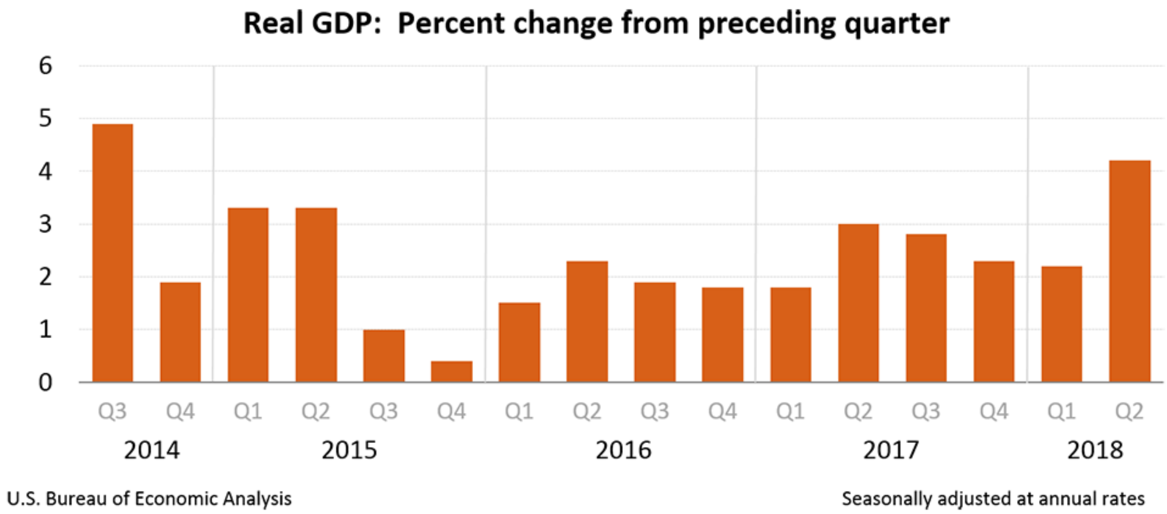
THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST

US Markets and Economy:

US stocks rallied strongly in August, with the broad-based S+P 500 Index reaching an all-time high above 2900. The technology-driven NASDAQ led the way, breaking through the 8,000 barrier to score another all-time high. Among the best-known indexes, only the venerable Dow Jones Industrial Average failed to reach an all-time high. The DJ did manage to push through the 26,000 mark and finished the month with a solid gain. Overall, the bull market also reached a milestone for length, becoming the longest in modern US history.

Corporate earnings were still the main story driving stocks higher. The second quarter (April-June) was at least as strong as the first quarter, with profits rising at better than a 20% pace. Improvement was broad-based, as the energy sector recovered (oil prices are 40% higher than a year ago), and the tech sector, led by Apple and Amazon, continued to surge. Both of these companies reached the once-inconceivable milestone of a $1 trillion valuation. Many firms benefited from lower corporate taxes, and a surging economy.

The latest estimate for second-quarter real GDP growth was revised slightly upward to a powerful 4.2% annual rate, which as the graph below shows, was up sharply from the first quarter, and the strongest in almost four years. The Commerce Department also reported that broad-based measures of inflation were running at about 2% in the second quarter, which is also good news. The Fed’s favorite indicator, the Personal Consumption Expenditures (PCE) price deflator, excluding food and energy, rose at exactly a 2% rate. (The most popular measure of inflation, the Consumer Price Index (CPI) is actually running above 2%, but it is heavily influenced by rising energy costs, which are quite volatile.)



Many economists have been surprised that the economy, which has been growing steadily since the end of the Great Recession, has been able to surge ahead without igniting more inflation. With the US unemployment rate at a historically low 4%, wages would normally begin rising faster as competition for workers intensifies, which would then put upward pressure on prices as businesses attempt to maintain profit margins. This has not happened yet, even though the number of vacancies in the economy has actually exceeded the number of unemployed workers for the first time since this ratio has been calculated. Whatever the underlying cause, moderate inflation means the Fed can return short-term interest rates to “normal” at a leisurely pace. The FOMC will likely raise short-term rates by ¼ point two more times this year, which will finally, after a decade, bring short-term nominal interest rates above the rate of inflation, which means the “real” interest rate (nominal minus inflation) will be positive.

The US economy can certainly continue to grow with positive real interest rates, since the last decade of negative real interest rates was the aberration. The stock market, however, sometimes swoons when rates rise, because higher rates provide more competition from bonds, and also because higher rates means that future profits are worth less today, since they are discounted at a higher rate. Nonetheless, stocks have mostly ignored this possibility, especially since longer-term interest rates have remained very low, with the 10-year US Treasury bond still yielding less than 3%. Other market mavens have worried that rising short-term rates will at some point overtake steady long-term rates, leading to the dreaded “yield-curve inversion.” Yet the bulls can point out that this is unlikely to happen for at least a few more years, if ever.

A more pressing concern for US stocks is that American trade barriers are rising. President Trump is still convinced that the US is not getting a fair deal when it imports more than it exports (known as a trade deficit), and he is willing to raise tariffs on imports from our major trading partners, including our NAFTA partners Canada and Mexico, and China and the EU. The future of NAFTA is now in doubt, and that raises the risks of supply-chain disruptions and further retaliation by our trading partners. President Trump has taken particular aim at China, which sells much more to the US than it buys from the US. But China is unlikely to bend to threats, and thus a trade tiff could escalate into a full-blown trade war, which could hurt all countries. The stock market, however, has shrugged off these worries in the belief that cooler heads will prevail and that any economic damage from new trade barriers will be small.

Political uncertainty may also spark a Wall Street tizzy. The odds are rising that the Democrats will wrest back control of the House of Representatives, and such a result could mean even more political gridlock and acrimony for two more years until 2020. While some would prefer that Congress do nothing, festering problems like health care policy do require attention.

Overall, however, US stocks have strong support as corporate profits continue to soar, inflation remains low and stable, and economic growth remains strong. Selloffs, induced by either rising interest rates or international events, may pop up at any time, much like summer thunderstorms. But like thunderstorms, there is much sound and fury, and then they pass.

World Markets and Economy:

European stocks were weak in August. The blue-chip Euro Stoxx 50 dropped almost 3% for the month, led by declines in the FTSE (Britain), DAX (Germany), and the ITLMS (Italy), which lost 5% for the month. All of these losses are primarily responses to politics, but a potential trade war with the US is also a concern. The British are still stumbling toward Brexit, with no real plan for a post-EU world. The Germans have a weak coalition government, while the Italians have the strange bedfellows of a right-left populist coalition which is not really prepared to govern.

In Asia, Japanese stocks held to a small gain for the month, and are up 18% over the past 12 months. Although the Abe government has its own political problems and has to worry about trade with the US, monetary policy is still extremely easy, which has supported Japanese stocks for years. The real casualty for the month was the Shenzhen (China), which is in its own bear market, down 20% year to date. A trade war with the US will do real damage to the Chinese economy, since the government is already trying to throttle back growth and deal with a massive overhang of bad loans held by state banks.

OUTLOOK:

As we said last month, the long-term path for US stocks remains upward, as the US continues to outperform financially. A strong economy and tax cuts have boosted corporate profits, while US inflation and interest rates remain relatively low. This sunny outlook can be clouded over by fears of trade wars and political uncertainty, which could put pressure on all equities around the world. Long-term investors should ride out short-term selloffs. Every selloff in this long bull market has been followed by new all-time highs.