Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – NOVEMBER

US Markets and Economy:

In last month's review, we concluded with the old Wall Street adage, "the bears get Thanksgiving, the bulls get Christmas." November's stock market certainly followed the pattern! US stocks tried to rally in early November, but fell back to October correction lows. The November decline lasted right up through the Friday after Thanksgiving. And then the "Santa Claus" rally began, with stocks wiping out their November losses in one week.

The catalyst for the rally was Jerome Powell, head of the Federal Reserve, and chairman of the all-important FOMC, which makes US monetary policy. He hinted early in the week after Thanksgiving that interest rates may be close to "neutral," which Wall Street interpreted as a sign that the FOMC was about finished raising short-term rates. A nascent rally took off into overdrive immediately, with the Dow rising over 600 points on Wednesday alone.

While the rally looks strong enough to continue through December and January, historically the strongest months for stocks, the correction in October-November is a good reminder for investors that short-term selloffs, unnerving as they are, are the reason long-term investors are so well rewarded for holding equities.

The fall correction and recovery are also a good reminder that Wall Street cares a lot about interest rates. Low interest rates are generally good for stocks, as they reduce competition from low-yielding bonds, and also tend to stimulate economic activity, which usually means a rise in corporate profits, further bolstering stock prices. Corporate profits in the US are certainly in a sharp upswing, powered by strong economic growth, and the recent corporate tax cuts. These rising profits have driven stocks higher even though interest rates have been rising. Corporate profits will no doubt rise less rapidly in 2019 and 2020, so Wall Street is especially focused on the Fed. Even if the Fed follows through on raising short-term rates by ¼% in December (essentially a done deal) and then bumps rates up another ½% during 2019, real interest rates will still be historically low and should not choke off economic growth, or end the bull market. The latest data on US economic growth has real GDP growing at a 3.5% rate, which is an outstanding performance, considering that the economy has been growing since 2009. Employment growth has also been strong, with unemployment remaining at 3.7%, one of the lowest readings in recent decades. And inflation remains under control, which should encourage the FOMC to move very gradually in bumping up rates.

At the same time, the level of political uncertainty has fallen post-election. The Democrats took control of the House as expected, while the Republicans increased their slim majority in the Senate. Although divided government may slow the rate of deregulation (which boosts corporate profits), it may also mean that the two parties will try to find common ground, such as a bipartisan deal on infrastructure spending.

That leaves trade policy as the major concern for stock market bulls. The White House seems keen on raising tariffs further, against the Chinese in particular. Most economists agree that the Chinese violate WTO rules, especially when it comes to intellectual property, but argue that unilateral imposition of tariffs is not a good strategy since it invites retaliation of all kinds and raises prices for US consumers and businesses, which import from China. The stock market would certainly celebrate any US-China "deal" that keeps tariffs from rising, while it could easily sell off if no deal is forthcoming and the trade skirmish intensifies.

World Markets and Economy:

European stocks followed the US market down, but did not recover their November losses by the end of the month. In fact, the Eurostoxx 50, the blue-chip European index, is still down 15% from its January 2018 peak. The usual culprits have been holding European stocks back: the impending Brexit plan, which the British parliament may (or may not) approve, adds much uncertainty. British stocks were flat in November, but are down nearly 10% for the year. The Italian budget deficit is large enough to anger the European Commission, and it is large enough to worry bond and stock traders. Italian stocks managed to break even in November, but the FTSE Italia Index is still down over 20% from its summer high, which is the classic definition of a bear market. Italian government 10-year bonds saw their yields rise to over 3.6% in mid-November, more than double the 1.7% rate which prevailed in the summer. German stocks fell a bit for the month, and are down over 10% from their January highs. Political uncertainty is rising for Europe's economic powerhouse, as the Merkel era ends without an obvious successor. French stocks also fell for the month, and are down over 10% from their May peak. Macron's popularity has fallen as fast as the French stock market. His fuel tax increase was widely protested in November; these protests, which are as common in France as croissants, will certainly weaken French economic growth.

The Japanese Nikkei Index gained about 2% in November. The latest economic news is actually fairly good: economic growth is projected to continue at 1%, with modest inflation (instead of the dreaded deflation). A further boost to the economy should come from spending for the 2020 Olympic Games in Tokyo. While the Japanese government debt is exceptionally high relative to their GDP, a planned consumption tax increase in 2019 should help the government move toward budget balance.

OUTLOOK: US stocks remain in a bull market, although weakness in November reminds us just how rocky the upward path can be. December and January are the best months for US stocks, so the rally which began at the end of November could continue to carry stocks higher. European stocks, however, will have a tough slog as Brexit looms.