Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – FEBRUARY

US Markets and Economy:

Another great month for US stocks! A continuation of the post-Christmas rally carried the Dow Jones Average back to 26,000, and the broad-based S+P 500 Index back up to 2800. Each index is now within striking distance of the all-time highs set last fall. The NASDAQ Index had a more leisurely climb but still recovered to 7500, only 600 points from its all-time high. What fueled the continuing rise? First, the Fed appeared to put its planned short-term interest rate increases "on hold," and also suggested that it could stop its monthly sales of long-term securities, dubbed "Quantitative Tightening" by Wall Street savants. Stocks can rise while interest rates are rising, but the preferred environment is low and stable rates. Since the real Fed Funds rate (after subtracting inflation) is only slightly above zero, monetary policy is still expansionary, and may well stay that way all year.

A second plus is that the incipient trade war with China appears to be on hold. Each time a positive announcement about the trade talks is made, stocks rally, suggesting that Wall Street is rooting for a deal. A third positive factor is that corporate fourth quarter earnings were strong, albeit not as stupendous as earlier in the year. (20% growth was not sustainable.) In addition, fears of a possible recession in 2019 or 2020 have faded a bit, with fourth quarter real GDP showing respectable growth. Although this year's first quarter will probably show that GDP growth slowed markedly, the first quarter is usually the weakest of the year, in part because the Department of Commerce's seasonal adjustment process tends to overstate weakness in this quarter. But the first quarter will also be weak because of the government shutdown (now over) and a drop in consumer confidence (now recovering too). Wall Street also expects a down quarter for corporate earnings, but with a sharp recovery expected toward the latter part of 2019.

While the economy is solid, with substantial monthly employment continuing, unemployment hovering at very low levels, and inflation quiescent around the Fed's target of 2%, there are some *political* storm clouds on the horizon. The British are preparing to exit the EU without an agreement, although no one in Britain or Europe really knows what will happen when we reach the end of March deadline. Any European shock wave could travel across the Atlantic and create ripples in our own market, much as the Greek near-bankruptcy did some years ago. After an embarrassing summit failure, a nuclear-armed North Korea could return to its war of words with the Trump administration. And an old rivalry between India and Pakistan has flared up again in Kashmir. Both countries have nuclear weapons and have fought several wars in recent decades. Back at home, the Trump administration may be shaken by the soon-to-be-completed Mueller Report.

In summary, politics aside, the bulls have made another strong statement in February, as one of the greatest US bull markets ever prepares to celebrate its 10th birthday with no outward signs of age. But as we witnessed in late 2018, even a hard-charging bull can stumble, and long-term investors, battle-hardened by last fall's swoon, should be able to withstand the inevitable bouts of short-term weakness in 2019.

World Markets and Economy:

European stocks followed the US higher in February, although the rally was less spirited than in the US. The blue-chip EUROSTOXX 50 Index rose 4% for the month, but still remains well below its all-time high set back in 2015. Of course, British stocks, with a flat month in anticipation of the Brexit mess, held the European index back. Italian stocks, as measured by the FTSE Italia all-share Index, helped lead the way higher and once again showed that politics, and even economics, does not always drive stock markets. The Italians have a massive amount of government debt, an economy mired in recession, and a dysfunctional left-right populist government.

Chinese stocks were the stars in Asia in February. The Shanghai Shenzhen 300 soared over 10% for the month. Optimism about a trade deal with the Americans overwhelmed fears of a further slowdown in Chinese growth. Korean stocks, as measured by the KOSPI Index, lost all their February gains at the end of the month, as traders sold stocks after the failure of the US-North Korea summit. Indian stocks on the Bombay exchange, which have been on a 5-year bull market tear, were down for the month as fighting intensified with Pakistan on the Kashmir border.

OUTLOOK: US stocks remain in a bull market. Political trouble in Europe, Asia, and even here at home could create ripples in the US market, but stocks still provide the best long-term returns.