Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MARCH

US Markets and Economy:

American stocks capped off a phenomenal first quarter with a strong rally in March. All major indexes recorded double-digit gains for the first quarter, which would make for a very respectable *annual* gain in most years of stock market history. Almost all of the losses recorded in late 2018 have now been erased, and the Dow Jones, S+P 500, and Nasdaq Indexes are all within sight of their all-time highs set last fall. And once again, long-term investors who rode out the 2018 selloff have been rewarded for their patience and their discipline, while their short-sighted brethren were "whipsawed" by short-term fluctuations, which Shakespeare (if he were a long-term investor) would have called, "full of sound and fury, signifying nothing."

The story behind the continuing equity push upward has not changed: The Fed's FOMC has backed off from its suggestion that short-term interest rates will be going up this year. At the same time the Fed also announced that it would bring to a halt its program of monthly asset sales from its enormous hoard of government and mortgage securities. These were acquired during three rounds of Quantitative Easing (QE) that the FOMC undertook to end the Great Recession. The Fed was never comfortable with a balance sheet that ballooned to almost $4.5 trillion. In 2017, the process of gradual unwinding began. Wall Street quickly dubbed this reversal Quantitative Tightening (QT), and suddenly decided last fall that this program, in addition to projections of rising short-term interest rates in 2019, was responsible for the stock market swoon late in 2018. Whether this conjecture was correct or not, the Fed's twin decisions on rates and QT led to celebrations on Wall Street and rising prices.

Long-term interest rates also fell a bit more in March, as the closely-watched 10-year Treasury yield dropped to 2.4% by the end of the month. (This yield had reached 3.2% last November.) Lower long-term interest rates mean that bonds provide less competition for stocks, which yield about 2% based on S+P 500 dividends. Lower rates can also stimulate long-term business investment and the housing market, which is highly dependent on the level of interest rates. At the same time, however, the flattening of the yield curve, as long rates dropped down to the level of short-term rates, seemed to no longer scare those stock traders who were once fixated on yield-curve "inversion," which was supposed to be a sure sign of an upcoming recession. Yet the economy remains strong, with March employment figures showing very low unemployment at 3.8% and strong jobs growth. (These figures were reported in early April.) At the same time, inflation remains well-contained at slightly below 2%, which is the Fed's definition of price stability.

A healthy economy with a strong labor market and tame inflation means the Fed is still doing a great job steering the economy, and this is good news for stock market. The one cloud on the horizon for the Fed is that this August and nonpartisan policy-making body may get several new members who are neither knowledgeable about monetary policy and the economy, nor nonpartisan. President Trump apparently plans to nominate Stephen Moore and Herman Cain for the last two open seats on the Fed's Board of Governors. (All Governors are voting members of the FOMC.) Many reputable conservative economists have pointed out that these two individuals are "manifestly unqualified" to serve on the Fed. What Wall Street is hoping (and they may well be right) is that a) neither one will be confirmed by the Senate, or b) Chairman Jerome Powell will keep the Fed on its sensible nonpartisan course.

Wall Street was also pleased by the completion of the Mueller investigation without a "smoking gun." The Democrats will certainly continue their investigations in the House, but it is not clear that they will hobble the Trump Administration in any way. Traders also like the idea that the US and China seem to be moving toward an end of their trade skirmish, avoiding an all-out trade war which would have no winners.

In summary, the bulls continued to dominate in March, and may have the ammunition to push stocks up to new highs in the second quarter of the year. Long-term investors know, however, that the ride up is often not smooth.

World Markets and Economy:

European stocks, as measured by the blue-chip Eurostoxx 50 Index, barely managed to eke out a gain in March. Much of the weakness was a result of the end-of-March Brexit deadline, which has now passed without a resolution. No one (especially the British) has any idea whether or when or on what terms Britain will leave the EU, but a sudden departure will damage all of Europe, and the shock waves could be felt even in the US. In spite of a late-month selloff, the FTSE 100 Index of blue-chip British stocks actually rose in March, once again showing the folly of trying to predict short-term movements in stock prices. European stocks were also held back by comments by ECB head Draghi casting doubt on the efficacy of their long-running program of QE combined with negative nominal interest rates.

In Asia, Japanese stocks, as measured by the NIKKEI Index, were down a bit for the month. The Japanese economy is still wrestling with the twin demons of recession and deflation. Chinese stocks, after a huge rally in February, added to gains in March as a US-China trade deal seemed closer to reality. By early April, the Shenzhen 300 Index was up by a whopping 35% for the year. Investors should remember, however, that Chinese stocks are notoriously volatile: the current rally was preceded by a 35% tumble.

OUTLOOK:

US stocks remain in a bull market. Economic trouble in Europe and Asia could create ripples in the US market, but stocks still provide the best long-term returns, and the US has continued to lead the way upward.