# THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY

**US Markets and Economy**:

An old Frank Sinatra song has the lyrics: “Ridin’ high in April, shot down in May.” This fits the US stock market perfectly this year. May saw the Dow drop 1500 points, with big drops for the S+P 500 and the NASDAQ, which had both reached all-time at the end of April. (A sharp rally in the first week of June offset much of the losses: “Back on top in June.”) The May selloff was closely linked to an escalation of the trade war with China. Many American firms either operate in China, sell to China, or buy from China. American farmers rely heavily on Chinese demand for their products too. The modern era of complex cross-border supply chains makes economic activity dependent on the free flow of goods and services. A trade war is thus disruptive and costly. The Trump administration has already felt the need to dole out billions in federal aid to farmers hurt by Chinese cutbacks in purchases of US grains. Almost all economists agree that all countries lose in a trade war, and it seems clear that the Chinese economic growth rate has been reduced by American tariffs. This slowdown then impacts all of those countries and companies who sell in the Chinese market. The May decline in stocks suggests that Wall Street sees this downside risk, and traders’ fears of a broader trade war deepened when the Trump administration announced late in the month that Mexico would be subject to punitive tariffs too. (This threat was removed in early June and was a key reason for the snapback rally.)

What makes the trade troubles worse is that the US real economic growth rate has begun to slow down. The best estimate for the current May-June quarter, produced by the Atlanta Fed, is that real growth will slow to 1.4%, a sharp reduction from a strong first quarter. This slowdown is not surprising, since the effects of the tax cut package were bound to wear off. The Federal Reserve (and many other forecasters) believe that the long-term sustainable growth for the US is about 2%, since the growth in our labor force is now very slow at 0.5% per year, while labor productivity is only growing at 1.5% per year. The sum of these two growth rates will be approximately equal to the long-term growth in US potential output, or 2%. This rate of growth is not in itself cause for alarm, and it certainly does not mean the US is headed for recession. A recession means a general fall in output, employment, and incomes, and none of that has happened this year. In fact, the wages of US workers are rising at 3% a year, which exceeds the inflation rate of about 1.5% per year. And, even though the growth rate of jobs slowed in May (reported in early June) to less than 100,000, the growth rate in employment is still quite respectable over the last 12 months. In July, the US economic expansion will become the longest in our entire history.

Wall Street also worries about yield-curve inversion, that is, an unusual reversal of interest rates in which short-term rates exceed long-term rates. This phenomenon has often presaged a recession, but not always, and often not for many months. But Wall Street alternates between bouts of fear and greed, and long-term investors are wise to ignore the short-term gyrations created by these emotions.

The Federal Reserve also pays close attention to the data and to the economic outlook. Americans count on the Fed to keep our long economic expansion on track, and Jerome Powell has given every indication he intends to do so. Just the hint of a possible rate cut to offset economic weakness is enough to make traders forget their fears of trade wars and return to buying stocks.

To summarize, the US stock bulls are back in force in June after a rocky May. Long-term investors have been rewarded yet again for ignoring short-term fluctuations.

**World Markets and Economy**:

European blue-chip stocks followed the US lower in May, with the blue-chip Eurostoxx 50 Index falling nearly 7% for the month. (This index also began recovering in early June.) While Europe often follows the lead of the US market, it faces its own set of concerns: Brexit is now more likely this autumn, and with the fall of Prime Minister May, the next few months could be tumultuous for the English. A no-deal Brexit, which would damage the British economy and Europe, now looks likely. No one knows what will happen in Northern Ireland, or in Scotland, both of which preferred "Remain." British large blue-chip stocks have actually held up well, dropping only slightly in May, mainly because the fall in the British pound will make their products look cheaper both inside and outside Europe. The EU also must contend with the Italians, who seem determined to run unacceptably high budget deficits, even though the level of Italian government debt is already very high relative to Italian GDP, which is itself hardly growing. Not surprisingly, the Italian stock market fell 10% in May.

In Asia, Japanese stocks, as measured by the NIKKEI Index, sold off in May in sympathy with the US. Japan relies heavily on trade, and an escalating trade war has to worry Japan. The US and Japan have clashed over trade since the 1980s, when the Reagan administration placed quotas on imports of Japanese cars. With Japan's economic growth rate still extremely low, a trade-war nudge could push it back into recession. Chinese stocks, as measured by the Shenzhen 300 Index, continued a slide which started in April. By early June, the Shenzhen was down almost 15% from its April high. With no trade deal with the US in sight, and Chairman Xi unwilling to lose face by agreeing to US demands, the outlook for China, where economic growth was slowing anyway, looks especially cloudy.

**OUTLOOK**:

US stocks remain in a bull market, after weathering a mild correction in May. Economic trouble in Europe and Asia could still create ripples in the US market, but stocks still provide the best long-term returns, and the US bull market is still intact.