Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JUNE

US Markets and Economy:

US stocks came roaring back in June, erasing all May's losses and returning to or near all-time highs set in April. The rally was broad-based, with the Dow Jones blue-chip average rising almost 2,000 points to 26,000, while the broader S+P 500 Index actually reached an all-time high near the 3,000 mark before falling back a bit at the end of the month. The NASDAQ Index, not to be outdone, broke through the 8,000 mark again, recording a muscular 10% gain for the month.

The fuel for this rally came from two sources: The Fed and trade wars. The FOMC met in June and, although they did not cut short-term rates, made it clear that rate cuts would be on the table for the July FOMC meeting if the economy showed further signs of weakness. This change in monetary policy stance was emphasized in public statements made by Chairman Powell and other FOMC members. It was further underlined by the first dissent by a voting member of the FOMC in Powell's tenure. The June dissenter would have preferred that the Fed cut rates immediately. Wall Street, which loves low and falling interest rates, celebrated all month.

Although Wall Street is convinced that a rate cut is coming soon, the US economy may be too strong for the Fed to justify such a move. Although economic growth is slowing from its first quarter pace of 3%, the latest forecasts suggest the second quarter should see real GDP growth of close to 2%, which is still a respectable number and not a sign of a recession at all. At the same time, the US labor market remains very strong with unemployment hovering at a 50-year low of 3.6%. What does hearten the rate-cut bulls is that inflation remains stubbornly below the Fed's target of 2%. Thus, even if a rate cut boosted inflation a bit, it might only bring it up to the Fed's target.

What will help the Fed decide? The next employment report will be released on July 5th, covering the month of June. Another "weak" number (May's employment growth was reported at +75,000, down sharply from previous months), may convince the Fed to act, while a return to strong growth may lead to a postponement of monetary easing.

The second source of June's market strength was a temporary stand-down in the trade wars. The US and China agreed to restart talks, and the Trump administration backed off from the threat of tariffs on all Chinese imports to the US. The US also tabled its threat to place tariffs on Mexican goods. This truce in the trade wars is good for the US and world economy in the short and long run. Trade wars have never been easy to win, and all parties tend to lose from them.

Whether the US can reach an agreement with the Chinese is hard to forecast, since the US is demanding concessions that impinge on Chinese sovereignty. The negotiations are complicated by national security concerns, since the Trump administration believes that Chinese firms like Huawei may get access to sensitive technology, and may also be able in the future to sabotage America's communication infrastructure. The dramatic increase in the creation and deployment of cyberweapons by many nations (including the US) will make it harder for the US and China to reach an agreement on trade, especially in technology. President Trump's vaunted deal-making ability will clearly be put to the test in these negotiations.

We thus expect that the US market will maintain its upward bias, but investors must be prepared for sharp swings in response to Fed decisions and developments in the US-China trade confrontation.

World Markets and Economy:

European blue-chip stocks kept pace with the US market in June, with the blue-chip Eurostoxx 50 Index rising over 6% for the month. The E50 is now close to its annual high, but the index has yet to challenge its 2015 peak and has trailed the US S+P 500 this year. This relative underperformance versus the US reflects long-standing economic and political stresses across Europe. Top of the list is still Brexit, which now looks more likely to be a messy "no-deal" departure on October 31. With mercurial Boris Johnson likely to be the new Tory leader, even more uncertainty has been created. British stocks still managed to rally in June, but the gains were tepid. For the year, the FTSE 100 is trailing the E50 by over six percentage points. While other European markets outpaced the British, the big star was Greece, which was the European basket case only a few years ago. Greek stocks, as measured by the Athens Stock Exchange Index, are up over 40% for the year. Greece may have turned the corner economically. Greek GDP is forecast to grow at 2% or more over the next three years. By comparison, the German economic powerhouse is expected to grow by only 0.5% in 2019. More ouzo, less schnapps!

Japanese stocks rose modestly in June, but the Nikkei Index continues to trail both the US and Europe. For the first half of the year, Japanese stocks are up only 8.5%. Although nominal interest rates in Tokyo remain around zero, real economic growth also remains around zero. Every flare-up in the trade wars also hurts the Japanese economy, which still relies heavily on exports.

OUTLOOK:

US stocks remain in a bull market and are poised to lead world equities higher. No doubt nervous traders can create short-term selloffs as they fixate on Fed policy and trade negotiations. But the bull market has shaken off these short-term declines every time for the last 10 years. Smart investors know it pays to play the long game.