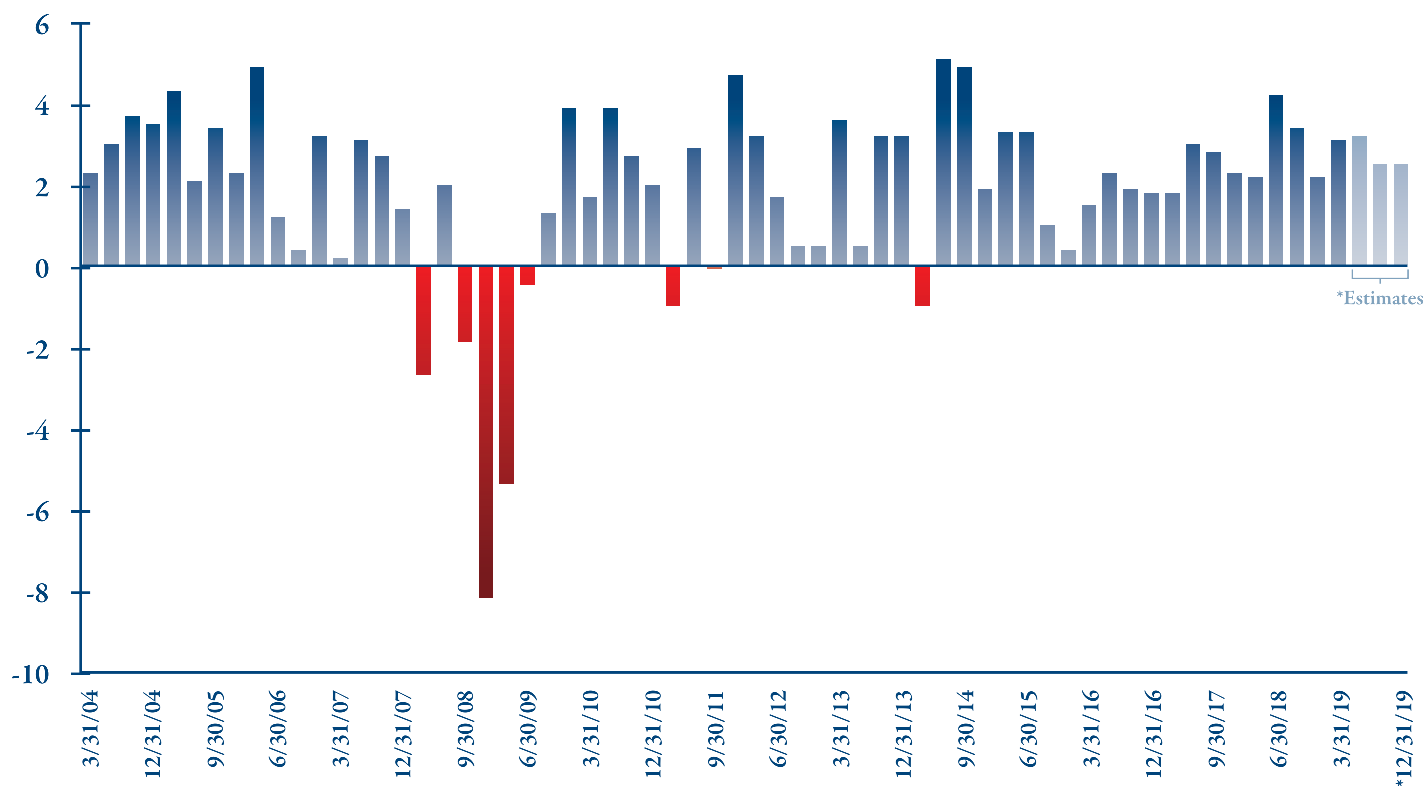
The Reilly Report:

THE REILLY REPORT FOR THE SECOND QUARTER 2019

THE US ECONOMY

Economic growth has been decelerating in recent months. After a 3% first-quarter surge in real GDP, second quarter economic growth should slow to a more moderate 2%. This is still a respectable rate, especially compared with Europe and Japan, and it should be sustainable for the long-term, since this rate is what many economists think is the current "speed limit" for the US economy. This projected continuation of growth is even more remarkable considering that the US business expansion, which started in 2009, is now the longest on record.

Figure 1: *US Real GDP Growth*



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Much of the credit for the longevity of the expansion must go to the Federal Reserve, which under the leadership of Ben Bernanke, Janet Yellen, and now Jerome Powell, has used very low (or even zero) interest rates to stimulate economy activity. Once the economy had recovered from the Great Recession, the Fed gradually raised its reference Fed Funds rate above zero to its current level of 2.5%. At its most recent meeting in June, the Fed left this rate unchanged and hinted that it was open to cutting this rate back toward zero if economic conditions worsened.

The Fed must tread a narrow path for the rest of this year, providing enough monetary stimulation to keep the economy from slipping into recession, but at the same time making sure that inflation does not rise above its target of 2%. Recent data suggest that the Fed has room to cut rates, since inflation is staying below 2%. This has been the case this quarter even though the US labor market is very strong, with unemployment hovering at a 50-year low under 4%. The Fed's path is even more tricky since the world could descend into an all-out trade war, which would hurt all economies. Monetary ease, though, has usually been quite constructive for equities.

Figure 2: ***Fed Funds Target Rate***

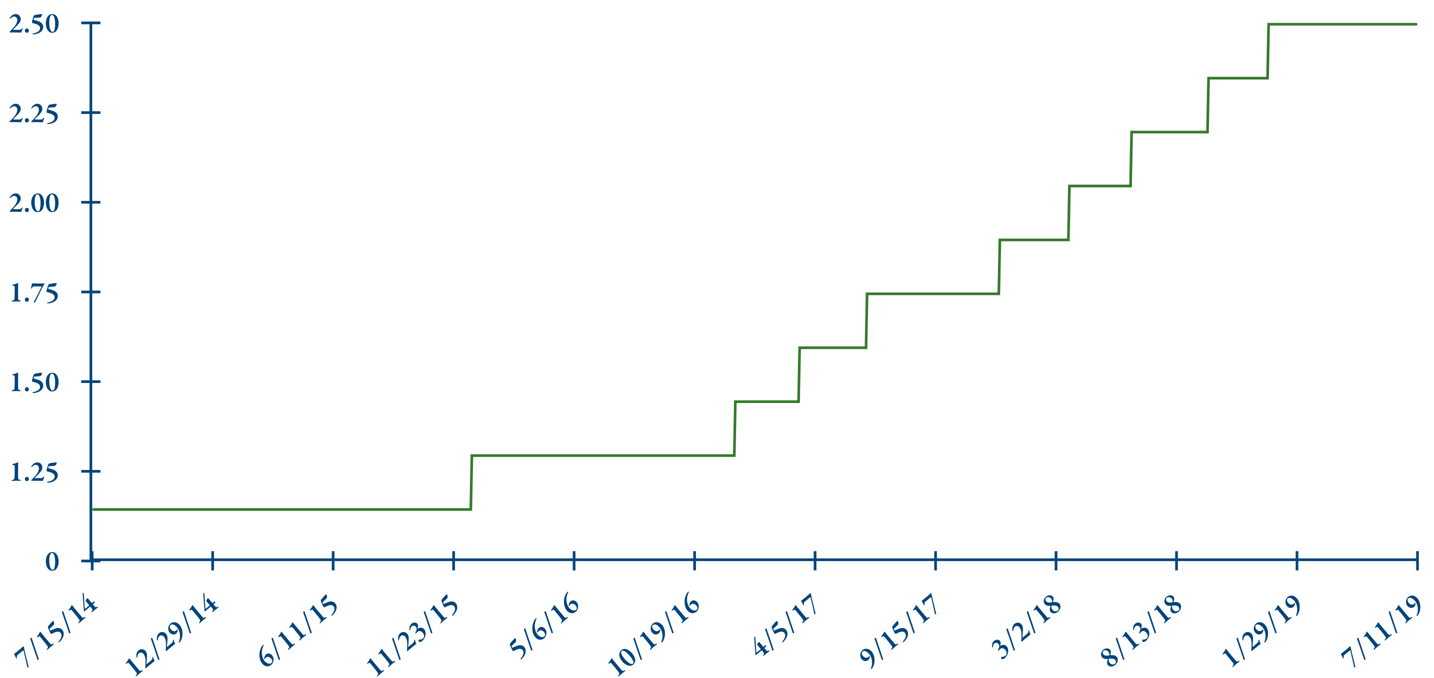
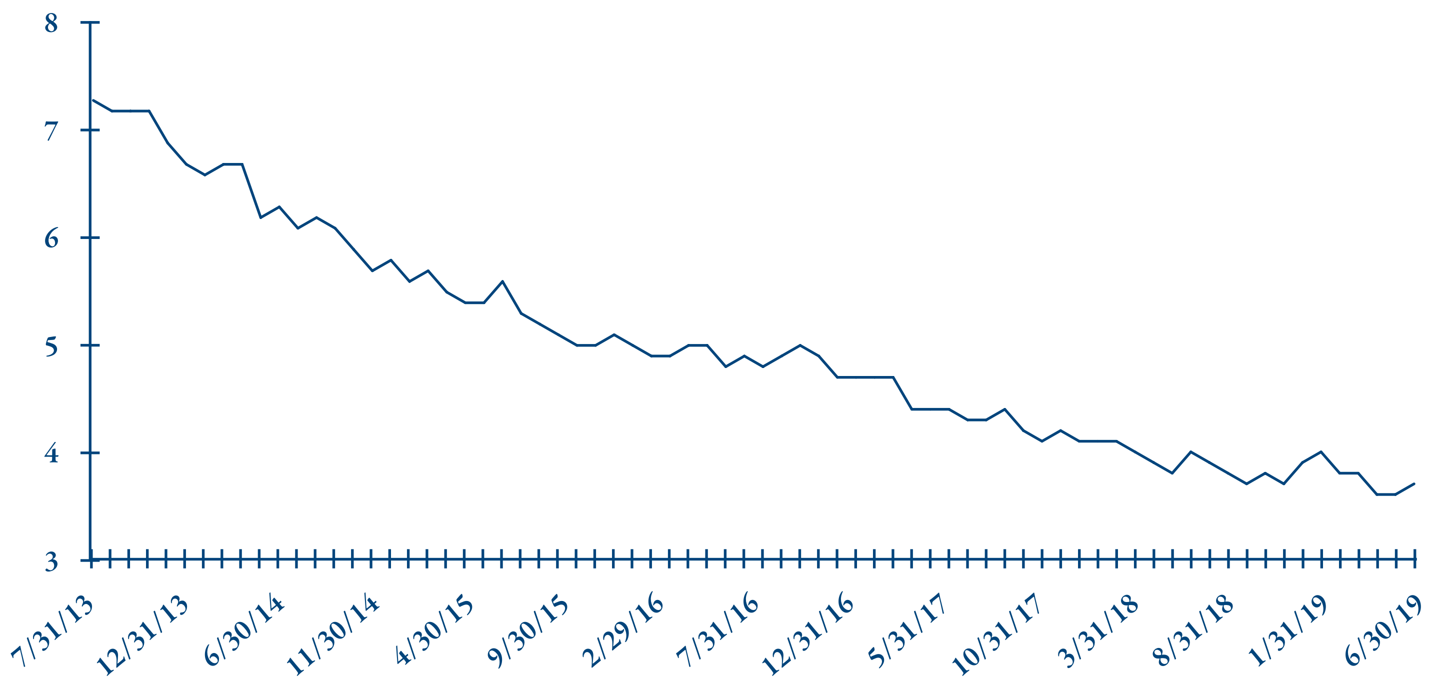


Figure 3: ***Unemployment Rate***



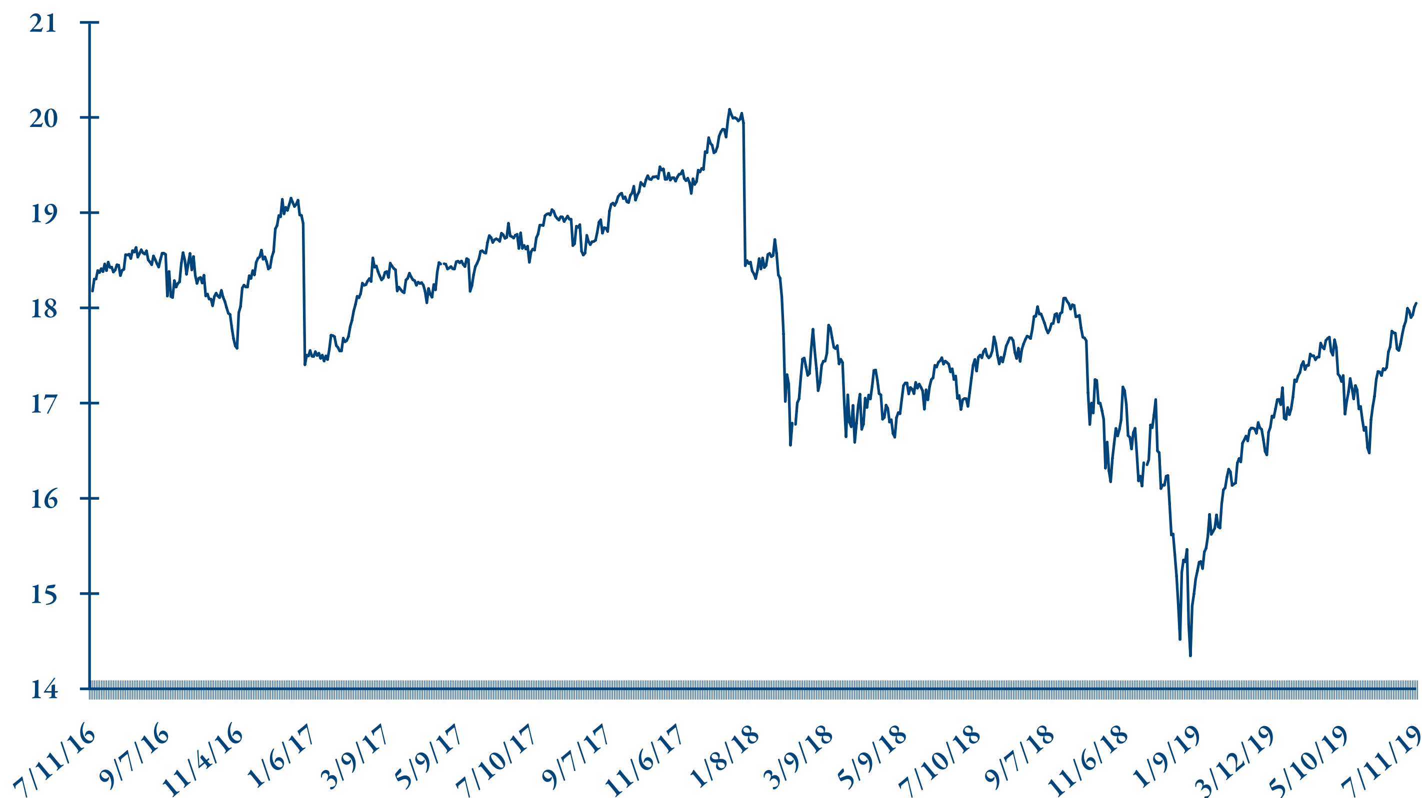
Europe and Japan are struggling in comparison with the US. Economic growth in Europe and Japan is close to zero, and countries like Italy have been flirting with recession. The ECB, the Eurozone equivalent of our Fed, has kept rates even lower than the Fed, and in some cases pushed them below zero. In spite of this stimulus, European growth has yet to respond. Even powerhouse Germany is expecting growth this quarter and next of only 1% or less. Countries like Greece, Spain and France still have elevated unemployment rates too. And then there is Great Britain, which is moving closer to a disorderly exit from the Eurozone. This adds uncertainty to economic projections, and also keeps a lid on equity prices.

Japan continues a multi-decade bout with deflation and economic stagnation. Even with expansionary fiscal and monetary policy, Japanese economic growth remains very weak. China's growth has also decelerated as the trade war with the US has heated up. Nonetheless, the Chinese economy should continue to grow in the current quarter at around 6%, which is still an extraordinary rate for the second largest economy in the world.

FINANCIAL MARKETS

Stock prices seesawed during the second quarter depending upon investors' view on the state of trade negotiations with China and potential changes in Fed policy, with the S&P 500 Index ultimately rising 4.3%, bringing the YTD total return to a solid 18.5%. Small stocks could not quite keep up with their larger brethren, rising 2.1% in the quarter with the YTD total return coming in at a very respectable 17.0%. Overseas markets are still lagging the U.S. in 2019, with Developed Markets up 14.5% YTD and Emerging Markets up 10.8%. The Technology sector has been the clear winner so far in 2019, up 27.1% YTD, although Financials outperformed in the second quarter, up 8.0% vs. 6.1% for Technology. Many large Technology companies which have driven the rally for several years are now beginning to draw increasing ire from politicians and scrutiny from regulators around the globe given their market dominance and social influence; their stock prices may come under pressure should these critics decide to act.

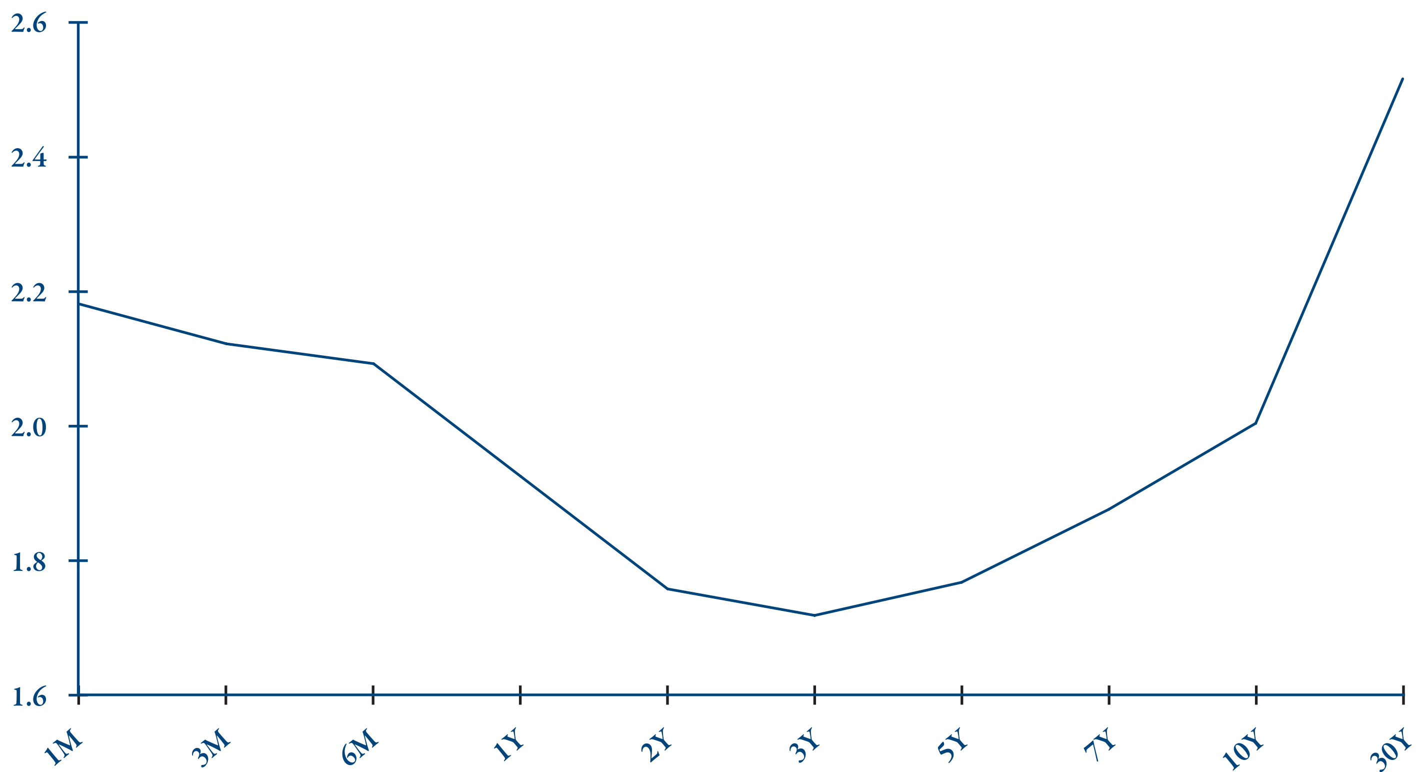
Figure 4: ***S&P Forward PE Ratio***



Even as stock benchmarks hit record highs, valuations remain moderate with the Forward P/E ratio of the S&P 500 Index standing at 16.7, only slightly elevated above its long-term average of 16.2.

Longer-term Interest rates have generally fallen this year with the benchmark 10-year U.S. Treasury bond ending the second quarter yielding 2.00% (bond prices rise as interest rates fall). Investors have faced two conundrums. First, both stock prices and bond prices have risen in 2019, sending mixed signals regarding investors' expectations about future economic growth, since historically they have tended to move in opposite directions based upon the outlook. Second, the US Treasury yield curve, a graphical representation of interest rates for different maturities, has undergone an odd "inversion" resulting in a V-shaped curve being negatively-sloped from 3 months to 3 years and then positively-sloped from 3 to 30 years. This is also sending mixed signals to (and frightening) investors since an inverted yield curve is a classic signal of impending recession, yet the current curve is only partially inverted.

Figure 5: ***Yield Curve***



OUTLOOK

While the current economic expansion is the longest in U.S. history, it is also the weakest by far, and therein lies the secret of its longevity: the economy isn't developing the kind of excesses, such as the valuation excess in 2000 or the credit excess in 2008, that ultimately doom an expansion. This has been a tortoise-like expansion that may just keep plodding along. The slowdown that we are currently experiencing may just be regression back to a sustainable norm rather than an indication of impending recession. However, the tortoise may stumble due to a policy "mistake", say if Fed policy ends up being too tight or more likely if trade skirmishes morph into something more serious, or an exogenous "shock" arrives from out of the blue.

While the economic expansion may not be nearing its end, we are clearly later in the cycle, as illustrated by the historically low Unemployment Rate. Stock market volatility can be expected to increase, which would only return it to long-term historical levels after years of being suppressed. With the S&P 500 up 440% since the market lows of 2009, the "easy" gains are behind us. After the record stock market surge in the first half of 2019, prospective returns in the second half of 2019 and beyond are likely to be muted.

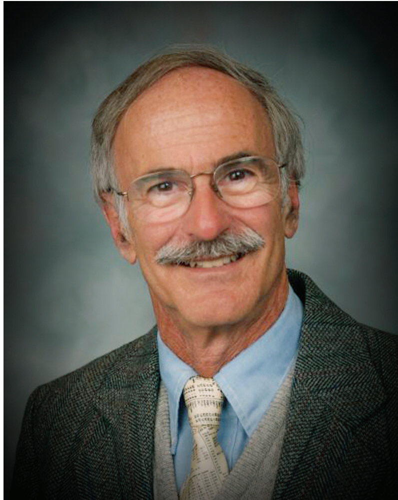
About Tom Weary:

As Chief Investment Officer at Reilly Financial Advisors, Tom chairs the Investment Committee and leads the Research Department in building and managing all client portfolios in adherence to the rigorous investment discipline of Reilly Financial Advisors.

With over three decades of investment experience, through several market cycles, Tom has experience managing portfolios for mutual funds, pension plans, insurance company reserves and high net worth families.

Tom graduated from Harvard University with an honors degree in Philosophy and attained the designation of Chartered Financial Analyst in 1993.

About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Daniel enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within context of the global economy.

Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

Daniel is the editor and publisher of The PAD System Report, an investment newsletter. He earned his Bachelor of Arts, Masters and Ph. D., all in economics, from Yale University.

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