Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY

US Markets and Economy:

American stocks were strong in July, with the Dow Jones Index reaching an all-time high mid-month. The S+P 500 hit a new peak above 3,000 late in the month along with the NASDAQ, which breached 8300. All indexes settled back a bit at the end of the month.

Stocks rallied in part because the Fed had signaled that it would cut interest rates at its late-July meeting. The FOMC did indeed announce that it was cutting the Fed Funds rate by ¼%, but Chairman Powell then described the cut as a "mid-course correction" rather than the beginning of a series of cuts. Two of the voting members of the FOMC actually dissented, and would have preferred no cut at that meeting. Wall Street, which had been hoping for more cuts (stocks love easy money), then sold off into the beginning of August.

The decline at the end of the month was exacerbated by a new salvo in the US-China trade skirmish. President Trump announced at the beginning of August that he would impose tariffs on the rest of US imports from China. (The fall in the Chinese yuan on Monday August 5th sent stocks tumbling further.)

As we have noted before, trade wars are in fact very hard to win, and economists have pointed out for decades that most parties lose. A widening trade war will drive up the cost of US imports at the same time that US exports will be hurt by new restrictions imposed by China in retaliation for the new tariffs. Most models of international trade and payments show that it is also unlikely that the US balance of trade will improve after the dust settles. These models do not even take into account the disruptions to complex international supply chains, which will raise business costs.

Nonetheless, the Us economy has so far sailed through these troubled waters very nicely. Second quarter real GDP growth clocked in at 2%, which is respectable, considering that the business expansion is now the longest in US history. A 2% growth rate is also much better than the 0-1% growth in Europe and Japan. Corporate profit growth has been subdued in the first half, but is predicted to show more strength by the end of the year. US economic growth has also lifted wages, which are now rising at 3% a year, even though inflation remains very tame at 1.5%. This low inflation has persisted even though unemployment has stayed at 3.7%, which is a pleasant surprise. Many economists (and the Fed) expected that unemployment this low would push up wages and prices faster.

But Wall Street looks ahead, and the potential for an all-out trade war could hurt the US and world economies. The bulls, who have been charging ahead for 10 years, must rely on the White House's fabled deal-making ability to defuse the trade issue before it does real damage to the US economy. But stocks could remain volatile while the trade confrontation unfolds.

World Markets and Economy:

European blue-chip stocks rallied a bit in the first half of July, but then sold off to lose their gains by the end of the month. The Eurostoxx 50 Index then fell further in early August in sympathy with the US. Europe is facing the specter of a "no-deal" Brexit under Boris Johnson, which, if it occurs, will hurt the British economy significantly, and will be a negative for all of Europe. With European growth already very slow, in spite of the ECB's efforts to stimulate economies in the Eurozone, a disorderly EU exit by the British, combined with fears of a larger trade war, could put pressure on all European equities. Germany's economic growth has been very slow, and the DAX Index fell in July. The only good news came from Greece, where a new government, which is maintaining fiscal responsibility, was able to borrow internationally at a favorable rate. Greek stocks were strong in July.

Japanese stocks, as measured by the Nikkei index, made a small gain in July, although this gain was wiped out in early August as world trade tensions rose. Chinese stocks gained a bit in July, but then sold off in early August. The selloff was muted, however, by the decline in the value of the yuan, which will offset for Chinese exporters some of the negative effects of US tariffs. It is also expected that the Chinese will use fiscal and monetary policy to maintain the growth rate of the Chinese economy, which has recently slowed to 6% a year.

OUTLOOK:

Although slowing back down to its "speed limit" in the neighborhood of 2%, the US economic expansion, now in its 11th year, remains intact. With earnings reporting season winding down, it appears that most companies have performed better the many feared late last year. US stocks remain in a bull market, but trade worries generated a selloff in early August given the high level of uncertainty they inject. A reduction in trade tensions should allow the bull market to resume its upward climb, but long-term investors know that short-term declines are the price to be paid for long-term investment success.