Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JANUARY

U.S. Markets and Economy

American stocks rallied sharply in the first half of January before giving back their gains in the final days of the month. That decline (since reversed in early February) was driven by the rapid spread of a new coronavirus in China, fueled by fears that the world could face a new pandemic causing severe economic disruption. These fears have been mostly unrealized outside of China, where economic growth will be severely impacted by the spread of the virus and measures taken to contain it.

The January rally and early February recovery were driven by lots of good economic news. Even though the U.S. economy continues to grow at a moderate pace of 2% in real terms, its performance is stronger than that of either Europe or Japan. At the same time, the labor market in the U.S. continues to amaze many observers, as U.S. firms continued to add jobs in January at a strong 225,000 per month pace, with unemployment staying at the historically low rate of only 3.6%. Wage growth, although still modest at 3%, is still exceeding inflation, which is well contained at 1.6%. All good news for the average American worker.

U.S. stocks were also buoyed in late January and early February by earnings reports for the fourth quarter of 2019. Many companies reported earnings that beat Wall Street estimates. This could be an indicator of the return of growth in corporate earnings, which went flat in 2019 as the effects of the tax cuts wore off.

The Federal Reserve’s adept pivot to easier money in 2019 continues to pay dividends too. Three cuts in short-term rates have given the economy a bit of a boost, which should help it weather any weakness caused by disruption in China (the cuts now seem especially well timed, as it usually takes 6–12 months for changes in monetary policy to be felt in the economy).

World Markets and Economy

The big news is that the British are indeed leaving the European Union. The actual terms of the “divorce” are yet to be worked out, with an unrealistic deadline for an agreement set for the end of 2020. While many economists still think this divorce will disrupt trade and lead to lower economic activity in both the U.K. and the EU, the die has been cast. Both British and European stocks followed the U.S. down late in January, with European stocks fully recovering in early February. The British FTSE 100 did not fully recover, however, suggesting that traders are still worried that Brexit will be a significant negative for the British economy. In addition, there is still the possibility that Scotland will have a new vote to leave the U.K. (and then stay in the EU), which would create serious economic disruption for England.

China's coronavirus has taken center stage in Asia. Although the Chinese have no doubt underestimated the number of infections and deaths from this virus, they have taken strong measures to contain it, essentially quarantining millions of those in areas near Wuhan, the source of the outbreak. Chinese leaders know they must succeed, as the Chinese public will hold them accountable. We may never know the true extent of the human and economic damage (we will never know how many were killed at Tiananmen Square), but it is likely that China's economic growth rate will be at least halved to 3%. The coronavirus drove Chinese stocks down 10% in a matter of days, even though the authorities injected funds to stem the decline. Other Asian markets also fell. If the virus continues to spread, Asian stocks will remain on the defensive.

Outlook

Given the size of the Chinese economy, the U.S. and the world will face some economic headwinds caused by even a coronavirus mostly contained in China. The Fed has already said that it is prepared to ease monetary policy further if the U.S. economy does show any significant signs of weakness from the spillover effects of the virus. The trade battle between the U.S. and China has also cooled as each side has taken steps back from the brink of a full-fledged trade war. While many tariffs remain in place, and many underlying issues of U.S.-China trade have not been resolved, the trend away from confrontation is comforting for both economists and stock traders.

One of the greatest bull markets in U.S. history continues. The economy continues to grow, the Fed remains accommodative with low interest rates, and corporate profits may have started growing again. Although the U.S. political picture remains cloudy as we approach November 2020, and that political uncertainty could still roil stocks in the short run, long-term investors should keep their eyes on the prize of outstanding *long-term* returns provided by stocks.