Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY 2020

U.S. Markets and Economy

U.S. stocks had a strong July led by the NASDAQ, which gained almost 7% for the month, reaching new all-time highs. The large-cap S&P 500 gained 5.5% and is now within striking distance of its all-time high set before the COVID-19 bear market. The Dow Jones, still weighted with "old-economy" stocks, gained only 2.5%, and remains well below its pre-COVID high set in February. The rally in July was again powered by strong rises in mega-cap tech stocks as Apple, Amazon, and Alphabet (the new "AAA Club," all with trillion-dollar market caps) rose sharply. The AAA Club has left many mid- and small-cap stocks behind: the Russell 2000 Index of smaller stocks is still languishing at 1,500, well below its February peak at 1,700. This divergence reflects the economic reality of the 2020 economy: although Main Street plunged into recession this year, the AAA Club still prospered mightily in a world of lockdowns and social distancing. Although the growing power of the AAA Club (and Facebook) was the subject of congressional hearings, there is no evidence yet that their dominance will be weakened by regulation or antitrust enforcement.

While the stock market continues to rise, the economic reality is still grim: second-quarter GDP fell at an astounding annual rate of more than 30%, unemployment remains higher than the worst months of the Great Recession, and more than a million Americans are still filing new unemployment claims every week. Even more concerning, Congress deadlocked over plans to continue $600 per week in additional payments to the unemployed; that program expired at the end of July with no compromise deal in sight. Although the elimination of that $600 per week may slow the economy in the third quarter, it is still likely that third quarter GDP will show a solid increase, as the economy was reopened in many states. Unfortunately, this led to a spike in new cases of COVID-19, which prompted many of the hardest-hit states to begin locking down their economies again. It is now very unlikely that economic recovery will show the hoped-for "V" shape. Economic forecasters may have run out of letters to describe the complicated shape of the recovery, which will depend greatly on progress against the virus.

World Markets and Economy

European stocks were flat in July, as measured by the STOXX Europe 600 Index. Although Europe has, with some exceptions, controlled the virus better than the U.S., new hotspots have been cropping up all over the continent. But the good news for Europeans in the eurozone is that they have agreed on a common fiscal policy that will be partly financed by pan-European bonds. The European Central Bank will continue its aggressive monetary policy too. And then there is Britain, which has done a poor job on containing the coronavirus while facing the disruption of a no-deal Brexit. The British FTSE Index dropped 5% for the month and remains far below its 2020 high set early in the year.

The Chinese stock market continued its sharp ascent in July, rising another 10% for the month. The Chinese government has encouraged speculators in this market, while at the same using infrastructure spending to drive the economy forward. These policies certainly work in the short run but have led to bubbles popping in the past.

Japanese stocks were weak, and the Nikkei 225 dropped nearly 3% for the month. Virus cases have been surging in the Tokyo area, which could cut consumption spending and further weaken an economy that is expected to shrink this year by more than 5%. The government is still spending trillions of yen to prop up the economy and taking on even more debt, although it has the highest ratio of debt to GDP for a developed nation.

Outlook

Clearly, the stock market is looking beyond the virus spike to better days ahead, including progress on vaccines for the virus and continued support for the economy from the Federal Reserve. There are more than 160 vaccines under development worldwide, with a few entering crucial Phase 3 testing on large numbers of subjects. Dr. Fauci has suggested that a vaccine could be available in early 2021. Although it could be months after that before it can be widely distributed and administered, an effective and generally available vaccine would be good public health news *and* good economic news.

Although there is no certainty about the vaccine (it is useful to remember that no vaccine against any coronavirus has ever been brought to market), there is certainty about monetary policy. The Fed will keep the “pedal to the metal” for as long as it takes to get the economy back on a sustainable growth path. Although the Fed can’t right the economy by itself (they would like more help from fiscal policy), near-zero interest rates at all Treasury maturities, plus the Fed’s support for lending and direct purchases of many kinds of debt, should be a powerful tonic for the economy and for stocks.

In summary, the stock market, led by the AAA Club, should have more room to run, even against a backdrop of stuttering economic growth and virus uncertainty. But volatility will not disappear, and sudden downdrafts can appear at any time. In addition to virus news, the U.S. election is now 90 days away, adding another layer of uncertainty for financial markets.