



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY 2020

U.S. Markets and Economy

The stock market recovered more of its bear market losses in May, with the S&P 500 Index and Dow Jones Industrial Average each gaining more than 4% for the month, while the NASDAQ powered ahead by almost 7%. These gains came amid continued evidence of severe weakness in the U.S. economy. As we said last month, stocks are looking beyond the pandemic to a resumption of economic growth. Because economic data are reported with a substantial lag, this disconnect between stocks and the economy could continue for some time as traders bid up stocks while economic activity remains depressed.

And depressed it will be. Unemployment in the U.S. officially surged to 14.7% in April (reported in early May), and the official measure will almost certainly rise to 20% in May (to be reported in early June). These numbers are unprecedented in the post-World War II era, and they rival the worst of the Great Depression. GDP in the first quarter of 2020 fell at a 5% annual rate and will probably fall in the second April-June quarter at an annual rate exceeding 20% (to be reported in late July)—a decline that would again rival the worst quarters of the Great Depression.

These grim numbers are reminders of just how powerful an adverse “demand shock” can be. With consumption expenditures accounting for 70% of U.S. GDP, stay-at-home orders have pushed the economy into a deep recession in spite of the best efforts of fiscal and monetary policy to soften the blow. If the stock market is right, though, recovery should begin in the third quarter, in part fueled by expansionary fiscal and monetary policy.

And expansionary it is. The federal government has allocated trillions of dollars in new spending to support newly unemployed Americans and provide lifelines for many thousands of businesses whose revenues have dried up. The Federal Reserve has reduced short-term interest rates to zero and unleashed a new quantitative easing (QE) program, QE 4, that dwarfs its heroic efforts in the Great Recession 12 years ago. For the first time in its history, under QE 4, the Fed will buy corporate bonds and even municipal bonds in addition to Treasury securities, and, if we add in new loans, the total expenditures of QE programs will be in the trillions of dollars.

World Markets and Economy

Most of the world's stock markets rallied in May. European blue chips, as measured by the EUROSTOXX 50, rallied almost 4% in the month but remain well below their February peak. The European Central Bank (ECB) did not react to the pandemic crisis as fast or as powerfully as the U.S. Fed, and Europe does not have a centralized fiscal policy like the U.S. (which can allocate trillions in new spending). In addition, Europe must contend with the overhang of impending Brexit, which will weaken all parties, and problem economies like Italy, where growth was minute and government debt was dangerously high even before the pandemic. Not surprisingly, the FTSE 100, even after a May rally, was still down more than 20% from its high, and Italian stocks were still down 30% from their pre-pandemic high.

Japanese stocks had a strong rally in May and are only 10% below their early-year high. Although the Japanese economy is again in recession, the pandemic has done less damage to Japan, in term of infections and deaths, than most countries. And the government's monetary and fiscal policies have become even more expansionary, with a new ¥117 trillion (about \$1 trillion) spending program and promises of even easier monetary policy.

The Chinese government reported that economic activity declined in the first quarter, but the government expects an economic recovery sooner than most of the world, as the virus was brought under control in China (while it continues to expand outside of China). Chinese stocks, though, were mostly flat in May after a sharp April rally.

Outlook

Although fiscal and monetary policy often act on the economy with a lag, the stock market is anticipating that these programs will help fuel an economic recovery. Stock traders are also anticipating that the worldwide race for an effective vaccine against COVID-19 will have one or more winners soon, as the U.S. economy (and the world) cannot fully recover until an effective vaccine is widely available. Just as importantly, because the vaccine will likely not provide absolute immunity (as with the flu vaccine), the race for a treatment also needs a winner.

Until the economy turns around, corporate profits will sink sharply, and the weakest firms in hard-hit industries may fail. These financial headlines will not make good reading, either. U.S. stocks can continue to climb this new "wall of worry," but the road up will be unusually rocky. Bear markets are notoriously volatile, and the risk of a second wave of infections, as well as the approaching U.S. elections, could spark sudden and sharp selloffs. But so far—as throughout history—patient, long-term investors have come out ahead.

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