Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST 2020

U.S. Markets and Economy

An August rally took U.S. stocks to new all-time highs, confirming the new bull market that started in late March. The NASDAQ led the way with a gain of almost 10% for the month, making a series of new all-time highs and ending August nearly 5,000 points above its March low. The megatech stocks that led the NASDAQ higher also powered the broad-based S&P 500 index to all-time highs and a gain of 7% for the month. Although the "old economy" Dow Jones Industrial Average has still not set a new all-time high, it gained a solid 7% in August and finished the month within striking distance of its February peak. The staid old Dow was rejuvenated during the month by changes to its 30 components, with Exxon Mobil leaving after many decades and taking with it Raytheon and Pfizer. The replacements were Honeywell, Amgen, and Salesforce.com. Thus, in the future, the Dow may be a little peppier during market rallies. Dow component Apple also reached another incredible milestone: $2 trillion in market capitalization. It took Apple 42 years to reach $1 trillion in market capitalization but only two more years to reach $2 trillion! Smaller cap stocks, represented by the Russell 2000 index, also gained in August but were still down for the year, as the 2020 market favored big tech above all else.

The new bull market has been powered by monetary policy, fiscal policy, and hopes that a partial reopening of the economy will restore economic growth and unleash pent-up consumer demand and business investment. Jerome Powell and the Fed have certainly done their part. In addition to pushing short-term interest rates to zero and buying up trillions in Treasury securities, corporate bonds, and even municipal bonds, the FOMC announced in August that it would keep rates at zero for some time, perhaps even after inflation reached or exceeded its target of 2% per year. This "rethink" for the Fed is a consequence mainly of recent history, in which the Fed's expectation that inflation would reach its target of 2% was never met, even when the economy was booming in 2018, 2019, and early 2020. The Fed has thus concluded that it is safe to keep both feet on the monetary accelerator for many more months, and Wall Street has always loved easy money with zero interest rates: a familiar Wall Street stock market acronym is TINA ("there is no alternative").

Fiscal policy, which is usually considered too difficult to enact to support the economy in a recession, has nonetheless helped the economy avoid a much more serious economic decline this year. Trillions of dollars in new federal spending, including generous unemployment compensation, has prevented the massive layoffs due to COVID-19 shutdowns from adding to the downward momentum of the economy. In fact, the third quarter of the year (July–September) should show a strong GDP rebound from the abysmal performance of the April–June quarter. Politics still make fiscal policy difficult, however. Republicans and Democrats cannot agree on a new stimulus package to further support the economy, and this deadlock has meant that much of the expired first-round stimulus will not be replaced in any second-round bill.

World Markets and Economy

The coronavirus is still the big story in Europe, too. European stocks followed the U.S. higher in August, and these gains were again augmented by a steadily weakening U.S. dollar, which amplifies the dollar value of gains in assets denominated in foreign currencies. The weakness in the U.S. dollar reflects the decline in U.S. longer-term interest rates (engineered by the Fed) relative to European and Asian interest rates. However, the broad-based 17-country STOXX Europe 600 index rose 3% for the month—a good performance unless compared to the even sharper gains in American stocks. Europe was again held back by the British, who are struggling with Brexit and a muddled response to the coronavirus. Year to date, the FTSE 100 index is down 20%. German stocks, on the other hand, rallied nearly 5% in August and ended the month down only 3% for the year, which becomes a gain when converted from euros back to U.S. dollars. Germany has managed its pandemic better than most European countries. Spain, where a reopening of the economy has led to a large increase in infections, has seen its stock market fall almost 25% this year.

Japanese markets took the sudden resignation of Shinzo Abe in stride, and the Nikkei index gained a strong 7% for the month (a weaker U.S. dollar versus the yen makes that gain even larger in dollar terms). The Japanese economy, although mired in a deep recession, is showing signs of recovery, and the Japanese have done well in controlling the virus. Chinese stocks added to their gains in August, even as the coronavirus reappeared in parts of the country. The Chinese economy recovered before the rest of the world, and the Chinese have managed to reignite their export industries, which boosted their economic growth. The Shenzhen 300 index is up about 16% for the year (one of the best performances in the world in 2020).

Outlook

Even though third-quarter economic growth will be strong, the economy will still be running cold compared to pre-pandemic levels. Unemployment is still far above its February 2020 level, and new layoffs continue at a high pace compared to the good times of recent years. The continued spread of the virus in the U.S. and elsewhere has slowed the reopening of economies around the world: even the Chinese have seen recurrences, and countries like South Korea, which appeared to have the virus well under control, have seen new outbreaks. These signs of the resilience of the virus have made the race for a vaccine and cure that much more important for a continued economic recovery in the U.S. Without a vaccine or cure, many millions of Americans are still hesitant to venture out to shopping malls and restaurants or travel by air, which acts as a continuing drag on the economic recovery. The worldwide race for vaccines and cures, with more than 100 vaccines in various stages of testing, makes it likely that COVID-19 will be conquered in 2021. This conquest will unleash a burst of pent-up economic activity, but the uncertainties of the timing, effectiveness, and distribution of a vaccine will continue to hold back economic activity and, as a consequence, subject stocks to sudden corrections as vaccine hopes ebb and flow (a sharp selloff in early September is an example of this likely volatility).

The upcoming U.S. national elections add to economic and financial uncertainty. Although Joe Biden currently leads Donald Trump in most polls, the race will likely be close and may again be determined by the results in a few swing states, as it was in 2016. A Biden win could mean that many economic policies would be changed, but if the Senate remains in Republican hands, politics could again be gridlocked.

Stocks can continue to build on their gains of recent months, but the twin headwinds of virus uncertainty and political uncertainty could engender sharp and sudden selloffs. But as we have seen once again since the lows in late March, patient long-term investors always get the last laugh over the “sky is falling” market timers.