Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY 2021

U.S. Markets and Economy

The American stock market had no clear direction in May. For the month, the NASDAQ suffered a small loss, the Dow Jones Industrial Average managed a small gain, and the S&P 500 index was just about unchanged. It is, of course, normal for stocks to "take a breather" after a sharp runup, and 2021 has been a banner year so far. The S&P 500 is up almost 12% for the year already and up an astounding 88% since the dark days of March 2020.

The "breather" in May reflects some traders' fears that the Federal Open Market Committee (FOMC) will, to paraphrase a former Fed chairman, "take away the punch bowl just when the party gets interesting." These fears led to a selloff in May that was essentially reversed by the end of the month. The Fed has continued to state in public that it wants to keep both feet on the monetary gas until the economy gets back to "full employment," which is probably an unemployment rate of 3.5%–4.0% (although economists cannot precisely measure this so-called "natural" rate of unemployment). With unemployment still at 6%, it is likely that the continuing economic boom will not drive it down to the natural range until 2022.

What could push the Fed to act sooner would be a pickup in inflation that was more than just a "blip" in the data. Current inflation has indeed picked up to 3%—even using the Fed's preferred measure—but it could easily subside in the coming months as the economy continues to reopen and supply chains get back to normal. At some point, the FOMC will at least have to water down the punch by reducing its regular purchases of long-term bonds (currently $120 billion per month), and traders will no doubt be skittish when this process begins. Jerome Powell and his Fed colleagues will have to thread the needle by gently taking one foot off the accelerator at just the right time without spooking the markets or the economy.

The nation's fiscal policy remains extremely expansionary, and previous rounds of government transfer payments have by no means all been spent by U.S. households. The Biden administration has unveiled even more spending proposals, any of which could push the economy forward even faster. Pent-up demand for goods and services will stay strong and may lead to spot shortages and price increases: a lot of the recent inflation "blip" has come from an increase in used-car prices as rental-car companies scramble to meet rapid growth in demand.

It is also possible that the expansion of vaccination to the under-18 U.S. population will enable us to reach the goal of "herd immunity," which would mean at least a temporary victory over the virus in the U.S. that should further boost the economy. So far, new variants of the virus do not pose significant risks for the vaccinated population. As we note below, however, the virus outlook is much worse for many of the world's poorer countries.

World Markets and Economy

For May, the broad-based STOXX Europe 600 index gained almost 2%, and the index is now up more than 12% in 2021, which compares favorably to the U.S. S&P 500 index. Over the last 12 months, however, the index is up only 25%, well below the one-year gain in the S&P 500 index of 37%. Although Brexit battles still await, the British economy should come back from its mini-recession with strong growth for the rest of 2021 based on a reopening of the economy. The British "one shot first" approach to vaccination has worked for them. Yet the FTSE All-Share index gained only about 1% for the month and is up only 7% for the year, lagging its main European competitors. A stronger pound has made those gains larger for foreigners holding British stocks.

On the continent, vaccinations still lag—as do many economies—but stock indexes have done well this year. One of the better performers has been Italy, where stocks rose almost 5% for the month and are up about 15% for the year. Italian economic growth, boosted by funds from the EU, should reach 4% this year. The French stock market has done even better, rising almost 17% so far this year. French economic growth could exceed 5% this year.

In much of Latin America, Asia, and Africa, the virus is still spreading disastrously. Peru recently admitted that the death toll was triple what had been reported, and unrest is rising in Brazil in response to a misguided vaccination policy. India's outbreak is severe and no doubt underestimates the level of illness and death. However, India's stock market still managed a gain for May and is up almost 9% for the year.

Outlook

The key drivers of the 2020–2021 bull market are still the same: massively expansionary monetary and fiscal policy; a gradual winning of the battle against the coronavirus as vaccinations drive down infections, hospitalizations, and deaths; and a concomitant reopening of the U.S. economy after its pandemic deep freeze. The economic data continues to be positive, with real GDP growing at an annual rate of 6.4% for the first quarter and many analysts projecting second-quarter growth of more than 8% at an annual rate. Even though growth should slow in the second half of the year, the U.S. economy should log a gain for the year of more than 6%, which will be one of the best growth rates in the world. This current and projected GDP growth drives up corporate profits.

Strong economic growth, rising corporate profits, and zero short-term interest rates should provide support for rising stock prices. Bumps in the road will appear, though, as traders overreact to inflation news and fear even a minor change in Fed policy. The dramatic market gains in the last 14 months have again rewarded long-term investors who have stayed the course and ignored "the madness of the crowds."

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