Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JUNE 2021

U.S. Markets and Economy

U.S. stocks resumed their bull run in June, with the large-cap S&P 500 index setting new all-time highs in the latter part of the month. For the quarter, the S&P gained a very strong 8%, and the index is now up more than 14% for the year (standing at approximately double what it was in the dark days of March 2020). The NASDAQ index also hit new highs and is up more than 100% since March 2020. The Russell 2000 index (smaller stocks) and the Dow Jones Industrial Average also gained in June but remain a little below their all-time highs; both have notched big gains for the first half, with the Russell up more than 18%.

The fuel for the rally came from excellent economic news: the nation's GDP is growing strongly, with the just-ended second quarter (April–June) likely to show an impressive annualized gain of 7.8%, according to the Atlanta Fed. Although this torrid pace is expected to slow in the second half of the year, most forecasters predict that real GDP will continue to expand at a more moderate and sustainable rate in 2022. This sunny outlook will also apply to corporate profit growth, which can drive stock prices higher. The good news on GDP also applies to the labor market, where monthly gains in employment have continued to show strength. For the month of June (reported in early July), employment grew by 850,000 jobs even though the rate of unemployment remained nearly unchanged. This is not an uncommon phenomenon in economic recoveries, because job growth (and the many unfilled openings) brings more individuals back into the labor force looking for work. At the same time, businesses have been raising wages to try to fill openings: for the most recent 12 months, average wages have been rising at about a 3.5% clip.

The one fly in the ointment is that much of these nominal wage gains are being offset by rising prices. The economic reopening process has generated spot shortages, which have pushed inflation above the Federal Open Market Committee (FOMC) target of 2%. Under their new flexible average inflation targeting (FAIT) goal, periods of inflation above 2% can be offset by periods of inflation below 2%, hitting the target on average. The Fed's preferred measure is now poking above 3%, which the Fed considers a blip that will fade as the year goes on. But it may mean that the FOMC will soon begin to taper its $120-billion-per-month purchases of long-term securities. Wall Street shrugged off any worries about either inflation or monetary policy, as the Fed still plans a very gradual easing off the monetary accelerator. The bond market's outlook for inflation is so benign that the U.S. Treasury benchmark 10-year yield fell below 1.5% at the end of the month, down from 1.75% earlier in the year.

World Markets and Economy

Much of Europe, Asia, and Africa are less well vaccinated than the U.S. Because several of the virus mutations are more transmissible (the Delta variant is spreading rapidly, even in the U.S.), lockdowns and other economic restrictions have been maintained or reappeared in many countries. In Europe, full vaccination percentages for countries such as Germany (37%), Italy (32%), and France (31%) lag well behind the U.S. (48%), giving virus mutations a better chance to spread. Thus, the economic outlook is not as favorable as in the U.S., and European stock markets reflect this. For the month of June, the broad-based STOXX Europe 600 was about flat for the month, and it lags the S&P 500 badly since the pandemic low of 2020, rising only about 56%.

In Asia, very low full vaccination rates in Japan (12%), Taiwan (1%), and Australia (7%) mean much of this part of the world is now vulnerable to highly transmissible vaccine variants. Increases in infections could slow economic recovery. In Japan, the government may end up banning all spectators from the Olympics to avoid a superspreader event. The Japanese Nikkei 225 index lost some ground in June and is now up only 5% for the year. Even though China has mostly contained the virus, the Chinese CSI 300 index is actually down for the year; it tumbled at the beginning of July after Chairman Xi gave a bellicose speech to mark the centenary of the Chinese Communist Party.

Outlook

U.S. vaccinations continue at about a million jabs per day, pushing the population ever closer to herd immunity. Current vaccines seem to provide very good protection against new variants of the virus, which means the economy can continue to reopen without further lockdowns. American consumers will continue to spend some of their pandemic-driven savings on automobiles and other consumer durables, as well as travel and leisure activities, fueling further gains in economic activity and employment.

The U.S. economy continues to be driven by easy money, heavy government spending, and reopening as vaccinations slow the spread of the virus. Rapid growth in GDP can continue to push corporate profits higher, and continued low interest rates can thus support even higher stock prices. Even though growth should slow in the second half of the year, the U.S. economy should continue growing faster than much of the rest of the world. Of course, the bull market in stocks has come a long way in a short time, and long-term investors should be prepared for the inevitable short-term corrections in the long-term upward trend.