Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY 2021

U.S. Markets and Economy

The bulls ran over the bears again in July. The Dow Jones Industrial Average of blue chips pierced 35,000 and closed the month just below that record. The broader S&P 500 index broke through 4,400 and finished just below that level. The NASDAQ also gained, inching closer to the 15,000 level. However, small stocks (as measured by the Russell 2000 index) continued to struggle in July and registered a loss for the month. The Russell soared after the pandemic lows, doubling in fewer than nine months, but these stocks have been mostly digesting their gains since March 2021.

The upward push in mid-cap and large-cap stocks has been driven by rapid economic growth that has pushed up corporate profits strongly. Analysts are estimating that second-quarter profits for S&P 500 stocks could come in with a year-over-year gain of 60%–70%, the biggest gain in more than a decade. While the comparisons will get more difficult going forward (the second quarter of 2020 included the bottom of the pandemic recession), the outlook for the year is more growth. The economy should continue to grow at a smart clip: the first estimate of U.S. second-quarter GDP showed an annualized growth rate of 6.5%, which is excellent even if Wall Street traders coded it as a "miss" because many forecasters expected an even higher number. What these traders missed was that the growth rate was pulled down by a substantial decline in inventories. Without going into the economic details, the growth rate without this factor (called "real final sales") was actually a muscular 8.2%. If producers rebuild these depleted inventories in the second half of the year, economic growth could be even stronger than many forecasts. If some of the supply bottlenecks, such as computer chip shortages, are relieved in the second half, the economy could also grow faster.

Growth will also be supported by an accommodative Fed. The Federal Open Market Committee (FOMC) policy statement issued after the July meeting shows committee members unanimously endorsing continued zero short-term interest rates and more months of QE4: purchases of long-term securities at the rate of $120 billion each month. While the Fed is likely to begin tapering these purchases by the end of the year, monetary policy should remain strongly expansionary until the economy has fully recovered from the pandemic recession. Fiscal policy is still mildly expansionary too, with child tax-credit payments underway and a likely $600 billion infrastructure bill headed toward passage in Congress. Although some economists fear that all this stimulation will drive up inflation to levels that will require the Fed to hit the monetary brakes, the consensus is still that the pickup in inflation will ease with the clearing of supply bottlenecks, allowing the Fed to stay stimulative longer. The Fed's preferred measure of inflation, known as the PCE deflator (excluding food and energy), is now rising at about 3.5%, which is not inconsistent with the Fed's goal of *average* inflation of 2%, seeing as prices were rising at less than 2% for almost a decade.

World Markets and Economy

Although Europe has caught up to the U.S. in vaccination percentages, much of the world continues to struggle with rising infections caused by the highly transmissible Delta variant of the coronavirus. Africa has been particularly devastated, as vaccination percentages there are very low. Asia and Latin America have also seen surges in cases—even in countries that previously had stellar records of virus control. Japan, trying to bring off an ill-starred, spectator-free Olympics, is facing its own surge of infections. Even the free travel corridor between Australia and New Zealand (the bubble) has been suspended. Aside from the negative impacts on economic growth, rising infections have also hurt stock markets. The Japanese Nikkei dropped enough in July to wipe out its gains for the year. Europe did better, with the STOXX Europe 600 index managing a small gain for the month. But the real pounding came in China, where the Communist Party intensified its crackdown on many businesses, including its tech stars. The Shanghai SE Composite index dropped more than 5% for the month, while stocks of targeted industries dropped even more.

Outlook

The reopening of the economy has generated strong gains in monthly employment and growth in average wages as businesses try to fill a record number of vacancies (more than nine million at last count). This process should continue for the rest of the year, although the pace of reopening will be influenced by the battle between the Delta variant of the virus and the pace of immunization, which, unfortunately, has slowed substantially. Although the rising case count and hospitalizations are mostly among the unvaccinated, the Delta variant now seems to be transmissible by the vaccinated. So even vaccinated Americans may need to mask up again in crowded indoor settings. But this masking will be a far cry from the lockdowns and isolation of 2020 and should not put a major crimp in growth. American consumers continue to spend freely, and consumption spending is almost 70% of GDP. A booster shot for the more vulnerable segments of society may also become necessary, but Pfizer already has such a booster ready to go, and this should not be a heavy lift for public health authorities.

The U.S. economy should continue to power ahead, which gives the stock market further room to run—especially with interest rates remaining at very low levels. A further pickup in inflation or another substantial surge in infections are both wild cards that could derail the bull temporarily, but long-term investors will keep calm and carry on.

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