



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST

US Markets and Economy:

It was a quiet month on Wall Street, but the long Bull Market remains intact. On August 15, the NASDAQ and S+P 500 Indexes both reached new all-time highs. A gentle pullback toward the end of the month brought most major indexes back to their August starting points, but the Bull Market is now almost 7½ years old, and is the second-longest on record. (The longest was the tech-boom bull market in the 1990s, which lasted almost 10 years.) These new index records have been posted this year even though corporate profit growth has stalled in the last twelve months, pulled down by losses in the energy sector. The rally power therefore comes from the extremely low level of interest rates, which makes stocks, especially US stocks, the asset of choice for investors around the world. The S+P Index has a current dividend yield of over 2%, while the US Treasury 10-year bond yields only 1.6%. And the S+P stocks have the potential for continued capital gains and increased dividends. What about other assets competing for the investor's dollar? With interest rates at zero or even negative in much of the developed world, it is likely that the dollar will remain strong, making foreign currencies even less attractive as investments. The weakness in oil prices has spread to many other commodities, making raw materials investments less promising. Real estate prices, especially in some US cities like San Francisco, have been in their own bull market since the Great Recession, but memories of that bubble bursting are still fresh in investors' minds.

If low interest rates are the key, the big question is, will they stay low? The arguments for continued low rates are strong: US real GDP growth was only about 1% in the first half of the year, well below historical growth rates in an economic expansion. At the same time, inflation remains well below the FOMC's target of 2%. **These two trends should prompt the Fed to go slow in raising short-term rates this year, with some members of the FOMC arguing for no increases at all.** The Fed itself has repeatedly lowered its long-run trajectory for future interest rate increases. While some of this downward shift involves the esoteric "real equilibrium interest rate," the essence of the argument is that we may have entered an era of very low rates, such that even if the economy reaches "full employment" and inflation rises to the target of 2%, short-term interest rates will be much lower than in past economic expansions. A lower trajectory for short-term rates brings down long-term rates too, and this is bullish for stocks. Political considerations also militate against any significant interest rate increases this year. The Fed must be, and must

appear to be, above the political fray, especially in an election year. This normally means no change in policy stance close to an election, to avoid even the appearance of the Fed's taking sides. **Hyperpartisan politics, and an increase in attacks on the Fed from left and right, make it even more likely that the nation's central bank will "circle the wagons" until after the election.**

World Markets and Economy:

European stocks also had a sleepy month, but unlike the S+P 500, the EUROSTOXX 50 remains in bear market territory, 20% below its high of 2015. While European stocks mostly recovered from the Brexit shock, the Eurozone economy is still stuck in low gear, even though monetary policy remains "pedal to the metal," with negative interest rates in many countries. European growth is also being held back by the anticipated negative effects of Brexit on trade flows in Europe, added to policy uncertainty in Scotland and Northern Ireland (leave or remain?) European policymakers must also contend with the dangers of terrorism, and the continuing flows of migrants from war-torn areas. The economic outlook is also dimmed by the prospect of an aggressive Russia doing its part to destabilize Europe and NATO, especially with more fighting in eastern Ukraine.

A sleepy August also kept stock prices in a narrow range in Japan, but like Europe, the Nikkei remains well below its 2015 high. The Japanese are also mired in slow growth, in spite of heroic new monetary and fiscal policy measures. Even with negative interest rates, the Japanese yen remains puzzlingly strong; this strength holds back exports and further weakens the economy. The Abe government has yet to find the "magic bullet" which will restore sustained Japanese economic growth.

OUTLOOK:

The US stock market continues to plow ahead, fueled by low interest rates and the lack of investing alternatives in the US and the world. While interest rates should remain very low and be supportive for stocks, investors should be prepared for the inevitable sharp corrections which characterize all bull markets.