



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – FEBRUARY

US Markets and Economy: US stocks capped an excellent February with climbs to all-time highs for both the Dow-Jones Average (18,200) and the S+P 500 Index (2,100). Foreign events gave the markets an upward push: the Greeks and the lenders known as the Troika (EC, ECB, and IMF) reached an agreement during the month which gives the Greeks much needed short-term funds and a few months to follow through with reforms to their economy. With this potential source of instability at least temporarily removed, financial markets in Europe and the US could celebrate. US stocks also benefited from mostly good news on the economic front: monthly employment continued to show strong gains, the economy's output of goods and services continued to grow, and inflation remained very low. The good news on inflation was driven in part by the collapse in oil prices, but underlying inflation, which the Fed follows more closely, is also quiescent at less than 2%. This is an ideal combination for stocks: low inflation, which encourages the Fed to postpone increasing interest rates, and strengthening economic growth, which can drive corporate profits higher.

Wall Street is fixated on divining the date when the Fed will finally raise its short-term interest rate target above zero, where it has been since late 2008. The exact timing of the first increase is almost irrelevant, however. What matters is how far and how fast the Fed will raise rates once it starts, which could certainly be this summer. **With inflation still below the Fed's target, and with a majority of FOMC members convinced that there is still plenty of slack in the labor market (no significant upward price pressure from wage increases), the Fed is likely to step on the monetary brakes very lightly in 2015.** If the Fed raises short-term rates by ½ percent (a reasonable guess) in 2015, they will still end the year under 1%, which is slightly less than the US rate of inflation (1½%) and still a very accommodative monetary policy, which is a strong positive for stocks. Although these increases will put more upward pressure on the international value of the US dollar, as hot money flees countries with even lower short-term rates, this rise in the dollar's value will also act as a mild brake on US growth, as exports weaken and imports rise. This mild braking effect of the dollar's rise means that the Fed will be even more inclined to raise interest rate rises slowly.

World Markets and Economy: The Eurozone celebrated the short-term agreement between Greece and its creditors. The celebration was strongest in Greece, with stocks in Athens up as much as 25% during the month, but the rally was broad, with Spain and Portugal up nearly 10%, and even Germany up more than 5%. The sense of relief that the euro has been saved may be short-lived, however, since the Greeks have only bought a few months time to make the reforms that their lenders demand. Greek banks are still being propped up by the Troika, and withdrawal of support could collapse the Greek financial system and lead to a disorderly exit from the euro.

Even more ominous for Europe, the slide into deflation seems to be picking up speed, abetted by the fall in oil prices and general economic weakness. The most obvious symptom of deflation is the spread of negative nominal interest rates across countries and maturities. Negative nominal rates were once considered by economists to be an extremely rare historical curiosity, since savers and lenders could always hold cash and earn zero interest. But now negative rates on government securities have appeared in numerous European countries, not just in Switzerland, which is battling to keep its currency from rising further against the euro. In Germany, 5-year bond yields have dropped below zero, and yields are negative in Belgium, Norway, Austria, and a host of other European countries. Negative nominal rates are possible because it is neither safe nor convenient to hold large amounts of currency. And buyers of these bonds may be anticipating more deflation, which could make their real yield positive. The beginning of QE in Europe could also push bond prices even higher, earning a capital gain if yields fall even lower. It may seem bizarre, but some savers will end up receiving less than they deposit in banks, which have been reducing their deposit rates in tandem with other interest rates. Even more surprising, 10-year government bond yields in Portugal and Italy (neither a bastion of economic strength and safety) are now equal to the US 10-year yield.

These low or negative rates should eventually stimulate economic growth in Europe and a return to positive inflation. These low rates also will weaken the euro and other European currencies, which should stimulate export sectors, further adding to growth. No doubt the ECB will be sorely tested in 2015 as it attempts to deliver Europe from both deflation and anemic growth.

The Japanese are unwilling experts in battling deflation and stagnation, and the latest economic data suggest they are succeeding. Their massive QE has not only boosted the stock market, which rallied sharply in February, but also returned the economy to positive growth. In China, growth is still slowing, and the PBOC is again easing monetary policy. Chinese stocks, like all others, have responded positively to the easing, and are again close to their highs reached in December.

OUTLOOK: In the short term, US stocks can extend their gains in 2015, as the economy strengthens with low inflation and low interest rates. The biggest risk for US stocks comes from Europe, since the Greeks have only bought a few months of reprieve. A resumption of the financial wrestling match between Greece and the Troika could send shock waves far beyond Athens.