



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JANUARY

US Markets and Economy: US stocks were surprisingly weak in January, normally one of the strongest months of the year. The markets were roiled in January by recurring fears that the Greeks would create a Eurozone crisis by electing an anti-austerity government (they did) which would collide head-on with the Troika (EC, ECB, and IMF), whose loans are keeping the Greek economy and banks afloat. In January, there was tough talk on both sides (market falls), but no action (market recovers). Since the Greeks want to stay in the Eurozone, and the rest of Europe does not want to set an exit precedent which might look attractive to other heavily-indebted Eurozone members like Italy and Spain, a compromise will probably be reached. Until then, US stocks could be buffeted by European news.

A continuing decline in oil prices also acted as a drag on stock prices. For energy producers, including “alternative energy,” a decline in their stock prices is understandable. US shale oil wells may not be profitable at an oil price of \$50 a barrel, the search for new deposits in the US and around the world is less urgent at that price, and alternatives like wind and solar are much less attractive when fossil fuel is so cheap. **On balance, however, cheap energy is a strong positive for the US economy.** Consumers receive the equivalent of a multi-billion dollar tax cut when they fill up at the gas pump. Since consumption is 70% of US GDP, cheap energy will drive consumption higher, further strengthening an economy which is already growing smartly. Employment gains in 2014 should be the best since before the Great Recession, while unemployment continues to decline below 6%. Even the average wage for American workers is beginning to grow, while inflation, pulled down partly by falling energy costs, remains extremely low. Energy-using businesses, like airlines, have seen sharp drops in operating costs, which flow directly to their bottom lines. All of these effects are the mirror-image of the 1970s, the stagflation decade, when sharply rising energy prices caused recessions and rapid inflation at the same time. Stocks (other than energy) performed poorly in that decade. Today’s rapid economic growth combined with low inflation should have the opposite effect, buoying higher stock prices (other than energy).

The Federal Reserve’s aggressively easy monetary policy also deserves much credit for the accelerating US economic expansion, and the strength of US stock prices in recent years. **Although the Fed is planning on beginning the process of raising short-term from zero this**

year, the good news on inflation will limit the increases in 2015. A few taps on the monetary brakes will certainly not derail economic growth. The Fed's goal all along has been to return the economy to a healthy rate of growth that does not require such massive monetary stimulus.

US bond prices were strong in January, with yields on the 10-year US Treasury falling to 1.7% by the end of the month, while the 30-year Treasury fell to 2.3%. **Although economic growth and less accommodative monetary policy will eventually lead to higher bond yields, there is no reason to think that these low yields are forecasting weakness in the US economy.** Extremely low inflation means that nominal yields on bonds can stay low, and since the US is still the safe haven for capital fleeing from other countries, bond yields are depressed even more. The strength of the US dollar confirms this analysis. Flight from the euro, ruble, and other weakening currencies makes even more sense if US dollar yields are augmented by gains in the dollar's international value.

World Markets and Economy: The Eurozone has finally begun its policy of Quantitative Easing (QE), since economic growth has ground to a near halt in much of Europe. Even worse, slow inflation in Europe is potentially turning into much-dreaded deflation, which trapped the Japanese economy in stagnation for two decades. European stocks rallied almost across the board in response to QE, of course with the exception of troubled Greece. European bonds also rose in direct response to the ECB purchases. The euro continued its descent against the dollar, in part because interest rates are now substantially lower in Europe than in the US, and are likely to stay low much longer. Germany's 10-year bond was yielding an almost unbelievable 0.3% at the end of January, and just as surprising, the Italian 10-year bond was yielding 1.6% at the end of the month, slightly below the US 10-year yield. The Europeans, however, must deal with the Greeks. If the Troika of lenders and the new Greek government cannot reach a compromise soon, Greece could end up being forced out of the Eurozone. Since this is not the desired outcome for either the Troika or the Greeks, it is likely that some face-saving compromise will be reached.

The Chinese stock market has come back to earth after soaring in the last half of 2014. The Chinese are still grappling with a slowing economy, an overbuilding of infrastructure, and a property bubble in large cities. The People's Bank of China (PBOC) has a difficult task in guiding the economy to slower growth, but not too slow, while trying to let the air out of a property bubble without damaging growth too much. Converting the economy to one with more consumption and less investment makes the PBOC's job even harder.

The Japanese are just trying to grow. The economy is close to emerging from deflation and stagnation, and Abe has wisely postponed what would have been another damaging increase in the national sales tax. Japanese stocks were flat in January, waiting to see if economic growth will reassert itself in 2015.

OUTLOOK: In the short term, US stocks can push higher as economic growth continues with low inflation, low interest rates, and a strong dollar. Weakness in January is a reminder, however, that stocks' upward path will not be smooth. Any disturbance in Europe will no doubt be felt on the other side of the Atlantic as well.