



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MAY

US Markets and Economy: American stocks managed a small gain in May, with an end-of-the-month rally bringing the S+P 500 Index back to 2100, within striking distance of its all-time high at 2130. The NASDAQ Index rallied more strongly, and the index is again approaching 5000, bringing it closer to 5200, its all-time high set a year ago. Stocks strengthened even though the US economy continued its slow growth. While real GDP growth was revised upward slightly for the first quarter of the year to an annual rate of 0.8%, and second quarter growth could be as strong as 2.5%, the recovery in the economy since 2009 remains one of the slowest on record. At the same time, US job growth has been stellar, with employment gains in recent years averaging almost 200,000 per month. This growth has driven the unemployment rate down to 5% (an early June report showed unemployment dropping to 4.7%, albeit with sharply slower growth in employment.)

Although this slow growth in GDP keeps a lid on the growth rate of corporate profits, it also will keep a lid on increases in interest rates engineered by the Federal Reserve this year. It is now likely that the Fed will not boost short-term rates until September, and then only by another quarter point. That means that monetary policy will remain strongly expansionary, which has historically meant good returns for stock investors. The sideways movement of stocks over the last 18 months can then be put down to the tug-of-war between a slow economy and slow (or no) corporate profit growth versus expansionary monetary policy. Economists are divided over who will win this battle: the productivity optimists argue that growth will soon accelerate as technological progress once again fuels an increase in labor productivity and output. The pessimists argue that the US has entered a long period of “secular stagnation” and slow growth.

This seemingly esoteric battle has implications for both investors and workers: in the long run, the business sector can only maintain its profitability while granting wage increases if the productivity of its workers is rising. This growth in labor productivity is the rising tide that can lift all boats. Unfortunately, the recent divergent trends in output and employment growth mean that labor productivity, measured as output per worker, has grown very slowly in recent years. (Political analysts need look no further than this phenomenon for the source of much of the

disaffection expressed by American voters in this presidential election cycle.) In 2016, it is unlikely that the tug-of-war will be resolved, so investors should expect more of the same: slow growth in corporate profits, offset by easy money, leading to a modest uptrend in stock prices.

World Markets and Economy: America's slow growth and political uncertainty is mirrored and amplified in Europe, which is still struggling to grow at all, with the threat of a British departure from the EU (Brexit) unresolved until June 23rd. Brexit would likely be an economic negative for Britain, which will lose its trade and financial integration with Europe. It would be an even bigger negative for Europe, which is already struggling to hold itself together in the face of a refugee crisis, the continuing bailout of Greece, and a stubbornly high Eurozone unemployment rate of 10%. In spite of rising uncertainty, European stocks, as measured by the EUROSTOXX 50, a blue-chip index covering most of the Eurozone, held on to small gains in May. But at 3000, this index is down more than 20% from its high of 3800 in 2015, meeting the common definition of a bear market. The European Central Bank (ECB) continues to do all it can to restore economic growth. Soon the ECB will begin buying corporate bonds, in addition to government bonds, and also will essentially pay banks to increase their loan books. Mario Draghi, head of the ECB, is sticking with a forecast of 1.6% real GDP growth this year, which would be an improvement over the stagnation of recent years. Of greater concern, the ECB is still forecasting growth of only 1.7% in 2017 and 2018, assuming no Brexit. While an old Wall Street adage is that stocks must climb a "wall of worry," this wall looks very steep in Europe in June.

In Asia, Japan's economy continues to founder. The government has now officially postponed the second planned increase in the national sales tax. The first installment pushed the Japanese economy into recession, and another increase would probably have done the same. This good news helped Japanese stocks hold their own in May, but they have also fallen more than 20% from their bull market highs.

China's economy continues to grow at the enviable rate of 6.5%. This world-beating growth rate is not leading to world-beating growth in Chinese stocks, which were flat in May, and remained down sharply from their bubble highs in 2015. Many economists also worry that the Chinese are maintaining their growth by piling on both public and private debt. With China now the world's second largest economy, any economic stumble will send shock waves around the world, much as its surprise devaluation of the yuan did last August.

OUTLOOK: The US bull market is still intact, having survived three short but very sharp selloffs in the past two years. With interest rates extremely low around the world, and commodity prices relatively weak, and Europe and Japan actually in bear markets, US stocks may still be the best game in town. However, the US tug-of-war between slow profit growth and easy money continues, and an overlay of uncertainty created by the upcoming election in the US could produce additional selloffs. **Long-term investors earn excellent long-term returns for riding out any short-term turbulence.** Stocks may temporarily lose their footing this year, but long-term investors should not lose theirs.