THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JANUARY

US Markets and Economy:

US stocks began 2018 just the way they finished 2017: bulling ahead to one new all-time high after another. The solid gain for the month was only slightly dented by weakness in the final few trading days. For the full month the S+P 500 Index gained over 5%, one of its best Januarys. Even better news for investors is the fact that stocks have usually risen in years in which January was an "up" month, especially if the S+P gains more than 5% for the month. Other indexes rose in tandem with the S+P: the Dow Jones Industrials were up almost 6%, and the NASDAQ again outperformed with a gain exceeding 7%.

The main drivers for US stocks continue to be rising corporate earnings, accelerating economic growth, a large corporate tax cut, and low interest rates. The consensus on Wall Street is that S+P 500 earnings could grow by as much as 18% in 2018, as the benefits from underlying growth are augmented by the tax cut. Although it is common for earnings estimates to be marked down during the year, earnings growth should easily exceed 2017's double-digit rate. The economy is showing no signs of slackening its pace either, with the latest data (published February 2) on employment, unemployment, and wage growth all showing a strong economy with low unemployment. But paradoxically, this is the one "fly in the ointment." The Federal Reserve's FOMC, now under the chairmanship of Jerome Powell, still has the job of "taking away the punchbowl just when the party gets interesting." The Fed, under its dual mandate to promote economic growth while maintaining price stability, has to be on the lookout for rising inflation, and must respond to it by raising interest rates.

The stock market selloff on Friday February 2nd was indeed caused by Wall Street's fears that the Fed would raise interest rates faster in 2018 than previously expected, since the employment report showed a pickup in wage growth. More rapid wage growth could mean businesses respond by raising prices faster to maintain profit margins. In response, the Fed raises rates faster to keep inflation from picking up beyond its 2% target. Since monetary policy acts on the economy with a substantial lag, the Fed must be "pre-emptive," and raise short-term rates even before inflation breaches the 2% mark. Faster increases in interest rates could dampen some of the enthusiasm for stocks, but investors must remember that stocks can rise even when rates are rising (they have been doing that for the last year), and that short-term and long-term interest rates are still very low in real terms (after subtracting inflation). In fact, the real Fed Funds rate, at 1½%, is still below zero in real terms.

So, on balance, the path of least resistance for US stocks is still upward, as earnings growth trumps rising interest rates.

World Markets and Economy:

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, followed the US market higher in January, logging a solid 3% gain for the month. (They also sold off in tandem with the US at the end of the month and the beginning of February.) British stocks gave up their early January gains even faster, and ended with a loss, as support for Prime Minister May continued to wane. The British economy also slowed in January. German stocks were stronger, finishing up for the month, although the gains were given back in the US led selloff in the final days of January. The German government is still mired in coalition talks, and this political uncertainty can be a drag on stocks. French equities followed German stocks upward and then also retreated at the end of the month. This pan-European correction was also tied to monetary policy. The European Central Bank (ECB) has been maintaining an extremely easy monetary policy, but the welcome pickup in European economic growth may convince the ECB, in the punchbowl metaphor, to put a little less Schnapps in the mixture going forward.

Japanese stocks reached a new recovery above 24,000 on the Nikkei Index before settling back with other world markets in late January. The Bank of Japan (BOJ) has pursued an aggressively easy monetary policy for years, and the evidence continues to build that easy money is finally getting the Japanese economy moving again. The head of the BOJ has recently noted that inflation is finally picking up, and could reach the BOJ target of 2% by 2019. This could mean that the era of deflation and stagnation in Japan will finally end, and that should be good news for Japanese stocks.

OUTLOOK:

The long-term path for US stocks is still up, driven by booming corporate profits and a strong economy. However, the ride upward is likely to be bumpier in 2018, as the Fed raises interest rates to keep inflation low. Long-term investors must have the patience and discipline to ride out the inevitable corrections which occur in every bull market.