



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – APRIL

US Markets and Economy:

US stocks had another bumpy month in April, and remain below the all-time highs achieved at the end of January. For the month, the major indexes were just about flat. Volatility remains high, with sharp swings up and down, often within a single day. The reasons for the bumpy ride are the same as last month: a tug-of-war between excellent corporate earnings for the first quarter of 2018, coupled with solid economic growth in the overall economy, pulling against fears of rising inflation, rising interest rates, and economic policy uncertainty.

The economy itself continues to push forward, even though the preliminary estimate of US real GDP for the first quarter came in at only 2.3%, a slowdown from the 3% rate achieved in the latter part of 2017. (Some of this slowdown is likely due to the way the government adjusts the quarterly data for seasonal variations.) Most economists expect the economy to pick up speed in the last three quarters of the year. In fact, the Atlanta Fed's "GDP Now" forecast is actually for a 4% real growth rate in the second quarter (ending in June), which would represent a dramatic acceleration rarely matched since the Great Recession ended in 2009. Nonetheless, the slower growth in the first quarter had no impact on corporate earnings, which surged at a double-digit rate in the first quarter. While the pace of earnings gains will probably slow somewhat over coming quarters, it appears that recent federal tax cuts have significantly improved the bottom lines of American businesses. At the same time, the US labor market continues to show strength. April data (reported at the beginning of May) showed unemployment dropping to 3.9%, the lowest rate in decades. Job growth continued for the 91st consecutive month, with a healthy gain of 164,000 for April. Wages showed a gain of almost 3% over the past 12 months. Many employers are having difficulty hiring qualified workers: according to the US Department of Labor, the number of job vacancies is now over 6,000,000, about equal to the number of unemployed actively seeking work.

For the Federal Reserve's money-policy committee (the FOMC), all this good news can be a cause for concern. The FOMC believes (and the recent data support it) that the economy is close to "full" employment, meaning that the unemployment rate cannot fall much further (if at all) without forcing businesses to raise wages at a more rapid clip to fill their job vacancies. While this would be more good news for the average worker, it could result in a more rapid rate of price inflation, if the wage increases are passed on to preserve profit margins. (A rise in labor

productivity would offset this, but American labor productivity continues to grow at a snail's pace.) Once inflation picks up, the FOMC must act to defend its dual mandate of "maximum employment growth consistent with price stability." The main defense is to raise short-term interest rates to keep the economy from overheating and inflation from rising above the Fed's stated inflation target of 2%. Wall Street prefers low interest rates, so any signs of a further pickup in inflation, or signs that the Fed may accelerate its gradual path of rising rates, can lead to sudden sharp selloffs. In fact, stocks can rise even when interest rates are rising, and today's rates are still extremely low ("accommodative" in Fed speak), especially if inflation is deducted to calculate a real interest rate.

The policy uncertainty can also upset markets, as US trade policy seems to veer from protectionist threats against our allies to negotiation, and back again. Most economists agree that trade wars are costly, with few winners. And they can add to inflation. Rapid turnover in White House personnel and federal agencies also adds to the policy uncertainty. And the midterm elections, which could see significant gains by Democrats (viewed as less business-friendly), could also weigh on markets.

Tugs of war like this are usually resolved in favor of corporate earnings, which are already fueling an expansion of stock buybacks, which often push up stock prices. But long-term investors must expect the occasional sharp tugs as interest rates rise and November looms closer. History shows, though, that perseverance and a long-term outlook pay large dividends.

World Markets and Economy:

Canadian and Mexican stocks rallied in April, as prospects for a renegotiated NAFTA seemed to improve. But policy uncertainty will drag on both markets, given just how important access to the US market is for these countries, both of which depend on trade more than the United States. Since many US businesses rely on exports to these countries, and also have integrated them in worldwide supply chains, it is still likely that a new agreement will be reached. Canadian stocks also were buoyed by the latest economic data, which showed Canadian GDP in early 2018 rising faster than forecasted.

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, had an excellent month, with across-the-board gains in all the major countries, led by Germany, England, and France. Even Italy surged, even though its banking sector is still sick and its politics are as gridlocked as ever. But economic growth is picking up in Italy, and unemployment has fallen, especially among youth. French stocks gained even though Macron's popularity continues to fall, jeopardizing the implementation of his economic reforms. All European stocks benefitted from continued monetary stimulus from the European Central Bank (ECB). As long as the ECB keeps interest rates around zero, and Quantitative Easing continues, these stocks will have a natural cushion.

Japanese stocks also managed solid gains in April, and are now up close to 18% for the last 12 months (better than the US S+P 500). These gains came in spite of further political trouble for PM Abe, whose administration continues to be dogged by scandals. Stock traders are paying much more attention to the economy, though: Japan has logged 8 straight quarters of economic growth, and monetary policy remains very expansionary.

OUTLOOK:

The long-term path for US stocks is still up, as a strong economy delivers higher corporate profits. Stocks around the world can move higher too. Long-term investors must have the patience and discipline to ride out any short-term gyrations.