



## THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY

### **US Markets and Economy:**

US stocks were weak in early July, as the Greek crisis reached a climax. Rather than risk a fall into a financial abyss, the Greek government finally agreed to terms set by its creditors, which meant negotiations on a third bailout could begin. US stocks then rallied sharply as the Greek crisis seemed temporarily resolved. Stocks weakened toward the end of the month, however, as attention turned back to the US economy, interest rates, and corporate earnings. The economy continued to grow slowly, with real GDP for the second quarter of the year up a little more than 2%, a plodding pace which has persisted for most quarters since 2009. The Federal Reserve, keenly aware of the slow pace of growth, again suggested that any increases in interest rates would be gradual, but also reaffirmed its intention to raise rates. This “liftoff” from zero could begin as early as September. With employment growth exceeding 200,000 almost every month, and the unemployment rate at 5.3%, well within the Fed’s estimate of “full” employment, the economy should be strong enough to withstand slightly higher interest rates. At the same time, the Fed does not want to wait for inflation (still a little below its target of 2%) to pick up significantly, since monetary policy acts on the economy with a substantial lag. Although Wall Street traders are fixated with the timing of the Fed’s first rate increase, this obsession will soon pass and corporate earnings will come back into the spotlight. The news here has not been good, as earnings have been weak this year, pulled down by abysmal results in the energy sector. Once oil prices stabilize, however, this drag on overall US corporate earnings should subside. Outside the oil patch, earnings for industries such as airlines, heavy users of fuel, have been very strong. Indeed, strong earnings for many technology stocks drove the NASDAQ Index to a new all-time high in July above 5200.

US bond prices rallied during the final days of the Greek crisis, as hot money fled to the safety of American bonds. These same bonds sold off after an agreement was reached, but then rallied again in the last half of the month. This recent rally has still left the US 10-year bond down for the year. Bond investors must contend with the likelihood that rising short-term rates will exert downward pressure on longer-term bond prices.

### **World Markets and Economy:**

European stocks were pummeled by the Greek crisis, and then rallied sharply after an agreement was reached. Greek stocks, however, were not trading for the last part of July, as the Greek

government shut down much of the financial sector during the crisis. Outside of Greece, however, European stocks have had a good year overall, with the German DAX up over 15% and even “weak” countries like Spain and Portugal up over 10%. (For comparison, the US S+P 500 is up only about 2% this year.) **Long-term investors must remember that the US is only half of the world’s capitalization, making diversification a must.** There is also only a tenuous link between economic performance and stock returns, so world diversification should not be abandoned even when the US economy is outperforming others.

The US is indeed outperforming the economies of Europe and Japan. And yet the Japanese stock market, as measured by the Nikkei, has far outperformed the US, and is up almost 20% this year. European and Japanese policymakers have been furiously pursuing Quantitative Easing (QE). The Americans tried it first, with some success, and Europe and Japan hope to duplicate the results. Stock prices tend to respond positively to QE well before the real economy does.

China is yet another example of the weak link between economic growth and stock prices. Although the Chinese still have a truly enviable real economic growth rate of 7%, their stock market suffered a steep decline in June that did not stop until early July. The Shenzhen Index fell more than 30% in approximately one month’s time. The Chinese government has attempted to stop the slide with trading halts, account suspensions, and easier money, but stock markets are very hard to tame, especially in the aftermath of a large bubble. This bubble was so large in China that even after the recent decline, Chinese stocks are still ahead by 65% over the last 12 months!

#### **OUTLOOK:**

The US bull market in stocks, like the US economy, may continue to plod ahead at a measured pace for the rest of the year. A modest increase in interest rates should not derail either stocks or the economy. The Greek financial drama could still have a significant negative impact on European stocks, and a minor one on US stocks. The negotiations between Greece and its creditors could still break down, and deteriorating economic conditions in Greece make it even less likely that the bankrupt nation can survive in the Eurozone without substantial debt relief. Long-term investors must remember that they are eventually rewarded for shouldering just these kinds of risks.