THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY

US Markets and Economy:

Stocks continued their post-Brexit rally in July, with the Dow Jones and the S+P 500 Indexes reaching new all-time highs mid-month. The tech-heavy NASDAQ Index rallied more strongly in the month, and came very close to its all-time high at 5200. The key market driver has been extremely low and falling interest rates. Although the Federal Reserve Open Market Committee (FOMC) left short-term rates unchanged as expected, the decline in long-term rates during late-July reached unprecedented levels. The 30-year Treasury yield at one point approached 2%, with the 10-year yield touching 1.4%. These rates help stocks for two reasons: first, with the dividend yield on the S+P 500 exceeding 2%, Treasury bonds of all maturities are weak competition for stocks, which have the built-in potential for capital gains. Second, these extremely low rates are expected to push the economy forward, which will increase corporate revenues and profits, driving stocks higher. This second effect, however, is more problematic, since corporate revenues are growing slowly at best, and US corporate profits are weak, pulled down in part by continued misery in the energy sector. Top-line growth for the business sector is linked to the rate of growth of GDP, which remains painfully slow. Late in the month, the first estimate of second quarter GDP was released, showing a disappointing annualized growth rate of real GDP of only 1.1%. Although this is a slight improvement over the revised rate for the first quarter of 0.8%, it extends a long streak of subpar growth that has persisted in the years since the end of the Great Recession in 2009.

Economists are divided over the underlying causes of this slow growth, which has been accompanied by even slower growth in prices and wages. Some argue that this is a semi-permanent condition (called "secular stagnation") that will continue to afflict most major economies, as their population's age and productivity growth remains low. Others point to the robust gains in employment (strong again in June), a recent uptick in wage growth, and an unemployment rate below 5%, as evidence that faster growth is just around the corner. The FOMC is clearly in the latter camp but the Fed committee consensus is to hold off on short-term rate increases until there is more evidence that the economy is indeed returning to more normal growth of 2-3%, combined with inflation picking up to the Fed target of 2%. It is possible, given weakness in Europe and Japan, that the Fed will not increase rates this year at all.

World Markets and Economy:

US stocks and bonds are also benefitting from capital flows from abroad. With interest rates in Europe and Japan at unprecedented negative levels, and the economic outlook clouded by Brexit, the US still looks like the best game in town. In Germany, government 10-year bonds had negative yields for the entire month of July. This means investors are paying the German government to hold their money for 10 years! This is not an isolated occurrence: most estimates show that the total amount of world debt with negative yields now exceeds $10 trillion. The European Central Bank (ECB) expects that these negative rates will jumpstart the European economy, but so far the results have been disappointing. The British may fall into a recession as they begin the process of leaving the EU, and the EU itself will also suffer from Brexit. Meanwhile, the Italian banking system, dragged down with a large amount of nonperforming loans, is still in need of a bailout of some kind, while Greece is still suffering from the rigors of austerity. European stocks, however, rallied for most of July, with the Eurostoxx 50 blue chip index rising almost 10% from its post-Brexit low. The FTSE 100 Index of large British companies actually reached a 12-month high in July, since the post-Brexit fall in the British pound will stimulate their export sales. Other European markets also rallied, although the advances in troubled Italy and Greece leave their stocks well below the highs of recent years.

The Japanese stock market also rallied in July, even though economic growth remains elusive. The Abe government, which postponed a scheduled increase in the national sales tax, has regularly announced new programs of fiscal stimulus, and the Bank of Japan has reduced short-term rates below zero. Both of these policies are good for stocks. But some of this monetary and fiscal thrust has been offset by a steadily rising international value of the yen, which hurts Japanese exports, and thus weakens aggregate demand. Japan, with its aging and declining population, is serving as a laboratory test of the battle against secular stagnation.

OUTLOOK: The US bull market showed new life in July, and will be buoyed for the rest of the year by the continuation of extremely easy money policies here and abroad. Low rates have overpowered concerns about weak corporate profit growth, but the “tug of war” between these two stock price drivers will likely continue.