



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JUNE

US Markets and Economy:

US stocks rallied in the first half of June, only to sell off in the last half and end little changed for the month. The factors we described last month were all in play again: a strong economy with rising corporate profits drove the market higher, while fears of a trade war and rising interest rates brought it back down again.

The good news: even though first-quarter real GDP growth has been revised downward to a meager 2%, corporate profits are soaring, partly in response to lower taxes. At the same time, expectations for a roaring second quarter were becoming stronger: the Atlanta Fed's GDP Now forecast is currently suggesting second quarter growth of 3.8%, and the Blue Chip average forecast is for 3.5% growth. These rates would be well above the slow pace of recent years, and constructive for further growth in corporate profits. Repatriation of profits held overseas could also stoke both stock buybacks and dividend increases, both of which could provide more support for rising equities.

Fears that more rapid growth would push the economy into a period of sharp increases in wage and price inflation (with concomitantly higher interest rates) have also not materialized. In fact the Fed itself thinks that unemployment will drop to 3.5% (the lowest rate in decades) by the end of 2018, *without* an increase in inflation above 2%, its current target. This is also bullish for stocks, which sometimes swoon in the face of increases in interest rates.

So what could go wrong with this Goldilocks scenario? Last month's Papa Bear was fear of a worldwide trade war, and in the second half of June, this unpleasant possibility seemed a bit more likely. President Trump showed no inclination to back off from his tariffs already imposed on steel and aluminum, with additional tariffs on more goods set to take effect soon, and with even more promised. Our trading partners have retaliated, aiming specifically at deep red states (Kentucky bourbon) and pro-Trump firms and industries (Harley-Davidson motorcycles). The case of Harley-Davidson is especially interesting, as increasing costs for aluminum and steel, and new tariffs in Europe on their motorcycles, resulted in a June announcement that they might move some production to Europe to avoid the tariffs and higher costs.

While so far the sizes of the tariffs and retaliations are small compared to either US exports or GDP or world trade, Wall Street fears that continued escalation could hurt all trading partners, including the US. While it is certainly true that the US “needs” trade less than most countries, since the size of our exports and imports is relatively small compared to our trading partners, millions of US jobs still depend on exports, and higher costs of imports could increase the cost of living for the average American, and even reduce profit margins of firms which rely on cheap imported inputs for production. (At the end of the month, General Motors made these points about potential US tariffs on automobiles.)

Mama Bear last month was increasing short-term interest rates. In this case, even though rates are still low, there is some fear on Wall Street that the FOMC, under Chairman Powell, may be a bit more hawkish than the Yellen Fed. The Powell Fed may therefore raise short-term rates faster than planned, especially if inflation pokes its head above 2%. There are two rather subtle reasons for this: first, the new guy in charge needs to show his inflation-fighting chops to protect the credibility of the Fed. In simple terms, this means that the Fed cannot effectively control the public’s expectations of inflation unless the public believes the Fed is serious (credible) about keeping inflation low. The Fed, like any central bank, does not want to lose this credibility: the last time it really lost it was in the 1970s, which was a bad period for inflation and for stocks. The second subtle reason is that the FOMC is currently not fully staffed, so that the Presidents of the regional Fed banks (5) have more votes than the sitting members of the Board of Governors (3). Historically, bank Presidents have been more hawkish (inclined to raise interest rates) than the more dovish members of the Board of Governors (less inclined to raise rates).

What has also unnerved some Wall Street traders is that the Fed’s plan to gradually raise short-term rates (they went up ¼-percent again in June) has occurred while long-term interest rates have been stable. This comparison between short and long-term rates is known as the “yield curve,” and it is true that if the curve “inverts,” that is short-term rates rise above long-term rates, the economy could end up in recession some time later. Yet the yield curve has not inverted, and it may not do so.

Thus stocks are still being pulled in both directions, as they have been all year: superb economic growth, with low inflation and sharply rising corporate profits, battling against fears of a trade war and rising interest rates. This tug-of-war has so far shown, as in June, a small bias to the upside with the selloffs being sharp but brief. The second half may bring more of the same.

World Markets and Economy:

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, followed US stocks fairly closely, rising in the first half of June, and then selling off in the second half of the month to end unchanged. Germany’s DAX was one of the worst performers, falling nearly 3%, and now down almost 10% from its January peak. Chancellor Merkel is stuck with a fractious governing coalition, slowing economic growth, and fears that an escalating trade war will particularly hurt Germany’s export machine, which is partly based on automobiles. Turkish stocks were the weakest in Europe, as Erdogan’s victory at the polls did nothing to stem the fall in the international value of the lira. Turkish stocks are now down 20% from their high, the standard measure of a bear market. (Turkey is a textbook example of what happens to markets when the central bank begins to lose credibility in its inflation fight.)

The big mover in Asia was the Chinese stock market, which fell sharply for the month, and is now also down about 20% from its high for the year. Chinese economic growth may be slowing, and a brewing trade war with the US could hurt Chinese exporters.

OUTLOOK: The long-term path for US stocks remains upward, as a strengthening economy can further boost soaring corporate profits, while US monetary policy remains, at this point, benign. This sunny outlook can be clouded over by fears of trade wars and rising interest rates, which could put pressure on all equities around the world. Long-term investors, however, are well-rewarded for riding out the squalls and holding on for the return of sunnier weather.