



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MARCH

US Markets and Economy:

US stocks had a strong March, rallying enough to wipe out the losses incurred early in the year. More evidence of economic growth in the US has allayed the (misguided) fears of a US recession: employment growth remains strong at over 200,000 net new jobs created every month, unemployment remains low at 5%, and more Americans are returning to the labor force to seek jobs which are actually paying more than a year ago. Real median wages are now rising at about 2% a year, which means the average American household has more to spend, further driving growth. The housing sector in the US remains strong, with prices rising in most of the US, and home construction is still rising. Even more American homeowners now have positive equity in their homes, which further fuels consumption spending. Fourth quarter real GDP was revised upward, and this year's first quarter real GDP could show growth near 2%. Short-term interest rates remain extremely low, and are still negative in real terms. With the Fed's FOMC and Janet Yellen herself suggesting that rates will rise very slowly this year, it is quite likely that short-term real rates will be negative all year, which should continue to stimulate economic growth. Somewhat more surprising is the continued good news on inflation, which remains stubbornly below the Fed's target of 2%. Very low inflation means that the Fed can adopt an even more leisurely pace of interest rate increases this year. Some of the low inflation can be put down to weak oil and commodity prices, but even removing food and energy from the calculation leaves inflation at very low levels. The US dollar will remain strong this year, since rising nominal interest rates in the US are more attractive than negative and falling rates in the Eurozone and Japan. A strong dollar is good for consumers, since it will keep down the price of imports, but it cuts into the overseas profits of US multinationals, which must convert those euro and yen profits into a smaller amount of US dollars.

Weak corporate profits cloud the otherwise sunny economic outlook. While energy sector earnings have been the hardest hit, corporate earnings overall have been flat to down for several quarters. This weakness is the main factor keeping a lid on stock prices, with a flat year in 2015 and now a flat quarter to start 2016. Since economic growth will probably pick up in the rest of the year, with oil prices bottoming out, corporate profits should begin growing again, albeit at a slow pace. With nominal GDP likely to grow this year at around 4%, corporate revenues will likely grow at that pace, and unless businesses can increase their profitability, overall corporate profits may only inch ahead this year. Of course, an average hides wide variation by industry. All

else equal, firms that export heavily or compete fiercely against imports will be constrained by the strong dollar, while firms that sell mostly in the US, and face less foreign competition, should produce stronger results.

World Markets and Economy:

European stocks made little progress in March, and are still down for the year. The threat of more terrorism, British exit from the EU (Brexit), and the intractable refugee problem have outweighed the strenuous efforts of the European Central Bank (ECB) to restart growth in the Eurozone. In addition to negative nominal interest rates and massive Quantitative Easing (QE), the ECB will now essentially pay banks for making loans. (Bank loans are a more important source of corporate finance in Europe than they are in the US.) So far, wildly expansionary monetary policy has not had the salutary effect in Europe that it had in the US.

But the spotlight in Europe will be on the Brexit referendum on June 23rd. If Britain does decide to leave the EU, the economic consequences for Europe will be negative, and the financial shock waves could easily wash up on American shores. All European stock markets will be on the defensive as the closely contested vote approaches.

Economic growth in Japan has also been weak in spite of heroic efforts by the Bank of Japan (BOJ) to stimulate the economy with negative interest rates and QE. (Although the Nikkei stock average had a good month in March, most of the gains were wiped out in early April.) Japanese stocks, which were stellar performers from 2012 to mid-2015, are now down more than 20% down from their peaks of last year. This decline is dwarfed by the drop in Chinese stocks, which are still down 40% from their 2015 bubble highs, even after a modest rally in March. The Chinese economy is still decelerating as Beijing tries to move its economy toward consumption and away from reliance on investment and exports. No one knows how much the economy has slowed, but countries like Brazil, Australia and Germany have seen their exports to China drop significantly. At the same time, many Chinese individuals and firms are taking financial capital out of China, which puts downward pressure on the yuan exchange rate. The Chinese have been defending the exchange rate, but another devaluation is certainly possible. The last devaluation did lead to a worldwide selloff in stocks.

OUTLOOK: The seven-year-old US bull market survived another sharp correction in January-February, and is now poised to show modest gains for the rest of the year. The path upward will not be smooth, since shocks emanating from Europe and China could cause sharp and sudden corrections. The US itself will add to the uncertainty as the presidential election is only seven months away.