



## THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JULY

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

American stocks had a good start to the second half. The broad-based S+P 500 surged almost 100 points (nearly 4%) in July, coming close to the all-time high set in January 2018. The technology-driven NASDAQ actually made a new all-time high in July, before settling back a bit at the end of the month. The blue-chip Dow Jones Industrials also kept pace, rallying over 1000 points for the month.

The key driver for the broad-based July gain was clearly corporate earnings. Although a number of companies have yet to report on their second quarters, it is possible that corporate profits were up almost 20% from a year ago. Much of this gain reflects a reduced corporate tax rate, and some of the remainder represents an economy in its ninth year of recovery still growing, with a full head of steam.

The initial report on second-quarter GDP growth showed a substantial acceleration in real GDP to a 4.1% annualized rate, one of the best in recent years. Consumption, business investment, and exports were all strong. Even more good news came on the inflation front, with the Fed's key measure, the Personal Consumption Expenditure (PCE) Deflator rising only 2% annually, and even after stripping out volatile food and energy prices, the "core" inflation gauge was still almost exactly 2%. This is an excellent result, since 2% is exactly the inflation rate that the Fed is shooting for, while the nation's unemployment rate, at 3.9%, is one of the lowest in decades. Employment continues to grow solidly, and even wages have shown an increase, so that the average worker is taking home more in real terms.

In order to keep inflation from picking up, the Fed is likely to raise short-term interest rates two more times this year (they made no change at their meeting in the beginning of August.) The Fed believes this will be sufficient to keep inflation at 2% while allowing the economy to keep growing, with unemployment dropping further to 3.5%.

The main dark cloud in this otherwise sunny picture is on the international front. The U.S.'s tariffs have brought about the expected retaliation by the Canadians, Mexicans, Europeans, and Chinese. While President Trump and the Europeans may have reached a temporary truce in their

tariff battle, the US is planning to move ahead with higher tariffs against the Chinese. An escalation here could cause economic pain for American exporters, especially farmers, when the Chinese retaliate further. If the Canadians and Mexicans refuse to renegotiate NAFTA, trade could be disrupted even more, which could put a dent in US economic growth and add to inflation. Economists call this double-whammy a “supply shock,” and Wall Street is still betting that a war of words will not lead to trade wars.

The second cloud on the horizon is the upcoming mid-term elections. Oddsmakers now give the Democrats an even chance to retake control of the House of Representatives, and this outcome would likely then return the US to full political gridlock until the 2020 election. While Wall Street is often happy with political gridlock, in this case it would mean the Trump pro-business agenda could be stymied.

Overall, US stocks have a strong tailwind from rising corporate profits, low inflation, and solid economic growth. Any US selloffs are likely to be induced by trade troubles or political uncertainty.

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

World markets are also hostage to political developments. The British, in particular, are facing the approaching deadline for Brexit, with no negotiated agreement in place for the departure from the EU. A “hard” Brexit with no agreement could cause a major economic disruption in England, with shock waves that would hit the continent, and could even be felt in the US. This worry has led to several selloffs in British stocks, which made no net gains for the month.

German stocks gained for the month, but are still down over 1% for the year. This weakness reflects both fears of a growing trade war between the US and the EU, since Germany is the EU export powerhouse, and also political fears that the Merkel coalition government could collapse.

French stocks had a good month, as economic growth is poised to exceed 2% in 2017, a big improvement from previous years of very sluggish performance. This strong growth has pushed French stocks ahead over 3% for the year, in spite of new political troubles (and loss of popularity) for Macron.

In Asia, Japanese stocks managed a small rally for the month. The BOJ’s Kuroda announced at the end of July that the central bank would keep short-term rates extremely low for an extended period of time. This is a version of Ben Bernanke’s “forward guidance” which he used to help stimulate economic activity by bringing long-term rates down. The BOJ’s task seems much tougher, since the bank is struggling to get inflation back up to 2%, a goal which the US has achieved. While this should be bullish for stocks, the economy in Japan is sputtering again. Economic weakness hurts corporate profits. The tug-of-war between these two factors has kept the Nikkei flat for the year.

**OUTLOOK:** The long-term path for US stocks remains upward. A strong economy and tax cuts have boosted corporate profits, while US inflation and interest rates remain relatively low. This sunny outlook can be clouded over by fears of trade wars and political uncertainty, which could put pressure on all equities around the world. Long-term investors should not be alarmed by short-term selloffs. Every selloff in this long bull market has been followed by new all-time highs.