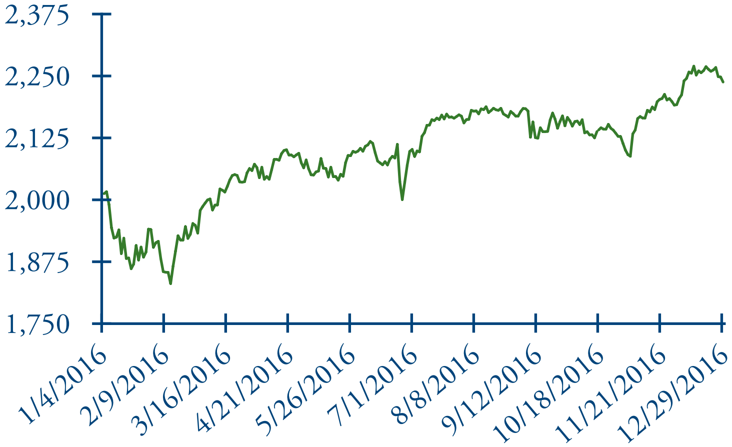
Q1 2017

The Reilly Report:

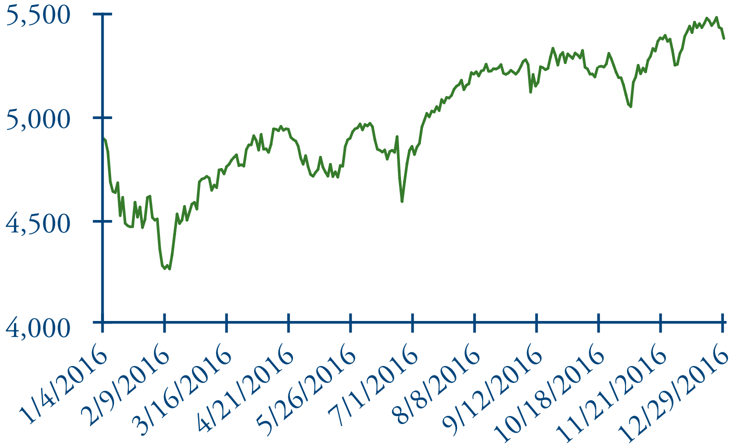
REILLY REPORT 2016: REVIEW AND OUTLOOK

The US bull market in stocks resumed in 2016, with major averages hitting all-time highs, and the Dow Jones Industrial Average finishing the year just below the once-unthinkable 20,000 milestone. The broader-based S+P 500 Index logged a gain of nearly 10% for the year, and the NASDAQ Index, which is filled with technology stocks, rallied 7.5% in 2016. Unlike 2015, small stocks were not left behind this time: the Russell 2000 Index of smaller companies rocketed 20% for the year, reaching an all-time high. All of these gains came despite a very poor start to the year, which took the Dow down nearly 2,000 points by mid-February. Another brief but sharp selloff (1,000 Dow points) occurred after the surprise Brexit vote. And, in the period from mid-July to early November, stocks were flat to down, reducing the market gain for the year to a modest 3%. But the post-election Trump rally was powerful, with the Dow gaining nearly 2,000 points in less than two months.

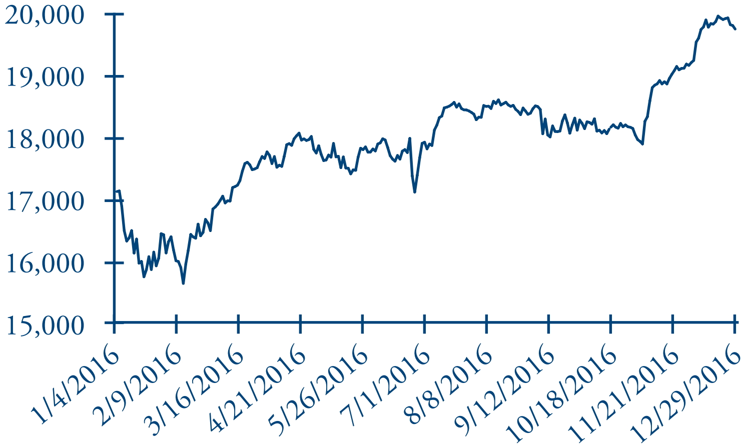
S+P 500



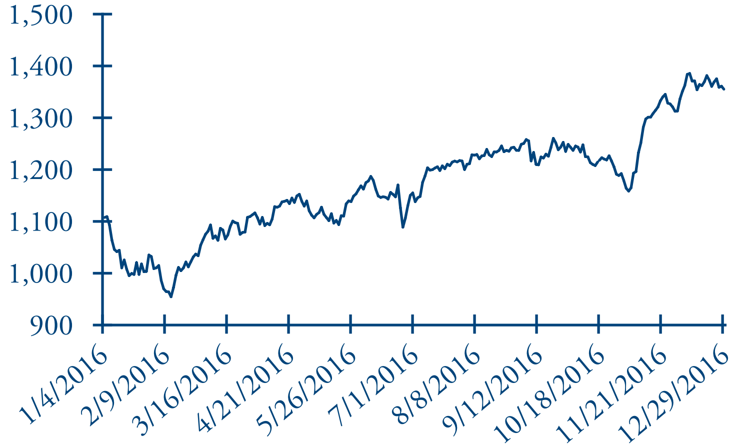
NASDAQ



DOW



Russell 2000



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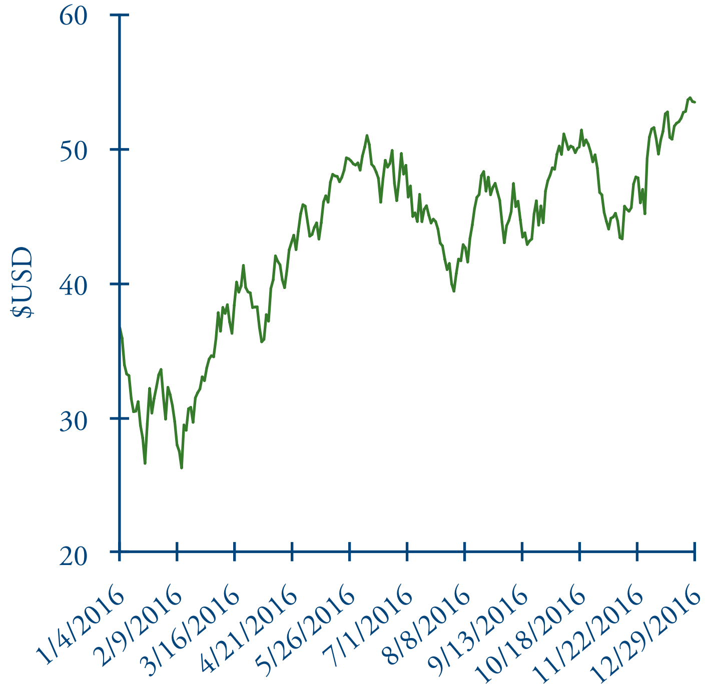
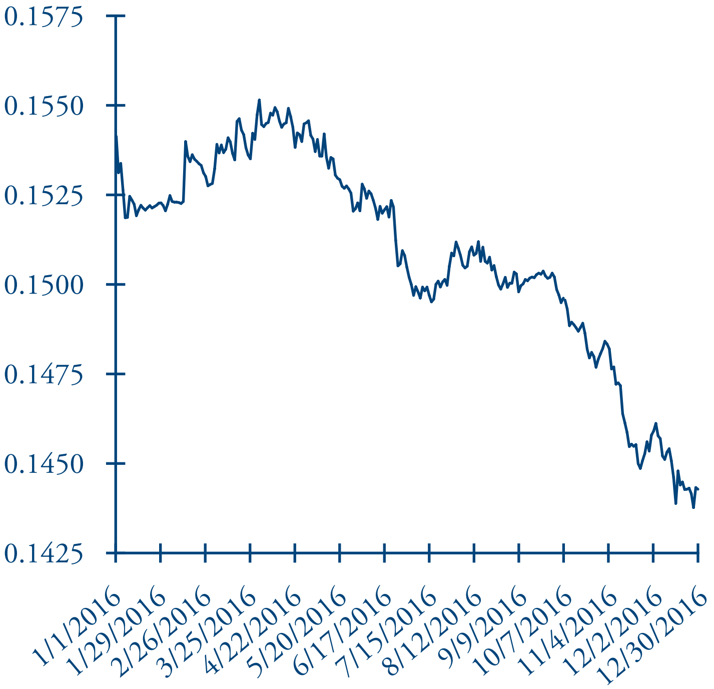
The early-year selloff was mostly based on fear: fear that an economic slowdown in China, together with a declining exchange value of the yuan, would combine with slow US growth to create a recession in the US, Europe, and Japan. Energy sector stocks led the way lower as oil prices collapsed to a mid-February low of $26 a barrel. But then fear gave way to reality: Chinese growth was indeed slowing down, the yuan was likely to depreciate further, and growth was slow in the US. But a recession was never likely. And then an oil price rally put recession fears to bed. Chinese growth did indeed slow down to an officially reported 6.7% annual rate, although the true rate might have been a percentage point or two slower. This rate would be considered outstanding performance for almost any country other than China, and Chinese growth of 10-12% a year was never sustainable. The yuan did continue to gradually depreciate, but there was no sudden shock like 2015, when the yuan was devalued overnight. And for the US, there was never a reason to think the US economy was about to enter a recession. The entire period of US growth since the end of the Great Recession in 2009 has been one of stop-start growth. In fact, the first quarter (January-March) of US growth has been artificially depressed for years. The Department of Commerce must seasonally adjust each quarter’s data, and this adjustment process is an inexact science, which in recent years has depressed first quarter GDP. More surprisingly, the fall in oil prices seemed to hurt US energy producers more than it helped US energy consumers, but the recovery in oil prices made that concern a moot point.

Oil Prices



Yuan Exchange Rate

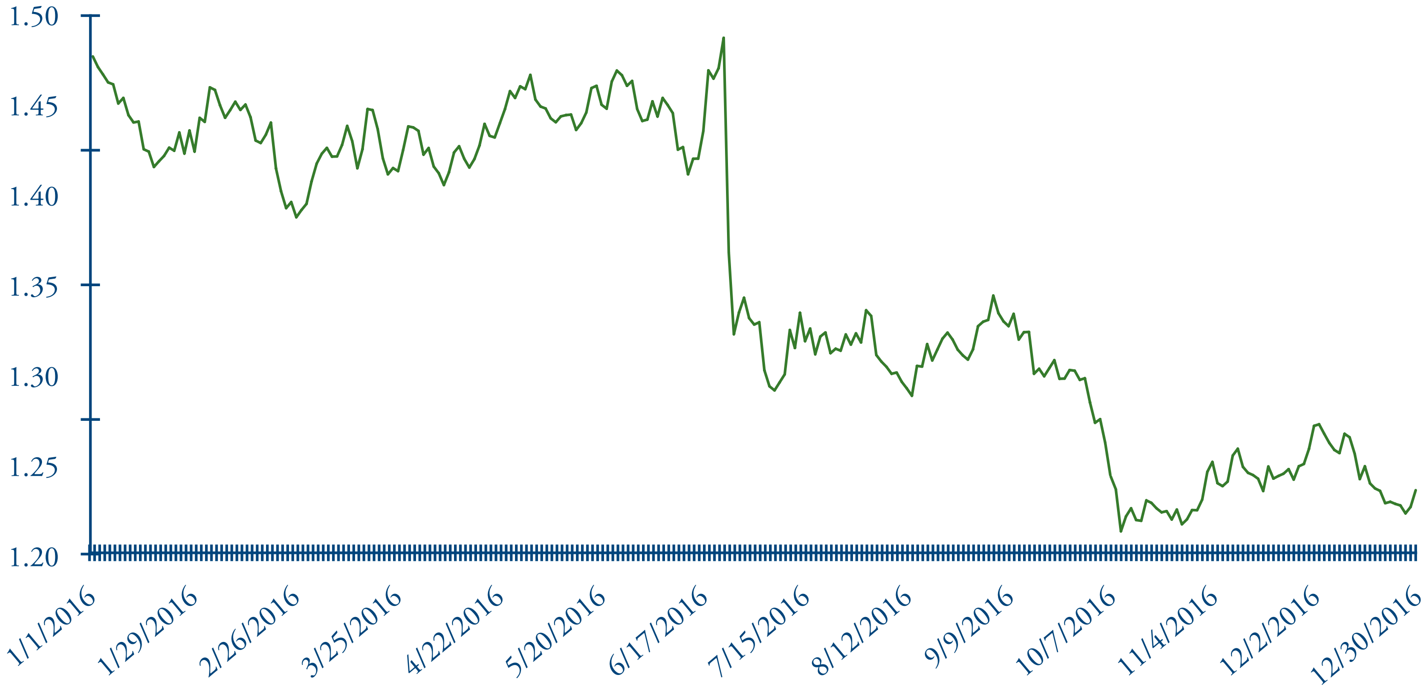


With recession fears debunked, stocks rallied, only to be blindsided by the Brexit vote in June. Polls had all suggested that Britain would vote to stay in the European Union, but the "Brexiteers" won anyway. The British pound sold off dramatically, and this decline, coupled with fears that the European Union (EU) would break apart, sent shockwaves around the world. But stock traders' bearish sentiments turned on a dime (or a shilling) very quickly. Large British exporters were likely to gain enormously from the fall in the exchange value of the pound, and this helped British stocks recover. (The pound did not.) At the same time, it became clear that a departure from the EU would take years to implement, and the British would have time to renegotiate trade agreements with their EU partners. Result: fears abated, stocks recovered.

The mid-July to early November weakness was likely a response to what economists call "policy uncertainty." Would Clinton win, and give the US four more years of Obama policies? (Thought likely, and considered a downer, even though stocks had risen mightily during the Obama years.) Or would Trump pull the upset? (Considered unlikely, but also an expected downer, on the belief that his statements did not reflect coherent or sound economic policies.) Defying the polls, Trump pulled the upset, an overnight collapse in stock futures was reversed the next day, and the market has been rallying ever since.

What has driven the intense post-election rally? Investors concluded that a business-friendly Congress, President, and Supreme Court would reduce or eliminate regulatory burdens, speed up economic growth with increased spending on the

British Pound Exchange

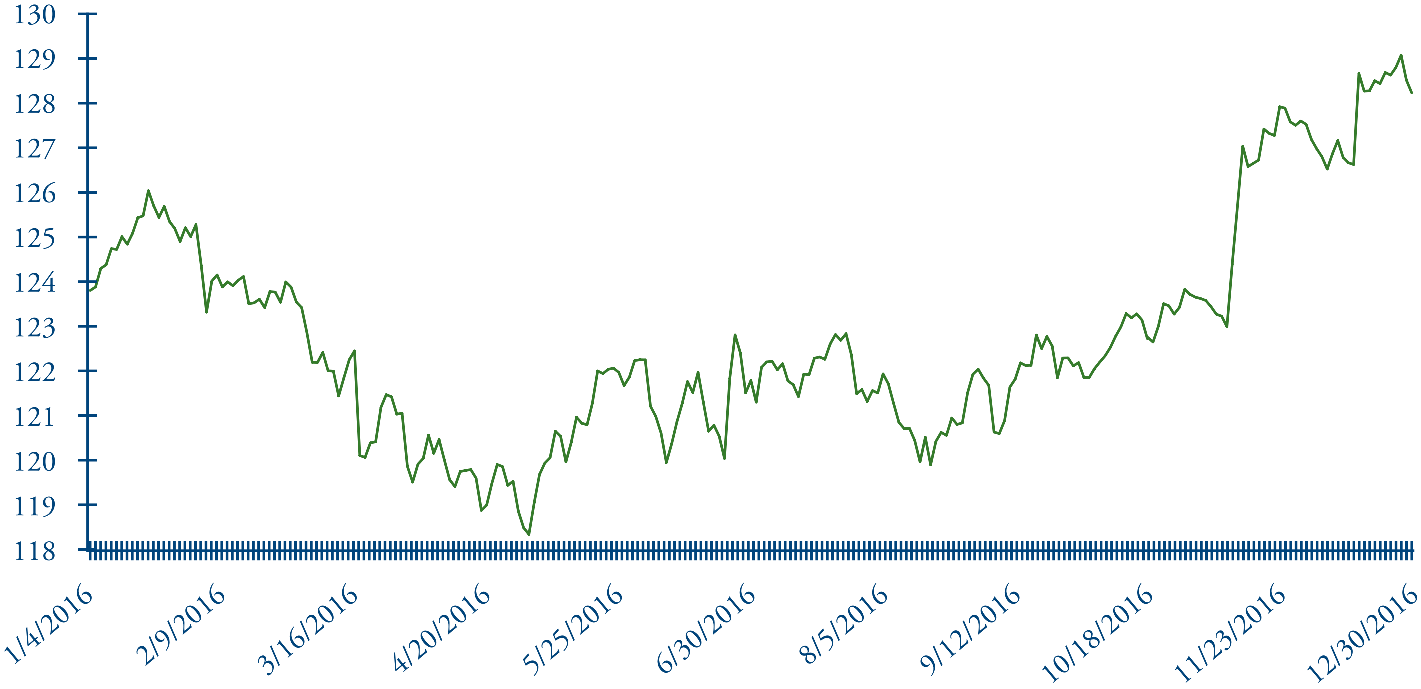


military and infrastructure, and cut taxes on businesses and households. This potent recipe could drive corporate earnings, which were flat to down in 2016, to much higher levels in 2017.

A pickup in US growth will likely be restrained by the Federal Open Market Committee (FOMC), which kept rates at rock-bottom levels all through 2016. The Fed's rationale for maintaining such expansionary monetary policy was that there was still "slack" in the economy and labor market, meaning that growth could accelerate without a pickup in inflation. By December 2016, however, the FOMC did tap the brakes with a ¼-percent increase in the Fed Funds rate. More importantly, the Fed suggested that short-term rates would be rising in 2017, as the economy reached potential, and inflation picked up to the Fed's official target of 2%. The measurement of the economy's potential is also an inexact science, although most economists agree that, for 2017, an unemployment rate of 4.5% is very close to potential. (Unemployment cannot go much lower in peacetime, since, in our modern dynamic economy, the labor market "churns," with millions of workers hired every month, while millions more quit, and hunt for a better job.) With the unemployment rate already at 4.6% in November, and wage growth showing signs of life, the Fed will likely raise rates multiple times in 2017.

Foreign currency traders anticipated some Fed tightening in 2016-17, and pushed up the exchange value of the dollar in 2016, especially after the election. The dollar is rising because dollar assets provide better yields than those available in Europe or Japan, and "hot" money tends to flow from lower-yield to higher-yield

Trade Weighted Dollar



assets. This rise in the dollar hurts the US trade balance. Export growth is restrained, since the dollar prices of US exporters appear more expensive in terms of euros or yen, while imports from China appear cheaper as the Chinese yuan slowly depreciates against the dollar. Since short-term interest rates in Europe and Japan will likely stay at zero or lower in 2017, while US rates increase, the exchange value of the dollar will likely continue to rise in 2017.

The Europeans will be keeping their rates at zero or below in a continued attempt to create sustained economic growth. The European Central Bank (ECB), which sets interest rates for the Eurozone, reduced its reference short-term rate further below zero in 2016, while announcing that its program of Quantitative Easing (QE), in which the ECB now buys €60 billion of bonds every month, will continue through all of 2017. This stance has helped reassure stock investors in Europe, enough so that the EUROSTOXX 50, a blue-chip pan-European index, gained nearly 20% in the second half the year. This recovery wiped out the losses in the first half of the year, which were partly a response to the Brexit vote. Weakness in the euro should also help push the European economy forward as exports strengthen across the bloc. Yet Europeans must face the possibility that the EU and the Eurozone could crack apart in 2017. An election in France in 2017 could bring Marine Le Pen to power, and she is likely to take France out of the EU, which, with Brexit, would be its doom. (Pollsters predict that she will lose the runoff election, but of course, polls showed Hillary Clinton defeating Donald Trump.)   European policymakers must also wrestle with continued slow growth in much of Europe, and persistent weakness in the Italian banking sector. The resignation of Italy's Prime Minister Renzi in December 2016 adds to the political uncertainty. Thus it is not surprising that European stocks could not keep pace with US stocks in 2016.

Japanese equities fell in sympathy with US and European stocks early in the year, and again after the Brexit vote, but the rally in the second half of the year was quite strong. The Nikkei rose more than 25% in the second half, for a net gain for the year. Although the Bank of Japan, like the ECB, is also pursuing a policy of massive QE and negative nominal short-term interest rates, there are signs that the Japanese economy is actually growing again, with GDP logging three straight quarters of economic growth in real terms. The Japanese outlook is also brighter because a weak yen should stimulate exports even more in 2017, and Japan is not facing the existential uncertainties of Europe.

China's economic growth has indeed slowed down to a more sustainable pace of 5-7% per year, as planned. This slower growth does mean that demand for raw materials will grow more slowly (impacting commodity-exporting countries like Australia and Brazil), but it also means that Chinese industries like steel need foreign markets to sell steel which cannot be sold at home. These increased exports create trade tensions with steel importers like the US, and have the potential to ignite a trade war if the US were to impose large tariffs on Chinese goods. Most economists agree that rising protectionism hurts all countries, and thus a trade war could send financial shockwaves around the world. Another factor which in the past sent financial shockwaves around the world is a sudden change in the value of the yuan. Chinese policymakers seem to realize this now, as they allowed the yuan to decline only gradually throughout 2016. Although this continued decline does help Chinese exports, the most likely source of the yuan weakness is an outflow of Chinese capital. The Chinese are still massive savers, and, as the economy becomes more integrated with the rest of the world, it makes financial sense for citizens and businesses to diversify their portfolios, rather than hold only Chinese assets. This movement entails a weak currency as yuan are sold for the dollars and euros needed to purchase foreign assets. As long as the Chinese engineer a slow decline in the yuan, with capital outflows kept at manageable levels, China should not be a major source of international financial instability.

THE 2017 OUTLOOK

The US bull market in stocks will likely continue in 2017, although sharp corrections can appear at any time, much as they did in 2016. Interest rates will be on the rise in the US (putting pressure on bond prices), although they will remain extremely low in Europe and Japan. This growing interest rate differential should push the exchange value of the dollar higher, which will act as a mild brake on US growth, and a mild stimulant for Europe. US GDP growth, in spite of some mild tightening by the US FOMC and a stronger dollar, could pick up a little speed. Increased government spending, combined with tax cuts, should stimulate consumption spending and investment spending, which will more than offset some weakness in our exports. This is still a favorable environment for US stocks, with corporate profits likely to rise after a weak 2016. Europe and Japan could see even larger gains if their zero/negative interest rate policies finally do lead to faster growth. Potential clouds on the horizon: a more sudden decline in the yuan exchange rate, further tremors in EU politics which could destabilize Europe, or a trade war among America and its trading partners, which could weaken the economies of all participants. For long-term investors, however, the British mantra should still be good advice in 2017: "Keep Calm, and Carry On."

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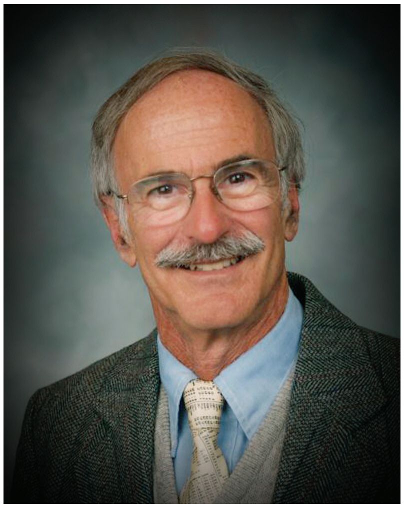
About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Daniel enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within context of the global economy.

Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

Daniel is the editor and publisher of The PAD System Report, an investment newsletter. He earned his Bachelor of Arts, Masters and Ph. D., all in economics, from Yale University.

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