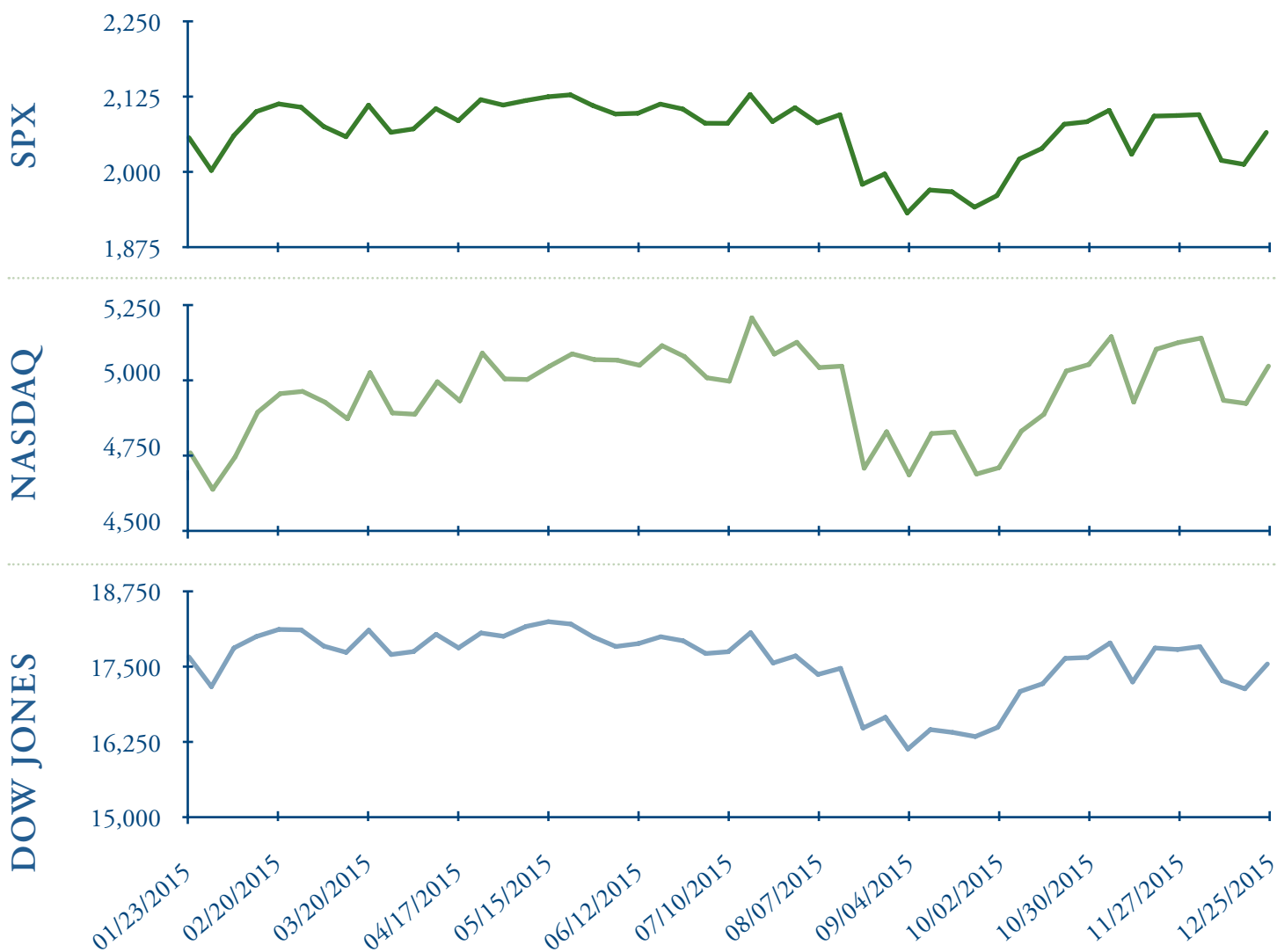


The Reilly Report:

REILLY REPORT 2015: REVIEW AND OUTLOOK

The long bull market in US stocks took a long anticipated breather in 2015. After surging yet again to new all-time highs in the first half of the year, stocks tumbled sharply in August, then rallied just as furiously, and ended the year about where they started. Although the Dow Jones Average had a small loss for the year, the broader S+P 500 Index managed a small gain on a total return basis, and the NASDAQ finished the year with a single-digit gain. During the summer drive to new all-time highs, the NASDAQ finally broke through its old high of 5048 set back in early 2000, although the NASDAQ fell faster than the other indexes in August.

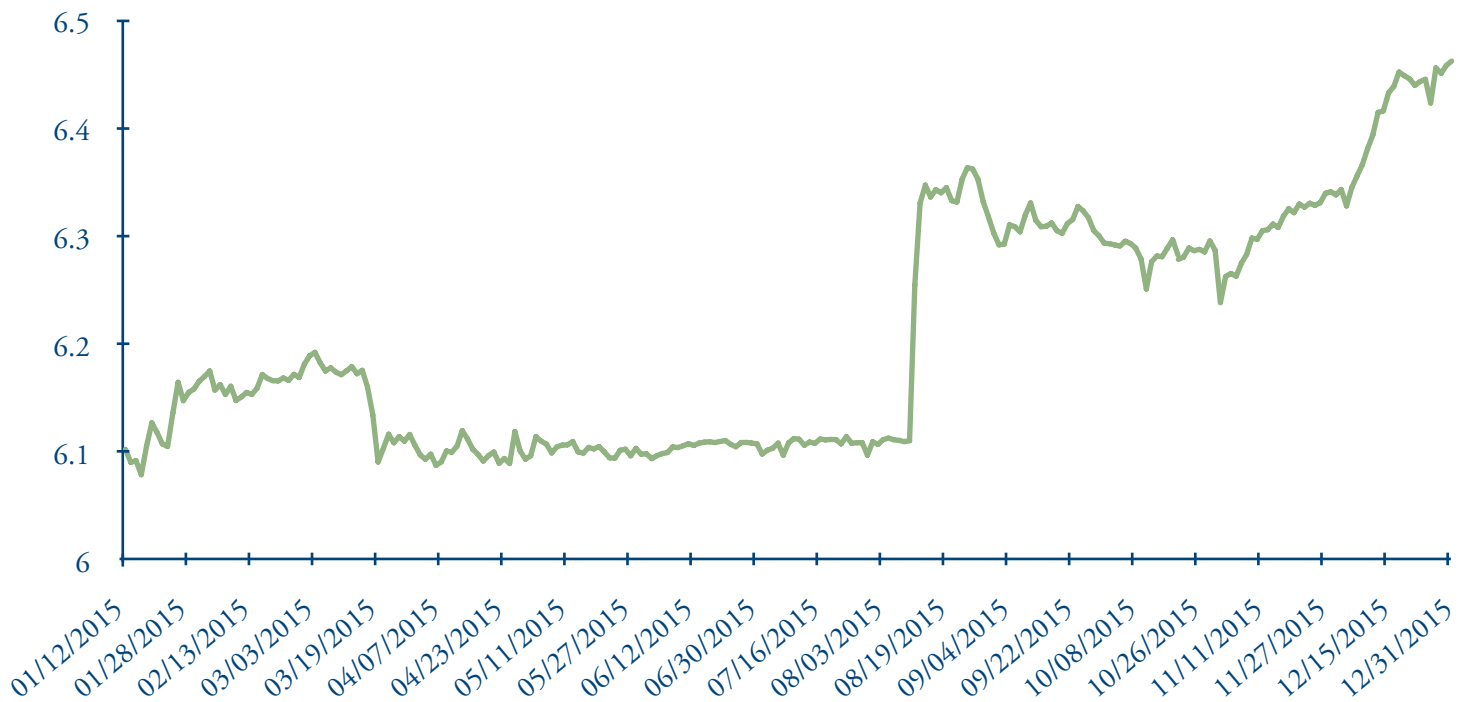
Figure 1:



The August selloff, one of the sharpest in recent years, coincided with a sudden change in Chinese exchange rate policy: the yuan (also known as the renminbi), was suddenly devalued against its “peg” to the US dollar. As the accompanying graph shows, the size of the devaluation was quite small in percentage terms, but marked a break with the essentially fixed 6.2 yuan per US dollar

which had prevailed for months. Many investors rightfully wondered why such a small change in the value of the Chinese currency should set off financial shockwaves around the world. Since the Chinese currency has renewed its decline against the US dollar, it is even more important to explain both the decline and its effect on financial markets. The Chinese government has tightly controlled

Figure 2: Yuan-Dollar Exchange Rate 2015



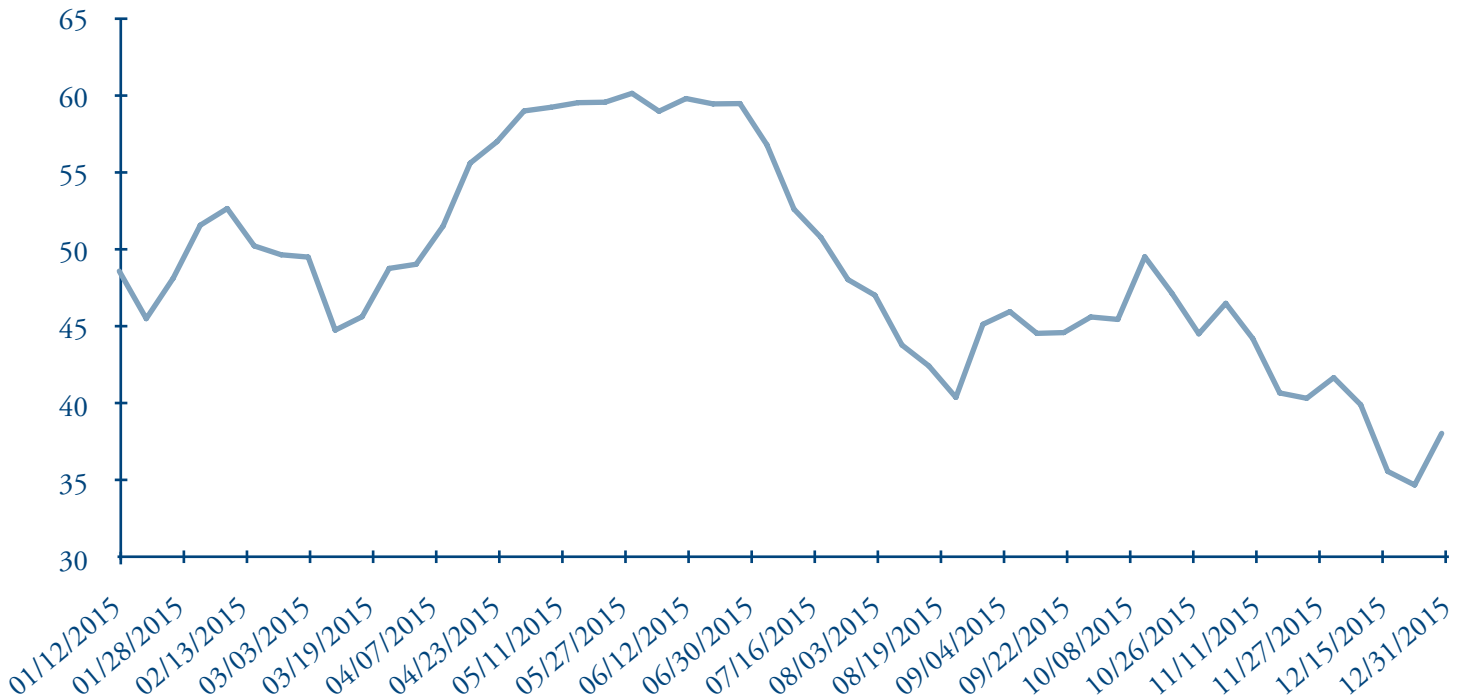
the exchange value of the yuan for decades, often holding it absolutely “fixed” against the US dollar for years at a time. When the value of the yuan was changed, it was normally to revalue it higher, to blunt criticism from its trading partners (especially the US) that the yuan was undervalued, giving Chinese exporters an unfair advantage. Revaluations also served to limit the growth in Chinese foreign exchange reserves, which

nonetheless have grown to several trillion dollars. An undervalued yuan has promoted Chinese exports. Rapid export growth, combined with a gigantic state-directed and state-financed program of domestic investment in infrastructure (roads, railroads, ports, and airports), factories, and housing have been the key drivers of the miraculous Chinese economic growth record of the past 30 years.

A side effect of this amazing growth feat, which has made the Chinese economy the second largest in the world, has been an insatiable hunger for raw materials and other imports, which has powered exports from countries as diverse as Australia, Brazil, and Germany. But this breakneck growth

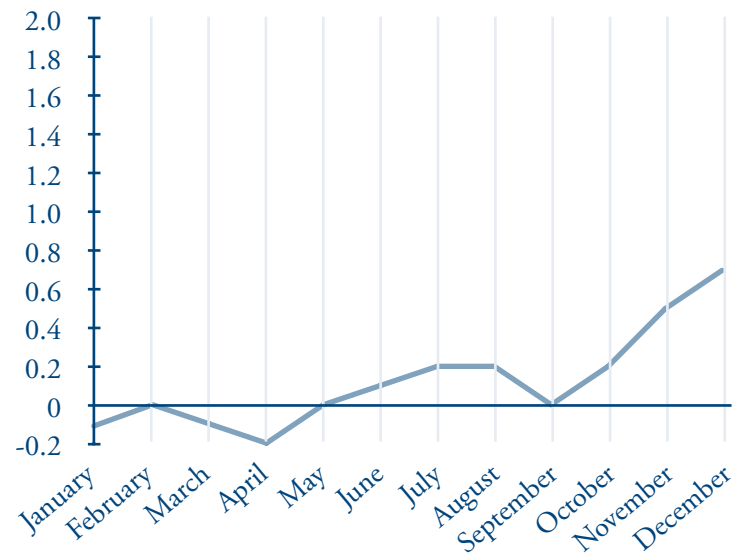
is now slowing from 10% per year to a more pedestrian 2-4% a year, as the Chinese attempt to rebalance their economy toward less reliance on exports and investment and more reliance on domestic consumption.

Figure 3: Crude Oil Price



The slowdown in Chinese growth had a major impact on almost all raw materials prices in 2015, especially oil. Oil, which had already declined sharply in 2014, was hit again because the Saudis maintained production while the US increased production from “fracking.” Declines in raw materials prices helped keep inflation very low in the US (see chart) and much of the world, but these declines weakened the economies and currencies of raw materials exporters like Canada, Venezuela, Australia, Brazil, and many others. At the same time, the Chinese decision to devalue the yuan, (taken in part to keep

Figure 4: US Consumer Price Index

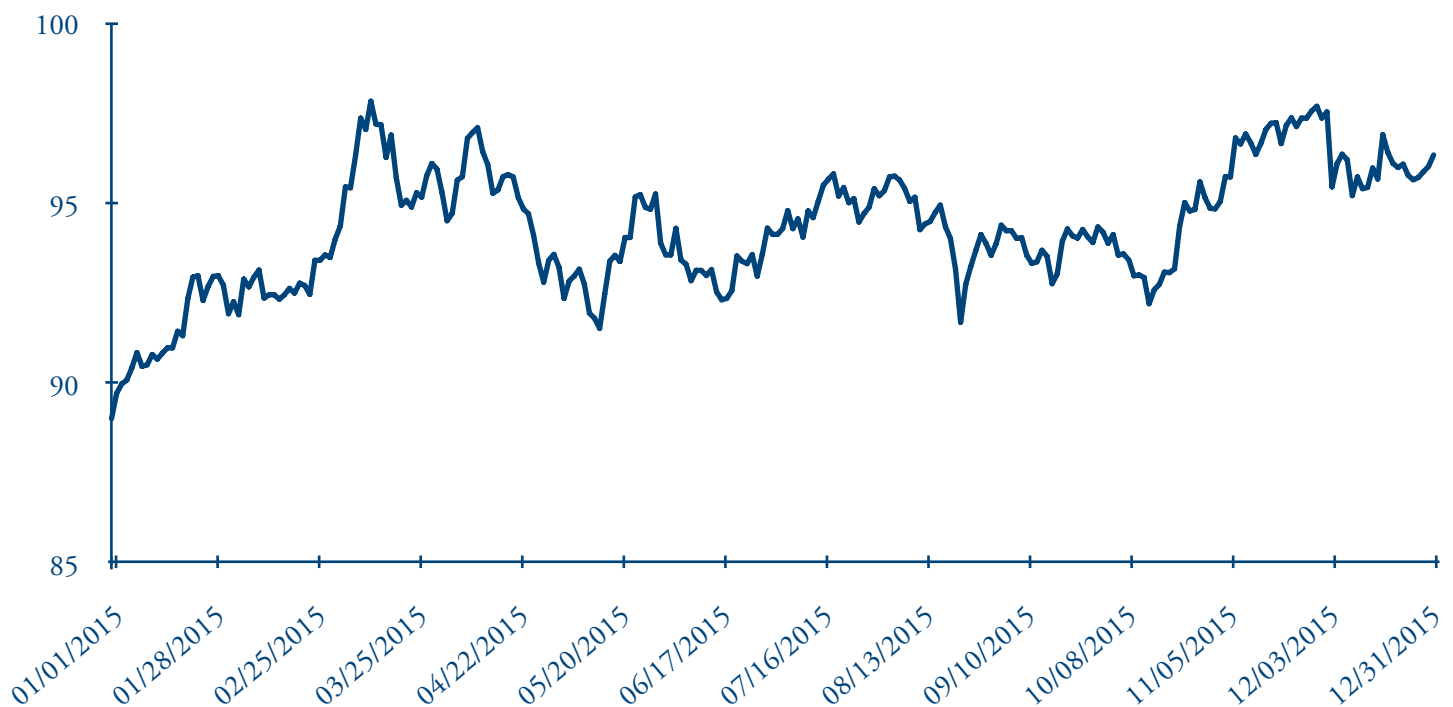


the Chinese economy growing), affected Asian countries like Vietnam, Thailand, and Indonesia, whose exports compete directly with China.

The final piece of the puzzle is why these financial and economic trends caused the US stock market to correct sharply in August. Less than 10% of US exports go to China, and international trade is a smaller part of GDP for the US than most rich countries. But if many world currencies are declining against the dollar, American multinational firms will see their overseas earnings weaken, and their sales in countries directly affected by China will also be impacted. As the chart shows, the international value of the dollar, measured against its main trading

partners, did in fact rise substantially in 2015. More directly, US energy firms (including the frackers) face dismal earnings prospects with oil at \$35 a barrel. Additionally, financial contagion tends to spread almost instantly around an interconnected world. For example, US stocks were pushed down briefly in 2011 when the Greek crisis was at its peak, even though the direct and indirect impacts on the US economy were very small. Another important historical example is the “Asian Contagion” of the late 1990s, when a series of currency devaluations destabilized Thailand, Indonesia, and others, and temporarily dragged down US stock prices, even though, once again, the economic impact on the US was small.

Figure 5: US Trade Weighted Dollar



In any event, cooler heads prevailed after the August selloff, and US stocks regained much of their losses. Long-term investors were once again reminded that the historically high long-term returns for stocks are in part the reward for weathering the often-bewildering short-term gyrations of the markets.

The August gyrations caused the US Federal Reserve to postpone its first short-term interest rate hike until December 2015. While this ¼ point increase was fully anticipated by the stock market, there is no doubt that the Federal Open Market Committee (FOMC) plans to raise short-term rates several times in 2016. Even though there is some disagreement

among FOMC members about the extent and timing of further increases, it is almost certain that US overnight interest rates will still be lower than the rate of inflation for all of 2016, which means that the “real” (nominal minus inflation) US short-term interest rate will still be negative all year.

The FOMC believes that economic growth in the US is now strong enough to withstand modest increases in interest rates, and employment growth and GDP growth in 2015 bears this out. The substantial growth in monthly payrolls has reduced the US unemployment rate to 5%, and further growth in 2016 could easily push this rate to 4.5%. At some

Figure 6: US Employment Growth

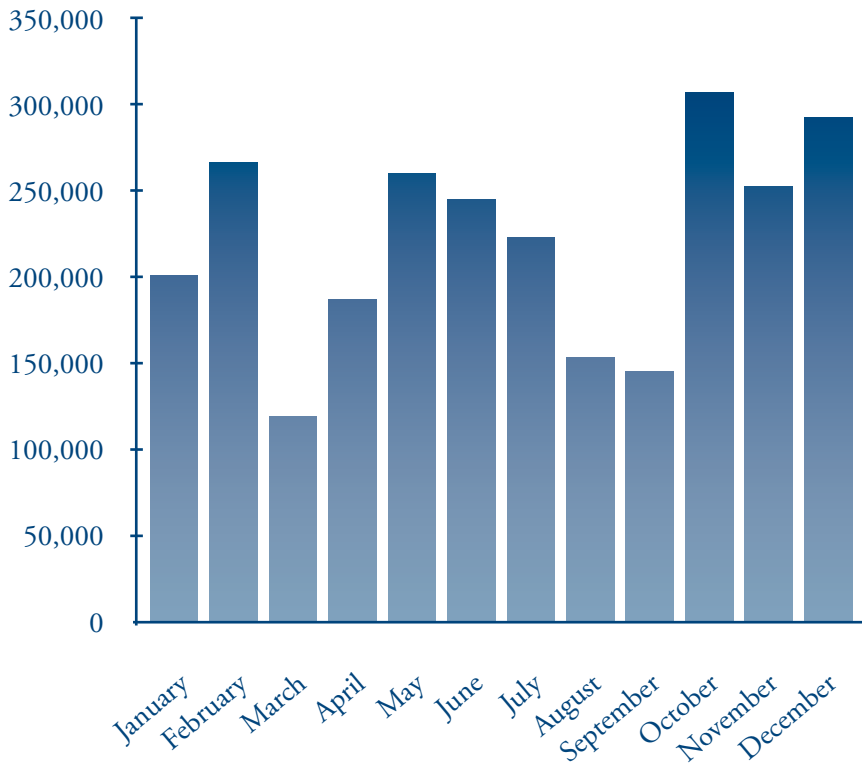


Figure 7: US GDP Growth

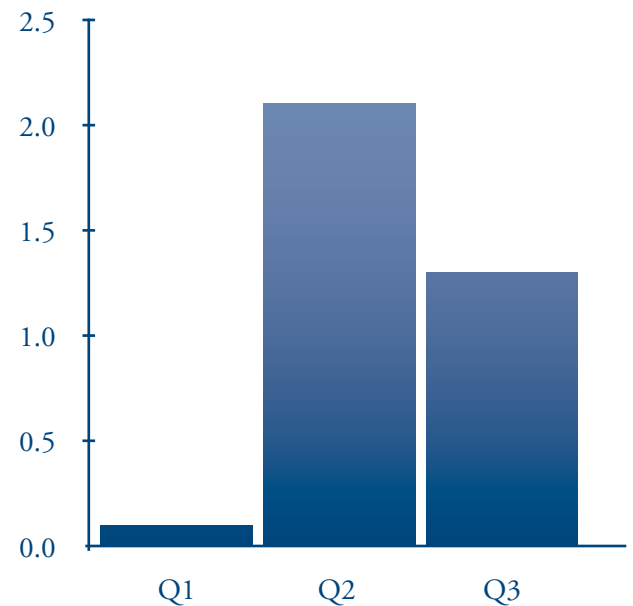
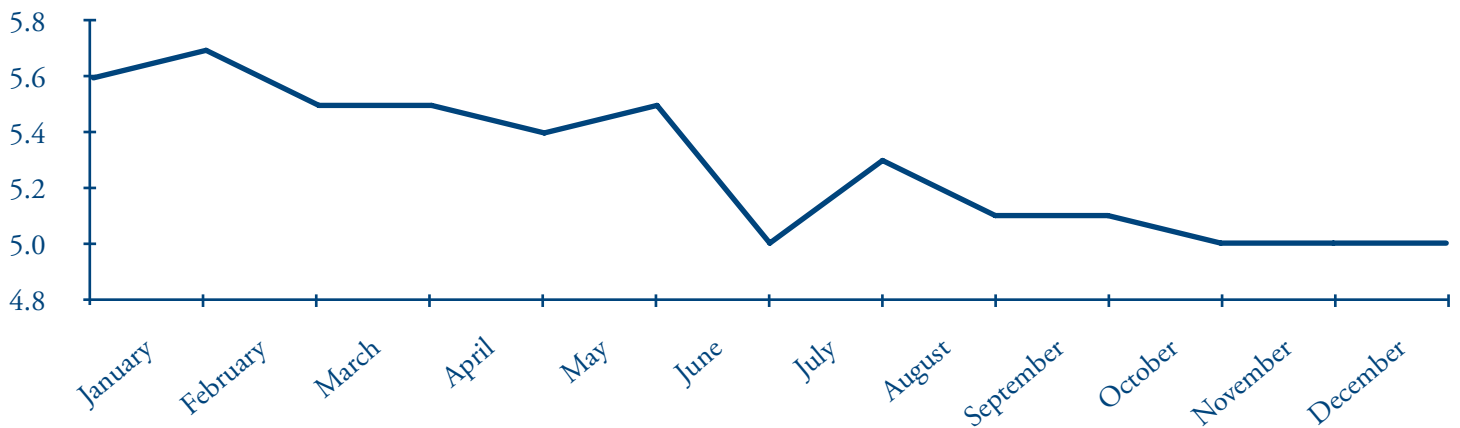


Figure 8: US Unemployment Rate



point, tightening labor markets will put upward pressure on wages (and then perhaps prices), but there is little evidence to date of this “Phillips Curve” effect. With tepid wage increases so far, and almost zero inflation, the FOMC can increase rates at a leisurely pace. Further support for economic growth in the US comes from low energy prices, which act like a tax cut for consumers. Indeed, low gasoline prices have helped the US auto industry achieve a record year for production in 2015, with another strong year on tap for 2016. The FOMC policy of very low interest rates has also helped the US housing industry, which continues to recover from the 2007-09 debacle. American households’ balance sheets

have also benefitted from the steady rise in home prices, which should also encourage more consumer spending, which is still 70% of total GDP. Thus the FOMC should be able to tap the monetary brakes lightly without derailing another year of solid economic growth in the US.

The European Central Bank (ECB) and the Bank of Japan (BOJ) face more difficult challenges. Both have adopted the US policy of Quantitative Easing (QE) to stimulate ever-declining economies. So far, this policy has mainly affected their stock markets, with both the Japanese market and the European markets outperforming the US market in 2015. At the same time, the prospect of zero

Figure 9: Nikkei

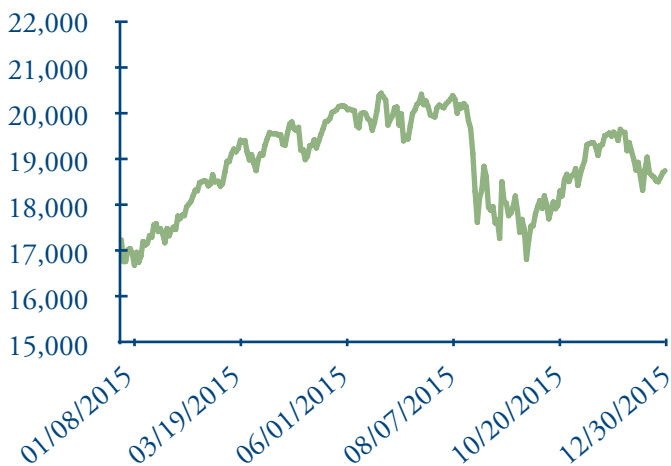


Figure 10: EURO STOXX 600

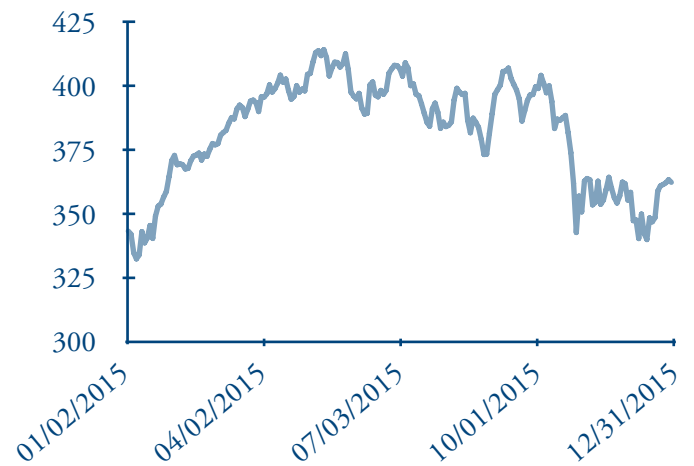
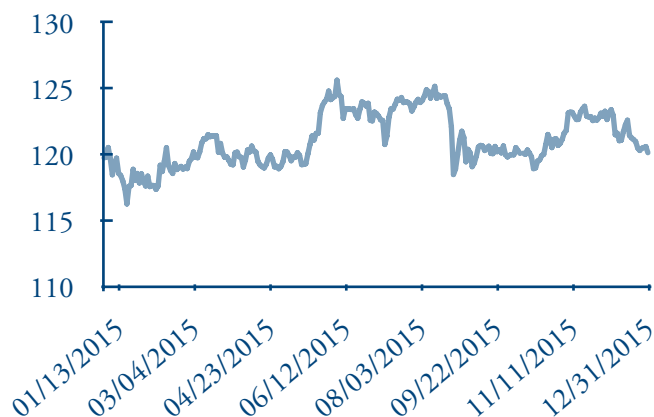


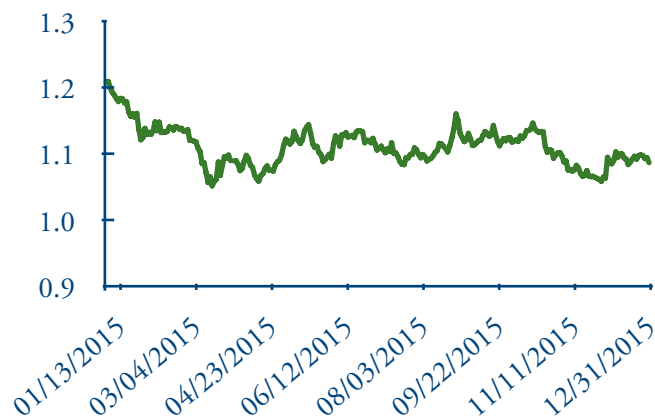
Figure 11: Euro vs. Dollar



or negative rates for the euro and the yen have driven down the value of these currencies versus the dollar, although the yen stabilized in the last half of 2015. While zero rates, QE, and a falling currency should propel the European and Japanese economies forward, 2015 provided scant evidence of the power of this powerful monetary medicine.

The Chinese central bank (PBOC) has an even more difficult task: to carry out a monetary policy that will both assist the economy in transitioning to slower growth, while maintaining some stability in the exchange value of the yuan versus the dollar. This balancing act is even harder since the US dollar will likely remain strong in 2016, while exports (which benefit from a weak currency) are still the main driver of Chinese growth. In late 2015, it became clear that China was digging into its massive hoard

Figure 12: Yen vs. Dollar



of foreign exchange reserves in order to keep the yuan decline modest. The world has already witnessed the turbulence created by a sudden drop in the Chinese currency.

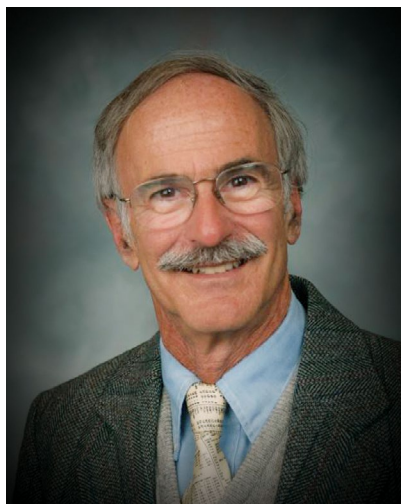
While the major risks to the world economy and financial markets may emanate from China, the US must also deal with uncertain politics: 2016 is an election year, with no incumbent running. Some of the Republican candidates have proposed policies which do not display a deep understanding of the US and world economies, while the Democratic candidates offer wildly different solutions to perceived economic problems. It is not unlikely that the election will feature a third party-candidate (Perot in 1992 and Nader in 2000 are two recent examples) which could add a level of uncertainty that might disturb investors of all stripes.

THE OUTLOOK

The US bull market in stocks may resume in 2016, much as it did after a correction in 2011. Interest rates will remain low, which is almost always a positive for the market, inflation is almost nonexistent (another positive), and GDP, driven by growing consumer expenditures, should continue to grow at a moderate pace. The headwinds for US stocks will be 1) a continued rise in the international value of the dollar, spurred mainly by China's yuan policy, but also by currency weakness in Europe and Japan, and 2) the vagaries of a US Presidential campaign, which will inject a rising level of uncertainty about economic policy during the year. European and Japanese stocks may continue to rally as monetary conditions remain extremely easy in both, even though economic growth is still slow to nonexistent. Emerging markets, which mostly struggled in 2015, will face the strongest headwinds from China and weak growth in Europe and Japan. US long-term investors must be prepared for another volatile year.



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.