MarketUpdate

Markets rally into January

January was a great month for financial markets around the world. Here in the U.S., equity markets continued their rally, as rising consumer and business confidence surrounding the new administration rolled over from 2016. Elsewhere, markets rallied on higher growth expectations.

All three major U.S. indices were positive for the month. The Dow Jones Industrial Average, S&P 500 Index, and Nasdaq were up 0.62 percent, 1.90 percent, and 4.35 percent, respectively, in January.

Fundamentals were also strong, as expected earnings growth came in faster than expected. Per FactSet, with 34 percent of companies in the S&P 500 reporting as of January 27, the blended average growth rate for the fourth quarter of 2016 was 4.2 percent, up from the 3.1-percent growth rate forecast on December 31. If the trend continues, it will be the second straight quarter of earnings growth for the first time in years. In addition, the positive earnings surprises announced thus far indicate that earnings growth is even better than analysts had expected.

Technical factors for all three U.S. indices were supportive in January, remaining above their respective 200-day moving averages for the entire month.

International markets had a strong start to the year. The MSCI EAFE Index notched a gain of 2.90 percent while the MSCI Emerging Markets Index climbed 5.48 percent. Despite concerns about the future of global trade following President Trump's decision to withdraw the U.S. from the Trans-Pacific Partnership (TPP), financial markets seemed to respond to signs of faster global growth. Technical factors were healthy for both indices, as they stayed above their trend lines throughout January.

Fixed income had a volatile month, with interest rates fluctuating on concerns about faster growth and rising inflation. At month-end, however, rates were stable. The yield on the 10-year U.S. Treasury started and ended January at 2.45 percent, and the Bloomberg Barclays Aggregate Bond Index posted a slight gain of just 0.20 percent.

U.S. high-yield corporate bonds fared better than the broader fixed income market. The Bloomberg Barclays U.S. Corporate High Yield Index rose 1.45 percent during the month. Much of this gain was driven by improvements in the lower-rated portion of the market and the continuing recovery of the oil and gas sector due to stabilized oil prices.

Economic fundamentals improve but at a slower pace

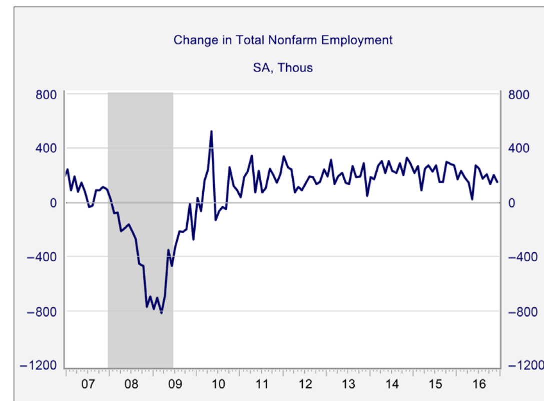
The news was also good for the economy, as fundamentals continued to improve, albeit at a slower pace, to begin the year. Perhaps the most evident example of this slowdown was the first estimate of gross domestic product (GDP) growth for the fourth quarter of 2016; at 1.9 percent, the number was down from the third quarter and below expectations. Much of the slowing was a result of trade imbalances, however, which are unlikely to continue going forward. When these are netted out, growth for the second half of 2016, at around 2.7 percent, remained solid.

Even with lower-than-expected GDP growth for the fourth quarter, business and consumer expectations were at elevated levels. Both the ISM Manufacturing and Non-Manufacturing indices beat expectations for December and remained in healthy expansionary territory. Consumer confidence fell slightly from December's 16-year highs but remained near those highs. Rising levels of confidence for consumers and businesses bode well for future growth.

Also on the manufacturing side, industrial production increased at year-end, surpassing expectations for growth in December. Manufacturing output and core durable goods orders showed modest growth, too, despite the ongoing strength of the U.S. dollar. Additionally, improving trends internationally suggest that this growth could continue.

Jobs were another area where growth moderated slightly, as the economy added 156,000 jobs in December (see Figure 1). Though this was below expectations, positive revisions to the numbers for previous months helped offset some of the shortfall. Slower job growth may also be due to a tightening labor market, rather than economic weakness. Wage growth supported this notion by surprising to the upside, with annual wage growth at 2.9 percent year-over-year, its highest level since the financial crisis. This combination of steady, albeit slowing, jobs growth and an uptick in wage growth suggests that the labor market continues to improve.

Figure 1. Change in Total Nonfarm Employment, 2007–2016



Source: Bureau of Labor Statistics/Haver Analytics

Headline retail sales rose 0.6 percent in December, below expectations but still representing a healthy rebound from November's slower growth. Unfortunately, in another sign of possible slowing, the core retail sales number, excluding autos and gas, was flat for December. With wages increasing and consumer confidence at high levels, this appears to be an area primed for future growth.

Housing stayed strong but also slowed in January, pulling back slightly from previous highs at the end of 2016. Existing and new home sales declined more than expected, but both were at healthy levels, and much of the weakness may be attributable to supply shortages rather than lack of demand. Even with the slight decrease in sales, homebuilder confidence was near historic highs while housing permits and starts increased more than expected. This could indicate that the recent slowdown in sales was transitory.

Inflation and the Federal Reserve

The headline and core consumer price indices advanced in January, with the former showing a 2.1-percent year-over-year increase and the latter increasing to 2.2-percent year-over-year growth. These are both above the Federal Reserve's (Fed's) 2-percent target. With inflation above the Fed's target and employment healthy, future rate increases are still likely.

That said, although the Fed has been positive about the economy in its statements, the slowing of recent data and uncertainty around the U.S. political situation suggest that rate increases are likely to be delayed until there is more clarity. This was probably a major factor in the volatility, but ultimate stability, of interest rates in January.

Policy risks move back to center stage

Although economic fundamentals are strong, risks remain, especially in politics and trade. Much of the recent increase in confidence was based on expectations of business-friendly policies from the new administration and Congress, but policy concerns have resurfaced.

Trade is one area where policy has the potential to reduce confidence. The decision to withdraw from the TPP and comments suggesting that NAFTA renegotiation is a priority signal that President Trump is likely to attempt to keep many of his campaign promises regarding international trade. This has increased the uncertainty for businesses that operate internationally.

Similarly, domestic policy changes were made more uncertain as the administration came into conflict with Democrats and Republicans over immigration laws. Markets reacted negatively to the changes, as they signaled further international disruption and the reduced likelihood of unified action in the future by the administration and Congress.

Going forward, the bulk of market risks in the short term will likely revolve around how the administration and Congress work together to change domestic policy and the relationship between the U.S. and the rest of the world. Significant issues, including tax reform, the dismantling of the Affordable Care Act, and potential changes to the global free trade philosophy that the U.S. has championed since the end of World War II, are on the table. Alterations to any of them could result in substantial disruption.

Political uncertainty versus economic strength

Even though U.S. growth may have slowed a bit, high levels of consumer and business confidence should keep it going and may well accelerate it. International growth also appears to be accelerating, which should help, as we have not seen a synchronized global expansion since 2008. U.S. and global markets did well in the face of uncertainty in January, and such an expansion could drive further gains.

It remains to be seen exactly how the U.S. will engage with the rest of the world in the coming months, but the continuing growth of the global economy and the return of corporate earnings growth indicate that prospects are encouraging despite the risks. As always, a well-diversified portfolio coupled with a time horizon that meets investment goals can provide the best opportunity to attain financial objectives.

All information according to Bloomberg, unless stated otherwise.

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