MarketUpdate

Mixed month for markets ends with gains

April was a volatile month for financial markets, but early declines turned to gains at the end. Investors reacted positively to U.S. tax reform proposals and the potential for a pro-European Union (EU) outcome in the French presidential election. The S&P 500 Index was up 1.03 percent for the month, the Dow Jones Industrial Average rose 1.45 percent, and the Nasdaq gained 2.35 percent.

Markets were also supported by improving fundamentals. The blended earnings growth rate for S&P 500 companies for the first quarter was 12.5 percent, according to FactSet. Although just over half of companies have reported earnings so far, this healthy rate is well above expectations and the highest number we've seen since the third quarter of 2011. This level of earnings growth is expected to continue over the next several quarters.

Because fundamentals drive performance in the long run, the earnings number represents encouraging news for future equity results. All three major U.S. indices stayed above their 200-day moving averages in April, which was a positive technical sign for markets as well.

Foreign equity markets fared even better than domestic ones. The MSCI EAFE Index rose 2.54 percent, with most of its gains occurring after the first round of the French election. Reports of faster-growing economies around the world also helped markets. Although the MSCI Emerging Markets Index experienced a bit more volatility in April, it finished with a 2.21-percent gain. Technical indicators were also positive for both indices throughout the month.

Fixed income also did well in April. The Bloomberg Barclays Aggregate Bond Index ended the period with a 0.77-percent gain, and the Bloomberg Barclays U.S. Corporate High Yield Index returned 1.15 percent. High-yield spreads remain near their post-recession lows.

Interest rates dropped slightly during the volatile month. The 10-year Treasury rate started April at 2.35 percent, declined to 2.18 percent mid-month, and ended the period at 2.29 percent.

Economy improves amid signs of slowing growth

Much of the economic news was positive in April, although overall growth appeared to slow. Differences between strong sentiment and weak spending continued to be a concern.

Gross domestic product (GDP) growth for the first quarter of 2017 was estimated at 0.7 percent, down from 2.5 percent at year-end. Although this is something to watch, slower growth in the first quarter has been the norm during the current recovery. Since 2010, first-quarter GDP growth has averaged 0.9 percent, before rebounding to an average of 2.4 percent for the other three quarters of the year. This pattern

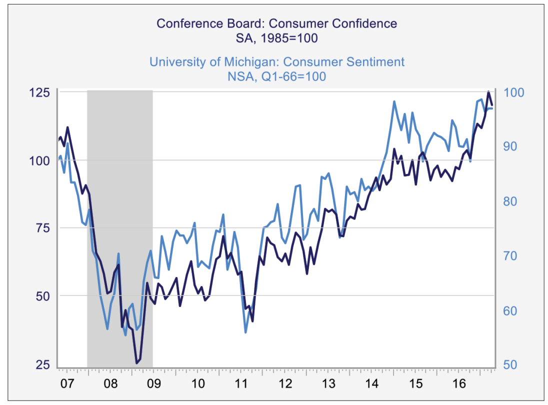
Economy improves amid signs of slowing growth (continued)

suggests that seasonal factors are at play and that growth may accelerate for the rest of 2017.

Supporting this notion, consumer sentiment has improved substantially since last year's election—up to its highest levels since the end of the dot-com boom (see Figure 1). Although it has started to stabilize recently, it remains high. These developments appear to be related to expectations of policy changes in Washington, DC.

Business confidence is also strong. Though the ISM Manufacturing and Non-Manufacturing indices—important indicators of overall business sentiment—decreased slightly in April, they remain at high levels. This signals the likelihood of further expansion. Durable goods orders, which are a proxy for business investment and therefore confidence, also increased in April, suggesting that business investment may start to accelerate.

Figure 1. University of Michigan Consumer Sentiment and Conference Board Consumer Confidence, 2007–2017



Source: The Conference Board, University of Michigan/Haver Analytics

Hard data lags soft numbers

Unfortunately, this optimism hasn't translated into increased spending. Consumer spending was especially disappointing in April. Retail sales dropped unexpectedly, and the previous month's gain was revised to a loss. Weather and low gas prices played a part in the decline, but ultimately increases in consumer spending will be critical for faster growth. Consumer prices, personal consumption, and personal spending also came in weaker than expected for the month.

On the business side, hard data also continues to lag sentiment. Manufacturing output missed expectations and declined for the first time in seven months. In addition, results for the previous two months were revised downward. The positive numbers from the last six months indicate that the slowdown may be temporary, but this gauge should be monitored.

The March jobs report also was quite weak, as the headline number of 98,000 new jobs fell well below expectations. On the other hand, the unemployment rate and the underlying data surrounding wage growth were positive. When combined with the strong January and February employment reports, these factors may indicate that the disappointing March results were an aberration. A healthy job market is essential for continued high levels of consumer confidence, so this will be an important indicator going forward.

Overall, the economy is still growing, and we may see growth accelerate in the remainder of the year once consumers and businesses translate their optimism into spending.

Housing continues to shine

One of the bright spots in the economic recovery has been the strength of the housing market. The trend continued in April, as housing data came in largely better than expected.

Home builder confidence remains near post-recession highs in large part due to rising wages and affordable pricing. And, although housing starts declined slightly during the month, the long-term trends are positive. An increase in building permits should lead to more growth in new home supply.

Existing and new home sales increased more than expected in April, exhibiting continued strong demand. The growth in new home sales was particularly impressive because this measure was expected to decline. Strong demand despite low supply bodes well for future growth in housing. It indicates that, at least in this sector of the economy, consumer confidence is translating into spending.

Political risks continue to drive markets

Domestically and abroad, political risks appear to be playing a larger part in financial markets. This was certainly the case during April.

In the U.S., the major political news was the Trump administration's release of its first proposal for comprehensive tax reform. The plan includes a dramatically lower corporate tax rate, a change in the way companies are taxed on earnings in foreign countries, fewer personal income tax brackets—from seven to three—and a lower top rate. Given the broad scope of the proposal and the current political climate, the proposal will likely lead to vigorous debate between the legislative and executive branches. Because much of the strength in consumer and business sentiment can be attributed at least in part to the promise of tax reform, the negotiation will be watched closely.

In Europe, the news was also dominated by politics. World stock markets bounced higher following first-round results in the French presidential election—widely seen as a referendum on the future of the EU. Emmanuel Macron, a strong EU proponent, moved into the second round and is expected to win the election against the far-right nationalist candidate Marine Le Pen. A surprise win by Le Pen, however, would likely create volatility in global financial markets.

Meanwhile, tensions surrounding North Korea continue to escalate. The topic was a key concern during the early April meeting between President Trump and China's President Xi. So far, the U.S. and China appear to be working diplomatically to defuse the crisis. The cooperation between the U.S. and China has not only served to reduce worry about North Korea but also to ratchet down the level of tension regarding economic issues.

Risks remain, but the future is bright

Despite the very real risks domestically and globally, the current outlook for the rest of 2017 is solid. Multiyear highs in consumer sentiment, as well as the potential tailwinds of looser regulations and tax reform, point toward the possibility of accelerated growth. How much this confidence will translate into increased spending remains to be seen. From a political standpoint, concerns remain, but so far actual results have been much less worrisome than analysts had expected.

As always, the possibility for shocks and instability continues. Therefore, a well-diversified portfolio designed around long-term needs is still the best strategy for meeting personal investing goals.

All information according to Bloomberg, unless stated otherwise.

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