MarketUpdate

Stock markets have strong start to the year

As we transitioned from 2017 to 2018, equity markets continued their advance, with all three major U.S. indices posting large gains in January. The Nasdaq Composite led the way, climbing 7.40 percent. The Dow Jones Industrial Average and the S&P 500 Index followed closely behind with gains of 5.88 percent and 5.73 percent, respectively. Despite a dip at the end of the period, this was another great month for investors.

This strong performance was supported by better-than-expected earnings results for the fourth quarter of 2017. According to FactSet, as of January 25, the blended earnings growth rate for the S&P 500 was 12 percent—a number seemingly buoyed by the recent Tax Cuts and Jobs Act. This was up from estimates of 11-percent growth at the end of December. Further, the growth was widespread, with all 11 sectors showing higher profits. As earnings ultimately power long-term results, this faster growth could help keep equity markets moving higher.

U.S. markets were also supported technically in January, as all three indices remained above their respective trend lines.

International markets did equally as well. The MSCI EAFE Index increased 5.02 percent during the month. The MSCI Emerging Markets Index fared even better with a gain of 8.34 percent. International stocks benefited from continued global expansion and a weaker dollar. Both indices also stayed above their 200-day moving averages in January.

Fixed income had a more challenging month, as increasing inflation expectations caused an upswing in rates. The yield on the 10-year U.S. Treasury rose from 2.46 percent to 2.72 percent during the month. This caused the Bloomberg Barclays U.S. Aggregate Bond Index to decline by 1.15 percent in January.

Although rising rates reflect growing inflation worries, the Federal Reserve (Fed) voted to keep interest rates steady at its January meeting. This was Janet Yellen's last meeting as Fed chair; Jerome Powell is scheduled to be sworn in as the next chair this month. Meanwhile, the market continues to expect a rate hike in March, with further hikes later in the year.

High-yield bonds, which are typically less dependent on changes in interest rates, had a better start to the year. The Bloomberg Barclays U.S. Corporate High Yield Index managed a gain of 0.60 percent in January. Valuation levels for high-yield bonds remained near post-recession highs.

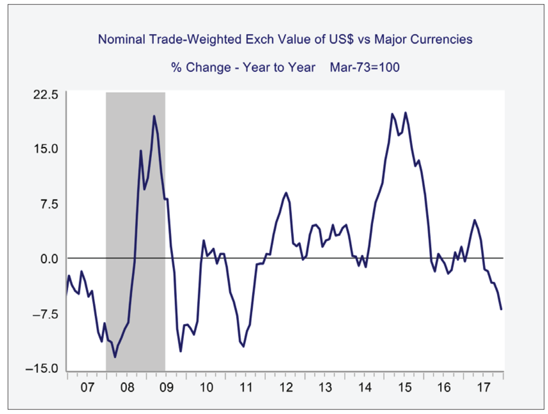
The economy keeps getting better

Like the markets, the economy started 2018 in good shape. Growth continued, and consumer and business confidence remained high. The first estimate of gross domestic product (GDP) growth for the fourth quarter of 2017 came in at 2.6 percent. Although this was slightly below expectations, seasonal factors likely contributed to this miss, and the surge in imports appears unsustainable. In fact, strong spending and confidence levels indicate that growth could well accelerate in 2018.

Business investment is poised to be one drive of that acceleration. Corporate confidence remains quite strong, holding near multiyear highs. The Institute for Supply Management's Manufacturing and Nonmanufacturing indices both retreated slightly from December highs, but they remain in healthy expansionary territory. In fact, at its current level, the Manufacturing index has historically pointed to GDP growth of 4 percent or more. Given the recent tailwinds from tax reform and the weaker dollar, it is not surprising that businesses are feeling confident, but it is still good to see.

Of course, high levels of confidence alone are not enough to increase growth; we need to see hard spending figures as well. Businesses are walking the walk as well as talking the talk. Durable goods orders increased by 2.9 percent in December, against expectations for more modest 0.9-percent growth. This is the highest month-over-month growth level in six months. The November figure was revised upward as well.

Figure 1. Trade-Weighted Exchange Value of the U.S. Dollar, Year-Over-Year Change



Source: Federal Reserve Board, Haver Analytics

Industrial production and manufacturing output also grew in the fourth quarter. Despite lower-than-expected growth in December, manufacturing still had the strongest fourth quarter in seven years. The weaker dollar likely played a large part in supporting manufacturers. As you can see in Figure 1, the trade-weighted value of the dollar has declined nearly 7 percent on a year-over-year basis versus major currencies. This boosts manufacturers and exporters, as U.S.-made goods become more competitive around the world.

Consumers also confident—and spending

January was a very good month for consumers as well, as confidence and spending both beat expectations. The Conference Board's measure of consumer confidence increased by more than expected during the month and sits at levels consistent with strong consumption growth.

On the spending side, both headline and core retail sales figures had another strong month. Personal spending data also came in stronger than expected—growing 3.8 percent, annualized, in the fourth quarter. Consumer spending accounts for roughly 70 percent of GDP, so growth at this level is something we need to see.

Although consumers did well in general, one important sector of the economy slowed down. Housing, which has been a major driver of the expansion, slowed across the board in January. Homebuilder confidence pulled back from previous multidecade highs, while housing starts and permits both decreased as rising construction costs and lack of labor put a damper on new development. Buyers also stepped back, as existing and new home sales declined from previous months. Given the previous strength in the housing sector, this slowdown may prove to be a temporary speed bump. As affordability declines, however, this remains a sector to watch.

Finally, on a more positive note, the January jobs report came in better than expected. The U.S. added 200,000 jobs against expectations for a more modest 183,000. December's headline figure was also revised upward. The underlying data was solid as well: Annual wage growth increased to 2.9 percent, and the unemployment rate stayed at 4.1 percent. This bump in wage growth was very positive, as the tight labor market has so far failed to produce meaningful wage increases. Given the low unemployment rate and the large number of open positions, this could be the year that wage growth finally takes off.

Political risks persist

While the economic picture appears quite healthy, political developments could rattle markets. The most pressing is the ongoing need to pass a long-term federal funding bill to avoid a potentially lengthy government shutdown. The brief shutdown in January was proof that politicians are willing to use this issue as leverage for their respective platforms. So, the next vote in February remains a concern. Given the high level of political confrontation, there is a real possibility that this situation could get worse than anyone now expects—making this the story to watch.

International risks, though not gone, have pulled back a bit. With the Olympics scheduled to begin in South Korea, and a delegation of North Korean athletes expected to compete, this may be a chance for further diplomatic efforts to resolve tensions in the region. In Europe, there seems to be real progress in the German governmental negotiations. Meanwhile, the pending Italian elections are looking to be less of a concern than had been feared. With that said, there is still the potential for volatility if any negative developments occur.

Foundation in place for a strong year

Despite the brief government shutdown, markets had a great start to the year, cushioned by a strong economy. As we look toward the rest of the year, we seem to be well positioned for growth. The positive economic data and improving earnings situation should provide a strong tailwind to help weather potential short-term turbulence.

Risks certainly exist, but many of the most pressing concerns appear to have moderated. As always, though, a well-diversified portfolio that aligns with your time horizon can be the best way to achieve financial goals.

All information according to Bloomberg, unless stated otherwise.

Certain sections of this commentary contain forward-looking statements based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Nasdaq Composite Index measures the performance of all issues listed in the Nasdaq Stock Market, except for rights, warrants, units, and convertible debentures. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Bloomberg Barclays Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Bloomberg Barclays government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Bloomberg Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Co-authored by Brad McMillan, senior vice president, chief investment officer, and Sam Millette, fixed income analyst, at Commonwealth Financial Network.