MarketUpdate

Positive month for markets as risks recede

May was a solid month for world markets. Supported by strong earnings and signs that the first-quarter economic slowdown was in the past, the three major U.S. stock indices were up in May.

The Dow Jones Industrial Average finished with a 0.71-percent gain, and the S&P 500 Index rose a healthy 1.41 percent. Leading the pack was the Nasdaq, which was up 2.67 percent.

Improving fundamentals drove the gains. FactSet reported that, as of May 26, 98 percent of S&P 500 companies had announced first-quarter earnings. Year-over-year, the blended average earnings growth was 13.9 percent. This was higher than the 12.5-percent growth forecast a month ago and the fastest growth since the third quarter of 2011. Earnings were up across the board, with 10 of the 11 sectors in the index reporting year-over-year growth.

Analysts expect the faster earnings growth to continue. Higher earnings and faster growth suggest that strong stock market performance may continue. Technicals for the three indices were also positive, with all three staying well above their trendlines.

International equity markets had an even better May. The MSCI EAFE Index rose 3.67 percent, and the MSCI Emerging Markets Index gained 2.98 percent. Faster global growth and diminishing political risks encouraged investors to allocate assets abroad. Lower valuations than U.S. markets, as well as rising growth rates, may support the trend going forward. In terms of technicals, both indices were well supported and spent the entire month above their 200-day moving averages.

Fixed income markets also had a solid month. Driven by declining interest rates, the Bloomberg Barclays Aggregate Bond Index was up 0.77 percent. Lower inflation data pulled the 10-year Treasury rate down, from 2.33 percent at the start of May to 2.21 percent by month-end.

The market expects the Federal Reserve to raise the federal funds rate at the June 14 Federal Open Market Committee meeting. An increase would reflect the Fed's confidence in the economy. Currently, markets consider increases beyond June less probable, which also helped lower Treasury rates.

The high-yield market had a positive month, as the Bloomberg Barclays U.S. Corporate High Yield Index gained 0.87 percent. High-yield spreads compressed during May, driving prices up. Although a bit higher than their March lows, spreads are near post-recession lows. This suggests that investor confidence is high.

Economic slowdown fades

After a weak first quarter, data in May indicated that the economic slowdown was passing. First-quarter U.S. gross domestic product (GDP) growth was revised upward, from 0.7 percent to 1.2 percent. Much of the increase was due to positive revisions in personal consumption and business investment data.

Improved consumer and business data has led to expectations of faster growth for the rest of the year. In particular, second-quarter growth is expected to be much stronger. At the end of May, the Atlanta Fed estimated 3.8-percent growth for the period.

Consumers spend more

Faster growth requires both the ability to spend and the confidence to do so. Here, the news was mixed. Job growth declined in May, down to 138,000 against expectations for an increase of 182,000. This brought the three-month rate down to 121,000 per month.

Even though job growth does seem to be slowing, it is continuing. The same can be said of wage growth. Despite the slowing trend, growth continues and personal incomes continue to increase. With personal income on the rise, the consumer's ability to spend is there.

During May, the confidence necessary for spending growth was there as well. Both major consumer confidence surveys remained near 14-year highs. Also, for the first time in 2017, job growth and confidence led to higher consumer spending—a very positive sign. Retail sales were up in April, and the low levels for March were revised upward. This helped ease fears that the strength in the "soft" confidence data hadn't led to increases in "hard" spending data. Continued strength in job creation is positive for the economy and supports a potential June rate hike.

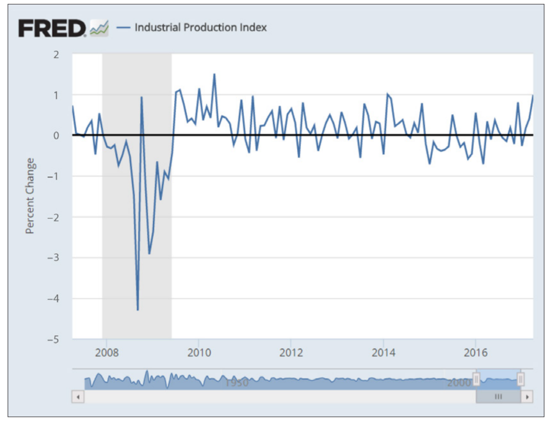
Business hard data begins to catch up

The ISM Manufacturing and Non-Manufacturing surveys had been in healthy expansionary territory. But, as with the consumer sector, actual investment had been lagging. In May, the gap started to close. First-quarter investment data was revised upward. Significant gains in industrial production were also reported.

May industrial production growth was the fastest in more than three years, as illustrated in Figure 1. The increase was widespread; manufacturing and mining led the way. Manufacturing and industry has been a weak area for some time, and the resurgence bodes well for future growth.

Durable goods orders, which are a proxy for business confidence, decreased a bit in April. The decline was offset by upward revisions to previous data, which suggests that overall growth may be accelerating. The headline and core figures still show year-over-year growth. Once the final results for May are announced, the monthly decrease may turn out to be an outlier.

Figure 1. Industrial Production Monthly Change, 2007–2017



Source: Board of Governors of the Federal Reserve System (US)

Housing slows down

Another good example of confidence versus data is in housing. Home builder industry confidence bumped up in May, though housing sales came in below expectations. This may appear inconsistent, but the driver for both rests in strong demand combined with low supply.

The supply of existing homes for sale is near all-time lows, and the supply of new homes is below prerecession levels. This indicates that the disappointing sales number isn't due to lack of demand. Plus the industry sees an opportunity to respond to the unmet demand.

The data points bear watching. Increased supply could lead to further growth in the housing market and faster growth in consumer spending.

Political risks bear monitoring

Many recent political risks haven't been as damaging as had been feared, in particular the Brexit process and the French election.

But the U.S. situation remains a potential area of concern. The ability of the Trump administration to move forward on its policy goals is unproven. Also, pending legislation—specifically the need to increase the debt ceiling—may cause disarray.

North Korea continues to be a flash point. Also, the potential Italian election later this year is raising concerns similar to those raised before the French election. Some observers believe the Italians will choose a government that favors leaving the European Union.

Future growth appears likely

The economic environment in the U.S. is improving. Faster growth in consumer and business spending suggests that economic growth should continue. Market resilience despite political uncertainty indicates that strong fundamentals are supporting potential further gains. Other countries are also doing well, which has led to the first synchronized global expansion since the financial crisis.

Expansion is likely to continue and may be poised to accelerate. With hard data starting to catch up with strong confidence levels, we could see a virtuous cycle. Increased confidence leads to increased spending, which leads to higher levels of confidence and so forth. The signs are positive.

In the short and intermediate terms, real political and economic risks remain. Even with positive trends, we will see volatility. Investors need to take note of and brace for that possibility. A well-diversified portfolio aligned with financial goals is still the best way to prepare for the future.

All information according to Bloomberg, unless stated otherwise.

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