MarketUpdate

Another strong month for markets

Both domestic and international stock markets had another good month in November. Here in the U.S., the Dow Jones Industrial Average led the way with a gain of 4.24 percent. The S&P 500 Index and Nasdaq Composite followed with returns of 3.07 percent and 2.34 percent, respectively. All three indices hit all-time highs during the month.

Gains were driven by improving fundamentals. According to FactSet, as of November 24, the blended earnings growth rate for the S&P 500 for the third quarter was 6.3 percent. This was up from the estimate of 4.7 percent at the end of October and more than double the 3.1-percent estimate at the end of the quarter. Improvements were widespread, with 8 of 11 sectors beating their September estimates. As fundamentals ultimately drive performance, the better-than-expected results helped propel stocks to record highs. From a technical standpoint, all three U.S. indices remained above their 200-day moving averages for the month—a signal of probable continued strength.

International markets also moved up in November, although they didn't do as well as U.S. markets. The MSCI EAFE Index rose by a solid 1.05 percent for the month. As was the case in the U.S., this positive performance was driven primarily by improving earnings growth and general economic expansion. There was some volatility earlier in the month due to political drama in Germany. The strong fundamentals allowed the index to recover by month's end, however.

Emerging markets, as measured by the MSCI Emerging Markets Index, improved by 0.21 percent in November. Volatility was likewise an issue during the month, tempering gains. Despite their troubles, both foreign indices remained above their 200-day trend lines.

November was more difficult for fixed income, as yields on the short end of the curve increased in anticipation of a rate hike and the potential for a government shutdown in December. The Bloomberg Barclays U.S. Aggregate Bond Index declined by 0.13 percent in November. High-yield faced similar headwinds, with the Bloomberg Barclays U.S. Corporate High Yield Index falling by 0.26 percent. Looking forward, the market expects the Federal Reserve to hike the federal funds rate by 25 basis points at the December meeting.

Economic news to be grateful for

November's economic releases were generally positive, with notable improvements across the board. Following the disruptions caused by the hurricanes in the third quarter, job creation in October rebounded from negative headline figures with a print of 261,000 new jobs. The details of the report were also strong: unemployment and underemployment both declined, and wages held constant. This performance, following dampened results in September, shows the continued strength of the job market.

It is not surprising, therefore, that consumer confidence climbed during the month. The Conference Board's consumer confidence survey was especially positive. A greater-than-expected increase to 129.5 left this measure at a 17-year high heading into the important holiday retail season.

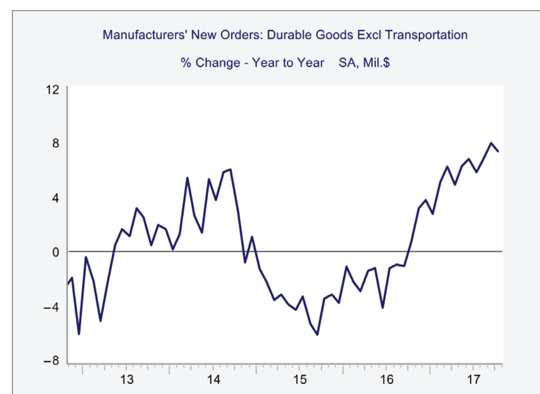
Although consumer confidence figures have been high since last year's election, hard spending data has fallen short of sentiment. Not so for the latest retail sales report. The headline figure grew, against expectations for a flat month. September's figures also were revised upward. Combined, this news paints a picture of solid if not spectacular growth in the fourth quarter.

Businesses also experiencing growth

The positive results for consumer confidence and spending were echoed by similar results for businesses. Manufacturing confidence, as measured by the Institute for Supply Management's Manufacturing index, declined slightly to 58.2—a still healthy number that indicates ongoing expansion. The Nonmanufacturing index performed better, increasing to 60.1 against expectations for a decline to 58.5. As the service sector accounts for the majority of economic activity, this increase to a 12-year high is a very positive signal.

Here as well, better sentiment was accompanied by improvements in actual spending. Core durable goods orders—which exclude the volatile transportation sector and are a better proxy for business investment—increased by 0.4 percent in October. In addition, the strong September figure was revised upward. Core business spending has shown solid growth this year compared to last year (see Figure 1), and growth is currently close to a five-year high. This is important, as this has been a weak area in the expansion.

Figure 1. Change in Core Durable Goods Orders, Year-Over-Year (2013–2017)



Source: Census Bureau/Haver Analytics

The housing industry also had a strong month. Here, again, improvements in industry sentiment were matched by additional investment. Homebuilder confidence rose during the month to an eight-month high, as strong consumer demand and rising prices continued to offset the high costs of labor and materials. The supply of new and existing housing stock remains near historic lows.

Businesses also experiencing growth (continued)

This, coupled with strong demand, has kept the industry confident.

Consumer demand came in much better than expected, with existing home sales growing at 6.2 percent, against expectations for a decline of similar proportions. On an annualized basis, the level of new home sales is the highest it has been since October 2007. Builders have started to react to low supply levels, with both housing starts and building permits increasing by more than double their expected growth rates for the month. As long as consumer demand remains strong, builders are expected to continue to invest in new construction, which will be positive for the economy.

With consumer, business, and housing spending all increasing, faster growth is quite possible for the second half of the year. In fact, the second estimate of third-quarter gross domestic product growth came in at 3.3 percent, up from the initial estimate of 3 percent. If this level holds, it will mark the first two consecutive quarters of growth above 3 percent that we've seen since 2014.

The rest of the world is growing as well. European growth continues to improve, with several countries growing faster than the U.S. Meanwhile, growth in China remains solid, and even Japan has started to improve. This is the first synchronized global growth cycle we have seen since the crisis, which could help all countries around the world.

Political risks remain elevated

With the economic news good, the major source of risk remains political. In Europe, the inconclusive German election and stalled coalition talks rattled European markets mid-month and still have the potential to create more uncertainty. The ongoing Brexit process in the U.K. is also creating concern. Looking to Asia, North Korean nuclear tests continue to destabilize the region.

The immediate political risks, however, are here in the U.S. The two major stories highlighting the rest of the year are tax reform and the debt ceiling. If tax reform passes, it could be positive for the markets. But that passage is uncertain—and that uncertainty could create volatility.

Of more concern is the potential government shutdown in early December. The current debt ceiling agreement expires on December 8. Without a new agreement between Republican and Democratic lawmakers, the government will shut down. Although the most likely outcome remains some sort of agreement, a shutdown—with all the uncertainty and turmoil that implies—remains a very real possibility.

Markets remain strong

The good thing about the political risks, however, is that the economy is in good shape to weather them. With the combination of economic growth, earnings growth, and high confidence likely to lead to faster growth for the second half, any political disruption will be cushioned by the strong economy. This, combined with the potential for passage of a business-friendly tax bill, signals that we may see faster growth over the next couple of quarters than we have for some time.

If not, market volatility is very possible. But even then, any short-term shocks should be offset by the strong economic and corporate fundamentals. As always, a well-diversified portfolio matched to your risk tolerance remains the best way to meet your financial goals over the long term.

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.

© 2017 Commonwealth Financial Network®