MarketUpdate

A bumpy ride for the markets

February was a rocky month for the stock market. A mid-month plunge of roughly 10 percent left the three major U.S. indices down at the end of the month, though they were able to make up some of the loss. The Nasdaq Composite lost 1.74 percent for the period. The Dow Jones Industrial Average and S&P 500 Index fared worse, losing 3.96 percent and 3.69 percent, respectively.

This was the first substantial market decline we've experienced in some time—since October 2016 for the S&P 500, in fact—so it was disconcerting. Much of the volatility appeared to come from concerns over interest rates. Fears about rising inflation and the potential actions of the new chair of the Federal Reserve (Fed) pushed rates higher during the month. Although worrying, this level of volatility is normal by historical standards. In addition, the partial recovery, combined with strong fundamentals, suggests that this rough patch may be more of a pause rather than a reversal of the ongoing growth trend we've seen.

Faster earnings growth continued to support the markets in February. In fact, fourth-quarter 2017 earnings came in well above expectations. According to FactSet, as of February 23, the estimated earnings growth rate for the S&P 500 was 14.8 percent. If this rate holds, it would represent the highest quarterly earnings growth since the third quarter of 2011. Positive sales surprises, at 78 percent, were also higher than expected. If this continues, this would be the best result since FactSet began collecting sales data in 2008.

Technical factors were also supportive of equity markets. All three U.S. indices were above their respective 200-day moving averages at month-end, despite the sharp drop early in the month.

International equities also had a rough February, with both developed and emerging markets underperforming U.S. markets. The MSCI EAFE Index of developed markets declined by 4.51 percent, while the MSCI Emerging Markets Index was down 4.60 percent. As was the case in the U.S., rising global interest rates fueled much of the volatility, even as economic fundamentals remained supportive. Technicals also were supportive for international markets. Both indices ended the month above their respective trend lines.

To make it three for three, fixed income suffered in February, as rising interest rates dragged down bond prices. The 10-year U.S. Treasury began the month with a yield of 2.72 percent and ended at 2.87 percent. This increase caused the Bloomberg Barclays U.S. Aggregate Bond Index to decline by 0.95 percent. High-yield bonds, which are typically less affected by interest rate changes, had a slightly better month, losing just 0.85 percent. Spreads for high-yield continued to remain tight, diminishing the prospects for further price appreciation in the asset class.

Economic growth continues, but at a slower pace

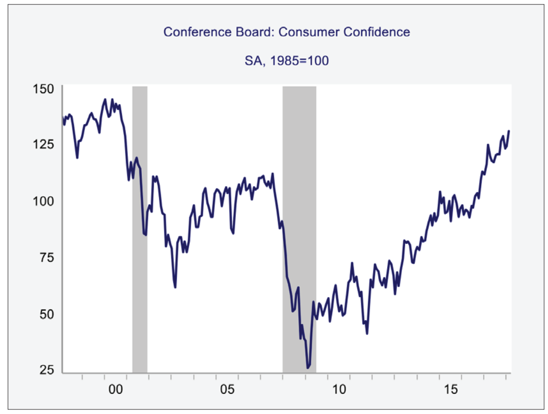
February's data showed that the U.S. economy continued to grow, albeit at a slower pace. Gross domestic product (GDP) growth for the fourth quarter of 2017 was revised down to 2.5 percent, primarily due to a larger-than-expected increase in imports. Although lower than the 3.2-percent GDP growth we saw in the third quarter, this remains a healthy level.

Despite the slowdown, there were plenty of bright spots in the data. The January employment report, for example, showed that 200,000 new jobs were added during the month, a very strong result. And the good news extended past the headline. December's new job figures were revised up by 16,000, and average hourly wage growth hit the highest level since 2009. Unemployment remained unchanged at 4.1 percent—well below the Fed's 4.6-percent target. With the strong increase in jobs and faster wage growth, more money for American workers is likely to spur further spending and growth.

Along with the ability to spend, the willingness to spend remained strong. Both major surveys of consumer sentiment increased by more than expected in January, despite rising gas prices and stock market turbulence. As you can see in Figure 1, the Conference Board's Consumer Confidence Index is now at levels last seen in 2000.

Like consumers, businesses were confident, with surveys stable at very high levels. Both of the Institute for Supply Management surveys, for manufacturing and nonmanufacturing businesses, moved to 13-year highs in February, indicating continued business investment and

Figure 1. Conference Board Consumer Confidence Index, 1998–2018



Source: The Conference Board, Haver Analytics

expansion. Although business confidence remains strong, the hard data came in somewhat weaker than expected. The core durable goods orders figure, which excludes volatile aircraft purchases, disappointed. It fell 0.3 percent against expectations for a modest gain of 0.4 percent—the first decline in this measure since November 2017. This follows a period of strong growth, however, so it is likely a pause rather than a trend change for business investment.

With growth continuing, markets currently expect the Fed to hike interest rates by 25 basis points at the March meeting. In addition, another two to three more hikes are expected in 2018 after that. New Fed Chair Jerome Powell increased expectations for further rate hikes during his first testimony to Congress in February by giving a positive outlook for the economy.

Housing a drag

Despite improvements in other areas of the economy, housing growth continued to slow. Homebuilder confidence remained near multiyear highs, but all categories of home sales fell during January—the second month in a row—against expected increases. The declines appear to be due to a combination of rising mortgage rates and low supply levels. Buyers simply are not able to find—and increasingly less able to afford—a new home. On the supply side, however, conditions are improving. Housing starts and permits increased by 9.7 percent and 7.4 percent, respectively, in January. Faster supply growth should help the housing market going forward.

Political risks recede—for the moment

The major source of risk for markets has continued to come from the political world—although those risks now appear to be receding. Following the brief government shutdown on February 8, both Democrats and Republicans cut a deal both to lift the debt ceiling until September 2019 and to increase spending. This removes the shutdown risk until then while providing additional fiscal stimulus to the economy.

In Asia, it also appears as if risks have diminished following the successful completion of the Winter Olympics in South Korea. All eyes were on the U.S. and North Korean delegations at the games, and a willingness from North Korean leaders to meet with the U.S. for diplomatic talks was a de-escalation of the previous fiery rhetoric between the two countries.

Finally, in Europe, Angela Merkel's attempts to form a coalition government and end a political state of limbo were finally successful after months of negotiations. As the German chancellor has been one of the most stable leaders in Europe over the past decade, this is good news for international markets.

Despite the good news, politics have the potential to be a real source of risk at any time. Notably, on March 1, an announcement of planned U.S. tariffs on steel and aluminum sparked worries about a trade war and sent markets into decline, just as they were recovering from the February downturn.

Real slowdown or blip?

With volatile markets and some weakening in the economic data, February was a more difficult month than we have seen in some time. That said, growth remains in healthy territory, and the weak data may well prove to be transitory. Further, strong corporate sales and profits should continue to support the financial markets. What this month's volatility gave us was a wake-up call, reminding investors that markets can go down as well as up.

This is nothing new, of course, just a return to normal—which is a good thing. As the economy has recovered, and as interest rates continue to normalize, we can expect more volatility. But that doesn't necessarily mean we need to worry. The U.S. economy and financial markets are the largest and most stable in the world and are well positioned for long-term growth. A well-diversified portfolio designed around your financial objectives and time horizon remains the best way to pursue your goals.

All information according to Bloomberg, unless stated otherwise.

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