MarketUpdate

Mixed May for markets

May was an eventful month for markets. U.S. equities and fixed income rallied while foreign stocks suffered declines. The Dow Jones Industrial Average was up 1.41 percent, and the S&P 500 Index gained an even stronger 2.41 percent. But the Nasdaq did best, leading the way with a gain of 5.50 percent.

Better-than-expected fundamentals supported the positive returns. According to FactSet, as of May 25, with 97 percent of companies reporting, the blended earnings growth rate for the S&P 500 was 24.6 percent. This marks the highest level of earnings growth since the third quarter of 2010, when companies were emerging from the financial crisis. Earnings growth of this size is rare and shows the positive effects that tax reform is having on corporate earnings.

Strong fundamentals supported strong technicals. All three major U.S. indices stayed above their 200-day moving averages for the entire month. This was a healthy development, given April's volatility, when the S&P 500 dipped below its trend line for the first time since 2016.

Although the results for U.S. equities were positive, the story was different for international markets. The MSCI EAFE Index dropped 2.25 percent in May, as European politics and trade worries weighed on investors. Emerging markets fared even worse. The MSCI Emerging Markets Index declined 3.52 percent on concerns over Federal Reserve (Fed) tightening and a strong dollar.

Signs of economic growth also grew weaker around the world. As international fundamentals slowed, technical support also decayed in May. Both international indices fell below their respective 200-day moving averages. The EAFE broke below its support line toward month-end, and the Emerging Markets index spent most of the month below support. This is not an immediate cause for concern, but it could serve as an inflection point between rising and declining markets. Going forward, it will be important to watch international markets to assess whether these declines signal the beginning of a downward trend.

Fixed income had a solid May. Early in the month, U.S. interest rates rose. But they ended the period lower on a global flight to safety because of rising political risks. The yield on the 10-year U.S. Treasury started May at 2.97 percent. It rose as high as 3.11 percent, before finishing the month at 2.83 percent. This left the Bloomberg Barclays U.S. Aggregate Bond Index with a gain of 0.71. Corporate high-yield bonds, which are less tied to interest rate moves, declined 0.03 percent on growing credit concerns.

Strong month for economic news

May was a solid month for economic data. Most major releases pointed toward a pickup in growth for the second quarter after a slowdown in the first three months of the year. Consumers and businesses remained confident about the economy, with consumer confidence, as measured by the Conference Board, rebounding in May to one of its highest readings in 18 years.

A strong labor market also bolstered consumer confidence. The economy added 233,000 new jobs in May, and the unemployment rate fell to 3.8 percent.

Businesses also remained confident. The Institute for Supply Management's Manufacturing and Nonmanufacturing indices were at levels that, historically, have indicated annual gross domestic product growth of more than 3 percent. This suggests that growth is likely to accelerate. The Federal Reserve Bank of Atlanta agreed. At May's end, it forecast second-quarter growth of around 4 percent—a big increase from the 2.2-percent growth of the first quarter. The economy appears to be picking up steam, quite possibly because of the sweeping tax cuts, which took effect at the start of the year.

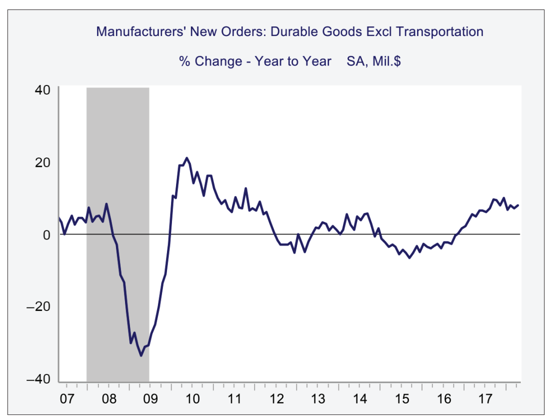
Spending fuels growth

One avenue of faster growth is increased spending, and continued strong consumer and business spending seems to be bolstering the economy. Consumers grew core retail sales at a steady 0.3-percent pace in April, following an upwardly revised 0.4-percent growth figure in March. This measure, which excludes volatile auto and gas sales, is seen as the best indicator of overall consumer spending patterns. The steady, methodical growth we saw in March and April is a positive indicator.

Business investment bounced back strongly in April, following a slight decline in March. Core durable goods orders, which serve as a proxy for business investment, grew an impressive 0.9 percent. This number beat expectations and showed that business owners across the country feel comfortable enough to make long-term investments in their companies. As seen in Figure 1, core durable goods orders have rebounded following a slowdown in 2015 and much of 2016.

But not all of the news in May was good. Although businesses and consumers were able and willing to spend, the housing sector showed signs of slowing. Despite positive industry sentiment, buyers continue to wrestle with low supply and rising mortgage rates. These factors resulted in declines in new and existing home sales of 1.5 percent and 2.5 percent, respectively.

Figure 1. U.S. Core Durable Goods Orders, 2007–2018



Source: Census Bureau, Haver Analytics

Even though the disappointing housing numbers may be due to the limited supply of homes, the decreases in housing starts and building permits indicate that supply constraints may last for a while, even as rising interest rates cut into

Spending fuels growth (continued)

demand. Given the importance of housing on the economy, this is an area to watch, although the slowdown may well be only temporary.

Overall, and despite the concerns around housing, the economy continues to improve.

In fact, markets expect the Fed to raise the federal funds rate by 25 basis points at its June meeting. Such an increase would be perceived as a ratification of continued growth.

Political risks take center stage

As economic risks appeared to subside, political risks returned here and abroad. International markets dropped as the prospect of a euroskeptical government in Italy became imminent, raising the chances of a new threat to the European Union (EU) and euro. The threat remains remote, but the risks are rising, calling to mind the 2011 Greece crisis.

Here in the U.S., the primary political concerns were North Korea and trade. The major questions going forward all revolve around the on-again, off-again summit meeting. Although the possibilities for progress are real, the fluid nature of the proposals has kept markets guessing.

On the trade front, at month-end, the U.S. imposed tariffs on steel and aluminum from Mexico, the EU, and Canada. All three entities have announced retaliatory tariffs on a wide range of goods. These actions could be the first salvos in a larger trade war, which could also include the ongoing talks to renegotiate NAFTA. Even though U.S. markets have largely discounted trade risks, international markets have been negatively affected. Certainly, U.S. markets could start to worry at any point.

Economy bright, growth should continue

U.S. markets largely shrugged off rising political concerns in May, serving up solid gains backed by a solid economy and strong corporate performance. Given the potential triggers to volatility that we experienced last month, it is a very encouraging sign that all three major indices were up. It is also good to see that, in times of global instability, the U.S. remains one of the most resilient economies in the world.

That said, risks remain. The political headwinds could start to rattle markets. Rising prices and interest rates, along with a potential slowdown in housing, could lead to volatility. We should enjoy the positive May performance but continue to expect risks. As always, a well-diversified portfolio that matches your goals is the best way to prepare for the future.

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, CFA®, CAIA, MAI, managing principal, chief investment officer, and Sam Millette, fixed income analyst, at Commonwealth Financial Network.