MarketUpdate

Strong March caps great start to the year

For the third month in a row, all three major U.S. equity markets were positive for the month. The Nasdaq Composite led the way with a return of 2.70 percent, and the S&P 500 grew by 1.94 percent. Meanwhile, the Dow Jones Industrial Average (DJIA) came in with a gain of 0.17 percent, held back by Boeing. The three indices finished the quarter in the same order, with gains of 16.81 percent for the Nasdaq, 13.65 percent for the S&P 500, and 11.81 percent for the DJIA.

Despite this strong performance, market fundamentals worsened during the first quarter. According to FactSet, the estimate for first-quarter earnings growth for the S&P 500 stood at 2.9 percent at the end of 2018. As of quarter's end, this estimated earnings growth had fallen to a loss of 3.9 percent. This weakening of company fundamentals was widespread. In fact, all 11 sectors showed declines in estimates over the course of the quarter.

Fundamentals drive performance over the long term. But over the short term, weakening fundamentals do not necessarily mean that markets will suffer losses. In fact, over the past 20 quarters, this marks the 15th time that market values have increased while earnings estimates have declined. Further, analysts still expect positive earnings growth for the next three quarters and for the year. This growth should continue to support markets.

From a technical perspective, the news was good. All three major U.S. indices spent much of January and parts of February below their respective 200-day moving averages. Still, they ended the quarter above this important technical level. The S&P 500 and Nasdaq fell below their trend lines briefly in March before rebounding into month's end.

International markets also had a strong month and quarter. The MSCI EAFE Index, which covers developed economies, gained 0.63 percent for the month and 9.98 percent for the quarter. The MSCI Emerging Markets Index was up by 0.86 percent for March and 9.97 percent for the quarter. Technicals here were also positive at quarter-end. Both indices finished the period above their respective trend lines.

Even fixed income markets had a steady start to 2019. The Bloomberg Barclays U.S. Aggregate Bond Index gained 1.92 percent for the month and 2.94 percent for the quarter. Here, yields declined, pushing capital values up. The 10-year U.S. Treasury yield started the quarter at 2.66 percent and finished the period at 2.41 percent.

High-yield bonds, which are typically less influenced by rate movements, also had a positive start to the year. The Bloomberg Barclays U.S. Corporate High Yield Index gained 0.94 percent in March and 7.26 percent for the quarter. The asset class benefited from lower rates and lower-risk spreads, which dropped during the quarter after a large increase at year-end.

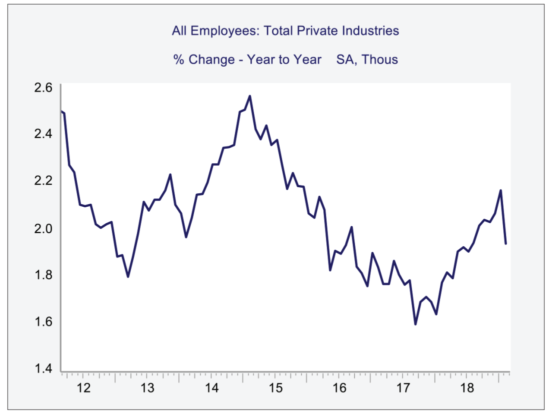
% Economic growth slows—but continues

The decline in bond yields was due to a slowdown in growth across the economy. Only 20,000 new jobs were added in February, for example, against expectations for 180,000. This low figure may have been payback for a stronger-than-expected January. Or it may be a sign that job growth is slowing. As you can see in Figure 1, employment growth grew at an increasing rate to end 2018 before falling in 2019.

Similarly, consumer confidence reversed its recent bounce to trend lower. This decline might also be a sign that the economy is weakening. A strong jobs market is one of the major drivers of consumer confidence. As such, recent weakness here may be a worrying signal.

With weak job growth and a slide in confidence, it was no surprise that consumer spending growth also pulled back. January's personal spending report showed modest growth of 0.1 percent. But this result was less than the expected 0.3 percent and not enough to offset a decline of 0.6 percent in December. Of course, the government shutdown to start the year has delayed some data. Still, the major measures of consumer spending also disappointed in the first quarter. Retail sales in February fell by 0.2 percent, against expectations for a modest increase.

Figure 1. Employment Growth, 2012–2019



Source: Bureau of Labor Statistics, Haver Analytics

While consumer confidence had mixed results during the quarter, business confidence showed improvements. The Institute for Supply Management Manufacturing and Nonmanufacturing indices, which measure producer sentiment, showed rebounds following declines in December and January.

Business investment showed growth to start the year. Durable goods orders increased by 0.3 percent in January. This increase followed 1.2-percent growth in December and 1-percent growth in November. Businesses confidence appears to have rebounded from the year-end turbulence. Spending also continues to grow, although below the levels of 2018.

Fed responds to slowdown

At its December meeting, the Federal Reserve (Fed) indicated that two rate hikes in 2019 were likely. But in response to weaker data, the Fed has since made a large turnabout in policy. At its March meeting, the Fed suggested that no further rate hikes are expected this year. Plus, it said it will end its balance sheet runoff activities in 2019. These moves left policy more stimulative than had been anticipated. Market participants have taken this updated guidance to heart. In fact, some have even projected a rate cut in the fourth quarter.

Of course, slower growth is still growth. Although the data is weak, there is reason to hope for a rebound in the second quarter. Some of this weakness may have been seasonal. First quarters have been weak over the past several years, only to rebound. So, the next couple of months will be important.

The risks are subsiding

Although the economic risks remain, they may be receding. To start, we avoided a second government shutdown. This likely played a part in the rebound in business confidence. Further, housing market concerns, although still present, have diminished somewhat. Lower mortgage rates made buying a house more affordable, leading to increases in new and existing home sales. Existing home sales were especially encouraging, with 11.8-percent month-over-month growth in February.

International risks have also receded for the time being—although they could reemerge. The ongoing Brexit negotiations appear to be deadlocked. The United Kingdom is not providing much clarity as it works toward avoiding a no-deal exit from the European Union. On the bright side, the United Kingdom and the European Union extended the deadline for a no-deal Brexit from March 29 to April 12. So, there is still time for a potential trade deal. A slowdown in Chinese growth also has the potential to affect markets. But, once again, this is more of a medium- to long-term concern than a pressing risk.

A new risk on the radar is the inversion of the yield curve, which occurred at month-end. After the Fed announced an easing of monetary policy, yields on long-term government debt were driven down. This move left longer-term interest rates lower than shorter-term ones. When this happens, it is known as a yield curve inversion and typically signals a higher risk of recession. Although this inversion garnered a lot of headlines, the risk is more for 2020—not 2019. It needs to be watched but not worried about just yet.

Strong quarter starts year off right

As we have discussed, risks remain both at home and abroad. But U.S. markets showed their resilience in the first quarter. Economic growth appears to have slowed, but slow growth is still growth. Earnings growth in the first quarter was disappointing. Here, there may be room for upside, given analysts' positive estimates for the rest of the year.

Conditions are not bad and may well improve as confidence and spending have room to catch up to 2018 levels. Further, lowered interest rates are generally supportive of faster growth. We can see this in the increases in home sales when mortgage rates declined in February.

The real takeaway from the drop at the end of 2018 and the rebound to start this year is that volatility can happen quickly. The past six months highlight the importance of creating well-diversified portfolios that can withstand short-term volatility.

All information according to Bloomberg, unless stated otherwise.

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