Market Update

Turbulent month for markets

August was a rough one for stocks, with all three major U.S. indices declining during the month. The Dow Jones Industrial Average (DJIA) fell by 1.32 percent, while the S&P 500 lost 1.58 percent. The Nasdaq Composite suffered the heaviest losses, finishing the month down 2.46 percent. Still, things could have been worse. With periods during the month where markets fell by as much as 4 percent to 6 percent, a bounce back at month-end helped stave off larger declines.

Despite the volatility, fundamentals improved in August. According to Bloomberg Intelligence, S&P 500 earnings grew by 2.2 percent in the second quarter. This result was up from the 0.8 percent estimated growth rate on July 31 and was driven by strong earnings growth in the health care and communication sectors. As we know, fundamentals drive long-term performance. So, the growth in the second quarter is encouraging.

From a technical perspective, all three major U.S. indices finished the month above their respective 200-day moving averages. The S&P 500 and Nasdaq Composite both spent the month above their trend lines. But this was not the case with the DJIA. It fell below its 200-day moving average for two days midmonth. The index recovered, although it came close to breaching its trend line again the following week. A sustained drop below the 200-day moving average could mean a shift in investor sentiment for an index. As such, it was a positive sign that the DJIA was able to recover both times it neared its trend line.

International markets also had a volatile August, as political concerns weighed on investors. The MSCI EAFE Index fell by 2.59 percent. Here, negative developments surrounding Brexit and a slowdown in key eurozone countries caused uncertainty. Emerging markets had an even worse month. The MSCI Emerging Markets Index fell 4.85 percent. Slowing growth figures from China and political uncertainty in South America contributed to the index's decline. Technicals were also not supportive for international stocks. Both indices spent most of the month below their 200-day moving averages.

On a brighter note, investment-grade fixed income had a strong month. Investors flocked to the relative safety of high-quality bonds, driving prices up and yields down. The 10-year Treasury yield started the month at 1.90 percent and declined to 1.50 percent by month-end. This drop helped the Bloomberg Barclays U.S. Aggregate Bond Index return 2.59 percent for the month. High-yield bonds also had a solid month. The Bloomberg Barclays U.S. Corporate High Yield Index returned 0.40 percent in August.

Political risks take center stage

Political developments dominated the headlines in August. Let's start with the continued escalation of the U.S.-China trade war. The month started with an announcement from President Trump of a new 10 percent tariff on $300 billion of imports from China. Then, the U.S. labeled China a "currency manipulator." This move was in response to the yuan-dollar exchange rate climbing above 7 yuan to the dollar for the first time since 2008. China answered by announcing its own tariffs on select U.S. goods and halting all purchases of U.S. agriculture by Chinese companies.

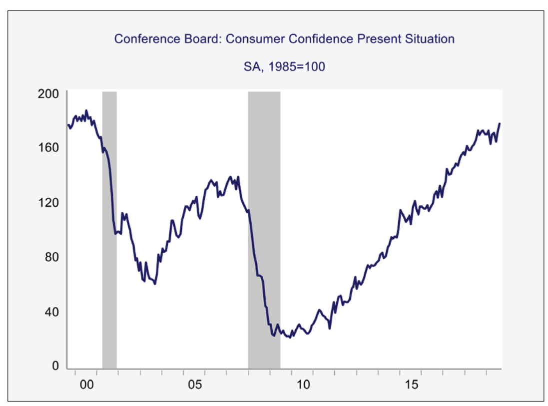
The escalation of the U.S.-China trade war was a big story, but it wasn't the only one. President Trump continued his attacks on the Federal Reserve (Fed) and Chairman Jerome Powell. The president questioned whether the Fed should be more aggressive in cutting interest rates. Further, markets were rattled when President Trump tweeted that American companies should remove themselves from China. He also asked whether Powell or Chinese President Xi Jinping was a "bigger enemy." Finally, there were growing Brexit risks to consider. The prospect of Great Britain crashing out of the European Union without a deal hit international markets hard. Of course, this move would affect Europe the most. But markets around the world sagged on fears of what this departure might mean for global growth.

Economy continues to grow

To be sure, political headlines knocked down markets in August. Still, the U.S. economic picture remained positive, driven by continued strength in consumer spending. July's retail sales figures came in much better than anticipated. Here, we saw 0.7 percent growth against expectations for 0.3 percent. Core sales came in even better, with 0.9 percent monthly growth. After suffering a slowdown at the end of 2018, consumer spending was a major driver for second-quarter growth. As such, these strong results are encouraging for economic growth in the third quarter.

Spending was supported by high consumer confidence levels. The Conference Board Consumer Confidence Index fell from 135.8 in July to 135.1 in August. Given market volatility, this result was better than economists expected. Plus, it is a very high level historically. As you can see in Figure 1, consumers were especially optimistic over the current state of the economy.

Figure 1. Consumer Confidence Present Situation Index, 1999–2019



Source: The Conference Board, Haver Analytics

The present situation part of the index hit levels last seen in the boom of the late 1990s.

Another positive sign could be found in consumer sentiment and spending. Strength here was enough to bring back signs of life to the housing market. For the past two years,

Economy continues to grow (continued)

housing growth has been disappointing. Rising prices and lack of supply in some regions have limited sales. But July's existing home sales report provided some hope for housing growth. It showed sales increased on a year-over-year basis for the first time since February 2018. Lower rates likely played a part in this increase in sales, as mortgage applications jumped in June when rates fell in May.

Of course, it is too early to say whether housing growth is here to stay. But this increase was a positive development. Housing is an area of the economy that has a large effect on growth, due to the spending related to buying a home. Going forward, we may be poised for further housing growth. Indeed, we saw another spike in mortgage applications in August as rates fell.

Business data a mixed bag

Consumer data was strong for the month, but businesses were not as confident. The Institute for Supply Management (ISM) Manufacturing and Nonmanufacturing indices declined during the month. Here, trade-related uncertainty weighed on business confidence. July's industrial production report highlighted manufacturers' worries over trade. Manufacturing output fell by 0.4 percent during the month. This drop led industrial production to a 0.2 percent loss, against expectations for a slight gain. Unless trade tensions diminish and international demand for U.S. goods returns, it may be difficult for manufactures to grow at higher rates.

Confidence and production were down during the month, but durable goods orders were better than expected. This proxy for business investment came in with 2.1 percent month-over-month growth in July. Still, this news wasn't as positive as it appears. Much of this growth was due to an increase in volatile aircraft orders. Core durable goods orders, which strip out transportation orders, fell by 0.4 percent. This result indicates that the month's decline in business confidence may have slowed business spending and investment.

Risks remain but fundamentals are solid

As we saw in August, politics and headlines can hurt markets in the short term. But a solid economy can cushion those declines, and there is a lot to like about the U.S. economy. Despite the uncertainty created by volatile trade developments, consumer confidence and spending levels remain high. At more than two-thirds of the economy, consumer spending is the most powerful factor in the economy. It can continue to power the economic expansions here at home. The return to year-over-year growth in existing home sales is just one example of this.

Looking forward, one of the primary areas of concern will be the unresolved nature of the U.S.-China trade war. We will want to keep a close eye on the impact that uncertainty may have on business confidence and spending. Recently, consumers have been able to keep the economy rolling. But there may be a limit to how much they can do, especially if we see a large drop in consumer confidence. So, an acceleration in business spending would be a welcome development.

Abroad, the looming Brexit deadline and slowing growth in the eurozone could lead to volatility. British Prime Minister Boris Johnson's attempts to shut down Parliament highlight the type of contentious developments we can expect from that process.

Here at home, the 2020 presidential cycle continues. The Democratic field is being narrowed down before the Democratic primary elections. Given the polarized nature of political discourse in this country, these elections may become a source of future volatility.

As we've seen many times this year, volatility can strike suddenly and be caused by a variety of factors. Given the risks discussed here, it is likely that we will see further volatility this year. But even if we do, the fact that the fundamentals of the economy remain solid should help serve as a cushion against any stumbles. As always, a well-diversified portfolio and a long-term view toward investing remain the best way forward in a volatile world.

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.

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