MarketUpdate

Strong June leads to positive quarter for markets

June was a great month for stocks, as all major equity markets saw positive returns. The S&P 500 gained 7.05 percent for the month, the Dow Jones Industrial Average (DJIA) returned 7.31 percent, and the Nasdaq Composite rose by 7.51 percent. Further, June's gains offset May's declines, leading to positive quarterly performance of 4.30 percent for the S&P 500, 3.21 percent for the DJIA, and 3.87 percent for the Nasdaq.

This positive performance came despite weakening fundamentals. According to FactSet (as of June 28, 2019), the estimated earnings decline for the S&P 500 in the second quarter is 2.6 percent. This estimate is down from the 0.5 percent decline projected at the start of the quarter. Keep in mind that earnings declined in the first quarter for the first time since 2016. As such, this projected earnings decline for the second quarter in a row is concerning. Analysts project further declines in the third quarter before a return to growth in the fourth quarter. Ultimately, fundamentals drive long-term performance, so this is an area that deserves attention going forward.

Although fundamental support worsened during the month, technical factors were another story. In May, all three major U.S. indices dropped below their respective 200-day moving averages. But they bounced back in June to close the month well above that trend line. This bounce was an important development, as long periods spent below the 200-day moving average could show that investors are becoming less confident in U.S. equities. In turn, this lack of confidence could be a headwind to future performance.

The international story in June was much the same. The MSCI EAFE Index returned 5.93 percent, and the MSCI Emerging Markets Index returned 6.32 percent. Once again, these gains offset losses in May, bringing the MSCI EAFE Index to a 3.68 percent gain for the quarter. The MSCI Emerging Markets Index, which fell further than the developed markets in May, ended the quarter with a 0.74 percent gain.

Technicals for international stocks were supportive during the month. The developed and emerging market indices finished June above their respective 200-day moving averages. These indices had ended May below their trend lines, so this rise was a very positive development, like what we saw in U.S. equity markets.

Even fixed income had a positive June, driven by falling interest rates. The Bloomberg Barclays U.S. Aggregate Bond Index returned 1.26 percent, as the 10-year U.S. Treasury yield went from 2.14 percent at the end of May to 2 percent at the end of June. In fact, rates fell throughout the quarter, as the 10-year yielded 2.49 percent at the start of April. These declining rates led the index to a quarterly gain of 3.08 percent.

High-yield bonds also had a strong month and quarter. The Bloomberg Barclays U.S. Corporate High Yield Index returned 2.28 percent in June and 2.50 percent for the quarter. High-yield spreads ended the quarter unchanged despite a large increase in May, as the rally in June helped drive spreads lower.

Economic growth: Slowing but still growing

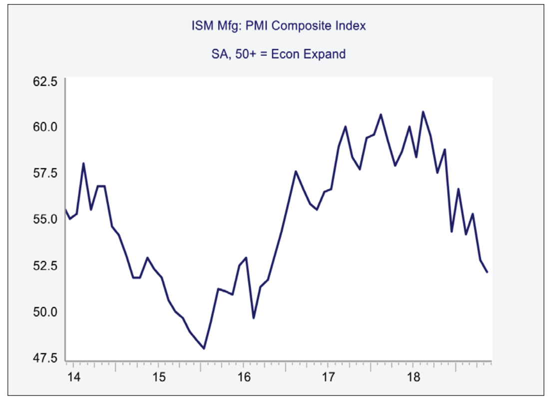
The fall in yields was due in large part to rising worries about economic growth. Only 75,000 new jobs were added in May. This result was below expectations of 175,000 and below the 2018 average of 215,000 new jobs per month. This disappointing number suggests that job growth is slowing.

Workers have begun to notice that new jobs are not as plentiful as they have been in years past. We saw this recognition in the declines in both major measures of consumer confidence in June. Positive market returns and a strong jobs market support consumer confidence. A decline in confidence—despite the strong market returns—indicates that workers may be starting to worry. That said, confidence remains at high levels, so this month's drop is not an immediate concern.

Although confidence may be down, it has not yet hit actual behavior or economic growth. In fact, consumers kept earning and spending. Personal income and personal spending were up by 0.5 percent and 0.4 percent, respectively, in May. Retail sales also grew by a healthy 0.5 percent.

Businesses had a similar quarter, with some spending growth despite mixed confidence indicators. The Institute for Supply Management (ISM) Manufacturing index declined during the quarter. This drop reflects manufacturers' growing concerns over a prolonged trade war. As you can see in Figure 1, the index is now at its lowest level in more than two years.

Figure 1. ISM Manufacturing Index, 2014–Present



Source: Institute for Supply Management, Haver Analytics

Despite the decline in sentiment, business investment and output continued to show steady growth. May's industrial production report showed a 0.4 percent gain. This result was better than economist expectations. Core durable goods orders, a proxy for business investment, showed solid 0.3 percent growth in May. These results suggest the sector may be doing better than the sentiment indicates. The ISM Nonmanufacturing index was also positive. It held on to a higher level, suggesting that manufacturing was not a reflection of weakness in the economy as a whole.

The mixed confidence data was disappointing, but business investment continues and should have a positive impact on economic growth.

Fed continues to support economic expansion

Another tailwind came from monetary policy. In a press conference after the Federal Reserve's June meeting, Chairman Jerome Powell indicated that the Fed would continue to watch for any negative economic impacts from the ongoing trade war. Further, he said the Fed would step in with stimulative measures if necessary.

Powell stopped short of saying that the Fed would cut rates at its next meeting. Still, market participants interpreted his comments as confirming the likelihood of a cut this year. At the start of the quarter, markets priced in a 65 percent chance of one rate cut during the year. Now, at the end of the quarter, the market has priced in a 100 percent chance of a rate cut at the Fed's July meeting. Further, a second rate cut in either October or December is anticipated.

Inflation remains stuck below the Fed's stated 2 percent target. But with slowing job growth and the rising concern around trade, a rate cut is certainly possible—and could be another tailwind for stocks.

Political risks remain

Although the economy continued to chug along, politics remained a concern, especially around trade. This impact was clear in May, when a couple of events rattled markets. First, we saw escalations in the China-U.S. trade war. Second, we had the surprise announcement of a blanket 5 percent tariff on all Mexican goods, although they never went into effect.

On a more positive note, the G20 meeting at the end of June was drama free. World leaders toned down political rhetoric leading up to and during the meeting. This relative lack of political drama, along with a commitment for further trade negotiations between the U.S. and China, helped calm investor concerns and paved the way for June's positive performance.

Economic growth poised to continue

All in all, this was a positive quarter for the U.S. economy. Despite concerns over international trade, the economy continues to grow at a solid clip. Consumers continue to show that they are willing and able to spend, and businesses are doing the same. Earnings declined in the first quarter and will likely do so again in the second quarter, but a return to growth by year-end should help support long-term performance.

Lower interest rates should support faster growth going forward, as lowered borrowing costs spur economic activity. We saw a surge in mortgage applications once rates fell in June. If rates remain low, there is a possibility that we could see housing growth return in the second half of the year.

Despite the very real political risks, the U.S. economy continues to grow. Markets have had a great start to 2019. Equities saw positive returns in five of the first six months of the year. These strong returns led all three major indices to double-digit year-to-date returns. There is a good chance that trend will continue. That said, the declines in May show that despite the positive tailwind from a growing economy, market volatility can come at any time. Thus, a well-diversified portfolio that matches your goals and risk tolerance remains 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.

Authored by Brad McMillan, CFA,® CAIA, MAI, managing principal, chief investment officer, and Sam Millette, senior investment research analyst, at Commonwealth Financial Network®