

July 2018

Strong July for global markets

Global markets had a strong July, rebounding from a volatile June. Here in the U.S., the S&P 500 Index gained 3.72 percent while the Dow Jones Industrial Average grew 4.83 percent. The Nasdaq lagged its counterparts with a gain of 2.19 percent, after a technology sell-off pulled down performance at month-end.

Better-than-expected fundamentals supported the positive returns. Spurred by the strong economy, corporate sales have taken off. Almost three-quarters of S&P 500 companies have reported sales increases above expectations, which is significantly above the five-year average. The size of the beats has also been above average. Not only is sales growth doing well in absolute terms, but it is surpassing expectations, which is positive for market performance.

Sales matter, but it is the money a company keeps—its earnings—that matter more. The news here was also very good, with five out of six companies beating estimates thus far. Earnings growth for the third quarter is also better than expected; it was 21.3 percent as of July's end, up from an estimated 20 percent on June 30.

Fundamentals drive long-term performance, so the second quarter was very positive. Moreover, analysts project double-digit earnings growth for the rest of the year.

Technical were also supportive for U.S. markets. Although it began the month below its 200-day moving average, the Dow finished July above this trend line. The other two major indices remained well above their respective averages throughout the month.

International markets bounced back in July after a weak June. The MSCI EAFE Index finished the period up 2.46 percent. Emerging markets posted similar returns, with the MSCI Emerging Markets Index rising 2.28 percent.

Technical for developed and emerging markets were challenging in July, as the June pullback proved too deep to recover from in just one month. Both indices stayed below their long-term trend lines.

Finally, fixed income had a difficult July, as a rise in rates on the long end of the curve at month-end upset markets. The yield for the 10-year U.S. Treasury rose from 2.87 percent to 2.96 percent during the month. Typically, rising rates are bad for bond returns, and the Bloomberg Barclays Aggregate Bond Index rose just 0.02 percent in July.

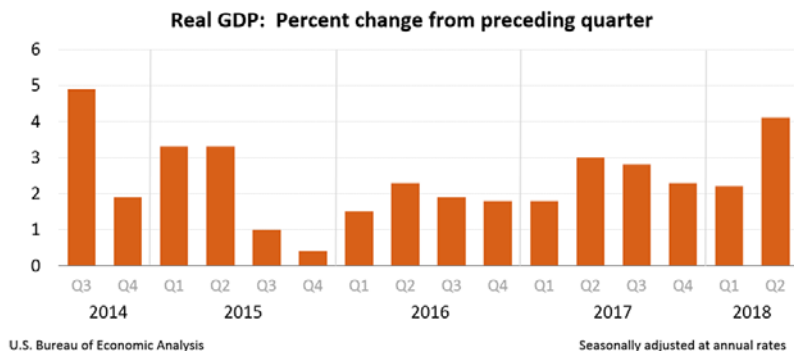
High-yield corporate bonds, usually less tied to interest-rate moves, had a better month. Interest rate spreads compressed slightly in July. The Bloomberg Barclays U.S. Corporate High Yield Index rose 1.09 percent, showing that investors are still comfortable paying up for higher yields.

Economic reports point to faster growth

The global economy continued to grow, and the U.S. in particular grew faster in the second quarter. Second-quarter U.S. gross domestic product (GDP) growth came in at 4.1 percent, the highest level since 2014, as illustrated in the chart below. Meanwhile, first-quarter growth was revised up from 2 percent to 2.2 percent.

The growth was broad based, engendered by higher consumer spending, solid business investment, and faster government spending growth, along with a notable bump from a surge in exports.

Figure 1. Real GDP: Percent Change from Preceding Quarter, 2014–2018



Job growth remains healthy as well, despite a lackluster report in July, which came in at 157,000 new jobs versus expectations for 193,000. What this headline figure doesn't show is that June's strong employment report was revised up from 213,000 jobs to 248,000, accounting for most of July's shortfall. The unemployment rate also improved from 4 percent to 3.9 percent, and average weekly hours worked stayed steady at 34.5.

The strong jobs market has helped support consumer confidence. The most recent Conference Board confidence survey rose to its third-highest level since 2000.

With consumers able and willing to spend, consumer spending growth also accelerated. It rose 4 percent against expectations for a more modest 3-percent gain. Retail sales data was also solid, with a 0.5-percent uptick and an upward revision to the prior month's number. If consumers can continue to spend as they did in the second quarter, we may see GDP growth of more than 3 percent for the rest of 2018.

Although consumers were a bright spot in the second quarter, they weren't alone in driving growth. Businesses were also confident and willing to spend. The Institute for Supply Management's Manufacturing and Nonmanufacturing indices continued to post high expansionary numbers, as faster growth and lower corporate taxes led to healthy levels of investment. Business investment for the second quarter grew 7.3 percent, and durable goods orders for June rose a respectable 1 percent. Export growth of 9.3 percent was another bright spot, although here the details suggest that such a large increase isn't likely to be repeated.

The Federal Reserve (Fed) also seems to be on board with the continuing recovery. Fed Chair Jerome Powell declared victory in congressional testimony in July, with both unemployment and inflation at Fed targets. This is a more positive take on the economy than we have had from the Fed in years, and it ratified the positive data we saw last month.

But housing disappoints

Not all the news was good. Housing, a key economic sector, appears to have slowed. Both existing and new home sales declined in June, with new home sales falling 5.3 percent. Homebuilder confidence, though still high, appears to be rolling over. Rising construction costs have lowered the profitability of new housing and led to a declining trend in housing starts and permits. During the past few years, builders have been able to pass along cost increases to homebuyers. Given today's higher prices and rising mortgage rates, however, this trend may be nearing its end.

Some of the slowdown in housing can be attributed to low levels of supply, but another key factor is slumping affordability. Housing prices are climbing faster than incomes, and, as mentioned already, mortgage rates are ticking up.

Housing is among the key drivers of the U.S. economy and a proxy for overall consumer confidence. Even though the financial markets remain strong, and the economy continues to grow, any slowdown in housing growth must be taken seriously.

Political concerns muted but still there

In July, political stories grabbed the headlines, but domestic markets took the events in stride. Overall, the market's perception of policy risks seemed to recede, as North Korea moved out of the headlines, and the trade war between Europe and the U.S. was put on hold. China, however, remains a major area of trade concern, with renewed U.S. tariff threats rattling markets at month-end.

In the months ahead, the midterm elections could lead to increased volatility. With a potential government shutdown in play, as well as the disruption brought about by the campaigns, political risks are more likely to rise than to fall. This will be something to keep an eye on as we move toward November.

Prospects remain positive

Despite very real risks, the positive economic news from July points to continued healthy growth for the rest of 2018. And politics notwithstanding, a healthy economy and rising profits should support the markets. That's good news, but it doesn't mean we won't see volatility.

We should expect that, at some point, the news won't be as good. But we should take it in stride. Whatever happens, a well-diversified portfolio that matches risk-and-return guidelines is the best path to follow for achieving long-term financial goals.

All information according to Bloomberg, unless stated otherwise.

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