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Positive U.S. consumer data fails to lift stocks

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Article Highlights

- Strong retail sales and consumer sentiment data are not enough to drive the S&P 500 higher.
- As U.S. stocks extend their losing streak, European shares notch a small gain, barely ending a two-week slide.
- High-yield bonds rally despite outflows, while a modest increase in demand supports Treasuries.
- Continued improvements in wages and consumption should lead to stronger Q2 growth, providing scope for the Fed to raise interest rates.
- Despite a range of potential headwinds, favorable fundamentals should support fixed-income performance.

Equities

Global equity markets struggled to gain traction this past week, as investors confronted two familiar foes: oil price choppiness and lackluster corporate earnings releases.

In the U.S., better-than-expected consumer data released on May 13 failed to provide support for markets. After posting its best one-day gain (+1.3%) in two months on May 10, the S&P 500 Index fell for the next three days, extending its two-week losing streak by declining about 0.5% for the week.

European stocks rose in the wake of the positive U.S. data, with the broad STOXX 600 Index gaining 0.9% in local currency terms, its first one-week advance since late April. Economic news showed that Eurozone GDP grew at a slightly slower pace (+0.5%) than first estimated during the first three months of the year, even as Germany—the region's largest economy—expanded at its fastest pace (+0.7%) since 2014.

In Asia, Chinese equity markets slumped on concerns over the country's economic growth, while Japan's export-heavy Nikkei 225 Index, bolstered by a declining yen versus the U.S. dollar, returned 2.1% in local currency terms.

Current updates to the week's market results are available here.

Fixed income

U.S. Treasuries rallied during the past week, as mixed global economic releases led to a modest uptick in demand for safe-haven assets. The bellwether 10-year note, which began the week at 1.79%, drifted down to 1.70% on May 13. (Yield and price move in opposite directions.)

Returns for non-Treasury “spread sectors” was mildly but broadly positive for the week through May 12. High-yield bonds overcame continued outflows to post a solid 0.53% gain. This asset class is up almost 7.0% year to date, but persistent negative flows may trim that return in the coming weeks.

Consumers start the second quarter in good form

In a relatively light week for U.S. data releases, consumers showed renewed optimism and a willingness to spend, two signs that the economy may be regaining some momentum after growth nearly stalled in the first quarter.

Among the week’s reports:

- **Consumer sentiment** topped forecasts by surging to 95.6, according to May’s preliminary reading of the University of Michigan index. Consumers cited income gains, an improved jobs outlook, and expectations for lower inflation and interest rates as reasons for optimism.

- **Retail sales** recorded their biggest increase in a year (+1.3%) in April, while March’s sales were revised slightly upward, from -0.4% to -0.3%. We have long held that if wages pick up, consumption growth should follow. With first-quarter wages rising more than in previous years, April’s retail sales report may suggest that stronger consumption levels are on the horizon.

  While we are encouraged by this data, it’s too early to say that wages and consumption will remain on an upward path. If the trend continues over the next few months, though, the U.S. economy should rebound in the second half of the year, providing scope for the Federal Reserve to raise interest rates.

- **Small-business sentiment** in April edged up off a two-year low, as measured by the National Federation of Business Optimism Index. Despite the gain, owners are still concerned about the economy and the political climate in Washington.

- **First-time unemployment claims** unexpectedly jumped by 20,000, to 294,000, a one-year high. The less-volatile four-week moving average also rose, by 10,250, to 268,250. Even though initial claims have risen by 46,000 over the last three weeks, they've held below the key 300,000 level for 62 weeks, the longest such streak since 1973.

Outlook

The fundamentals for fixed-income assets remain reasonably supportive: the Fed is unlikely to raise rates quickly, quantitative easing by global central banks will continue to provide liquidity, and corporate default rates (outside of the energy sector) are still historically low. Against this backdrop, we don't believe credit spreads will widen dramatically.

Meanwhile, the recent decline in U.S. equities, which are now off more than 3% from their April highs, may represent the beginning of the correction we have been expecting. Moreover, global markets are facing many potential headwinds, including upcoming elections in the U.S. and Spain, the "Brexit" vote, oil volatility, and movements in the dollar.

We are also increasingly concerned about renewed softness in Chinese economic activity and recent weakening in the yuan. As we saw last August and once more in January, the equity market could become vulnerable to further downside volatility if the yuan weakens again. If that were to happen, spreads across a wide range of fixed-income asset classes could widen. We would consider pullbacks in both the fixed-income and equity markets to be buying opportunities.

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