U.S. and European equity markets wobble as a solid earnings season winds down

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Article Highlights

• In a long-awaited rebound, Europe’s corporate earnings outpace strong results in the U.S.

• European stocks finish the week about flat, while the S&P 500 Index ends a three-week winning streak.

• April’s tame inflation numbers contribute to falling U.S. Treasury yields.

• Improving consumer spending and sentiment data are positives in a quiet week for U.S. economic releases.

• Eurozone investor confidence hits a 10-year high as inflows into non-U.S. funds continue apace.

Quote of the week

“I've been expecting you, Mr. Powers.”—Dr. Evil from the “Austin Powers” films

The Lead Story: Europe steals the earnings spotlight

In the first quarter, U.S. corporate earnings exhibited their strongest year-on-year growth since initially recovering from the financial crisis back in 2009. Profits increased by 15%, with companies beating analysts’ expectations by an average of nearly 6%. Perhaps even more importantly, revenues rose by almost 9%, a positive sign for equity investors concerned that the market has been overly supported by cost cutting and not enough by increasing sales. Among our favored sectors, Energy enjoyed particularly robust earnings growth, thanks to higher commodity prices since the beginning of last year. Technology, Consumer Discretionary, and Financials also posted strong top-and bottom-line quarters.

While this past earnings season bested expectations, it seems to have merely confirmed the optimism already factored into equity prices. As a result, the S&P 500 has barely budged since hitting a then-record high of 2,395 on March 1, before companies began reporting.
Keep an eye on earnings forecasts over the balance of this year and into 2018. They’ve shown few signs of meaningfully improving, which have kept stock valuations lofty. Investors had been anticipating a pickup in profits, and they’re banking on more of the same in coming quarters. But those expectations look pretty well baked in. We foresee few, if any, price gains in the S&P 500 for the rest of 2017.

In Europe, where earnings growth had been absent for going on six years, first-quarter results have been better. The outlook is brighter, too. European companies are averaging year-on-year profit gains of over 20%, topping analyst estimates by better than 10%. More companies are outstripping forecasts, and not since 2009 have so few fallen short of them, leading to expectations for upward earnings revisions for the remainder of the year. This, along with the benign French election result, has supported European equity markets relative to the rest of the world, especially the U.S. Consensus earnings growth for Europe’s STOXX 600 Index is nearly 20% for 2017, close to double that of the S&P 500.

In other news: Confident investors pack their bags, move overseas

Amid prospects for diminished political uncertainty and further economic improvement in the Eurozone, investor morale in the region maintained its uptrend since last fall by reaching a 10-year high in May, according to the Sentix Investor Confidence Index. With optimism rising, fund flows into non-U.S. equities have been positive for 22 consecutive weeks.

In contrast, outflows from U.S. equity funds have been accelerating since late March. Meanwhile, investor anxiety remained near historically low levels during the past week, as measured by Wall Street’s “fear gauge,” the VIX Index.

For the week, Europe’s STOXX 600 Index finished essentially flat (in U.S. dollars) after surging more than 7% over the previous two weeks. The S&P 500 Index lost 0.3%, ending a three-week winning streak.

Low volatility also permeated fixed-income markets despite heightened political uncertainty surrounding actions by the Trump administration and the continued cloudy outlook for U.S. fiscal policy. The yield on the bellwether 10-year U.S. Treasury, which moves in the opposite direction of its price, ended the week at 2.33%, down six basis points (0.06%), largely due to softer-than-expected inflation data. Returns for non-Treasury sectors were mixed. High-yield corporate bonds outperformed, lifted by a rebound in oil prices.
As always, we believe diversifying across a wide range of fixed-income asset classes and prudently allocating among shorter- and longer-dated bonds are keys to reducing volatility. In building our portfolios, we rely heavily on individual security selection to select those bonds with the potential to outperform given the current economic environment.

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

Below the fold: U.S. consumers regain their resilience

In a light week for U.S. data releases, gauges of U.S. consumer spending and inflation were the most revealing. Among the reports:

- Despite some disappointing first-quarter earnings results from major U.S. brick-and-mortar stores, retail sales jumped 0.4% in April, and March’s initial 0.2% drop was revised up to a 0.1% gain. And consumer sentiment climbed in May, according to the preliminary reading of the University of Michigan index.

- The Consumer Price Index rose 0.2% in April and 2.2% over the past 12 months, down from 2.4% in March and 2.7% in February. The “core” CPI, which excludes food and energy costs, edged up just 0.1% in April and 1.9% compared to a year ago. This latter reading benefits Treasuries and non-Treasury fixed-income assets alike, as tame inflation growth should allow the Fed to raise rates slowly.

April's modest inflation coincides with a 0.3% improvement in weekly earnings, thereby boosting consumers’ purchasing power. This has translated to better spending, as evidenced by the latest retail sales results. Whether the consumer picture will continue to brighten remains to be seen, although in our view it may have staying power.

- Small-business sentiment fell modestly in April for the third consecutive month but remained near January's all-time high. The decline was largely due to reduced expectations for business conditions and plans to make capital expenditures.
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The Back Page: And the winner is…

Arguably the most profitable corporation of all time, the Dutch East India Company (DEIC) was a multinational powerhouse and trading conglomerate from 1602-1799. With an estimated valuation of around $7 trillion (in today’s dollars), it would be some nine times larger than the current market behemoth, Apple, valued this week at a “mere” $800 billion. An innovative company that was first to offer freely tradable stock, the DEIC paid a whopping average annual dividend of 18% for nearly two centuries.

While some accounts blame the firm’s downfall on the aftermath of the 1636-1637 “Tulip mania”—widely considered to be the first financial market bubble—the company ultimately fell prey to global competition, mismanagement, broader economic forces, and, eventually, the French Revolution.

Speaking of tulips, I’m off to my local florist to pick up a dozen. To all the moms out there, Happy Mother's Day.