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GLOBAL ASSET MANAGEMENT

U.S. equities struggle to hang on to record highs

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Article Highlights

- The S&P 500 index finishes essentially flat for the week, while Europe posts a solid gain.
- Emerging-market economies continue to benefit from strengthening currencies.
- U.S. Treasuries rally in the wake of below-forecast retail sales data.
- Relative bright spots in the past week's data releases are welcome but don't suggest an upward shift in the economy's slow, deliberate pace.
- We believe the fixed-income environment is generally positive, although an equity correction or a dramatic change in global bond-buying patterns could spark volatility.

Equities

Global equity markets were mixed this week. Carryover effects from July's strong U.S. jobs report boosted returns, as did mostly better-than-anticipated corporate earnings results and expectations for continued central bank easing. Gains were tempered by volatile oil prices and disappointing U.S. retail sales data.

In the U.S., the S&P 500 Index see-sawed between retreating and setting new record highs. For the week, the index finished essentially flat. It also remained on its recent low-volatility path, having neither risen nor fallen by more than 1% on any of the past 24 trading days. In terms of corporate earnings, with 90% of S&P companies reporting, 71% have outstripped forecasts, and 53% have exceeded sales projections. Some of this solid performance can be attributed to a weakening dollar, a trend we believe will persist.

Overseas, European and emerging-market (EM) stocks are benefiting from economies that are currently outpacing the U.S. This should lead to further currency strengthening versus the dollar and support equity prices in those markets. Europe's broad STOXX 600 Index was buoyed by the embattled European banking sector, as second-quarter revenues and costs were better than expected. For the week, the STOXX 600 rose 1.4% (in local terms). Meanwhile, the MSCI Emerging Markets Index surged 2.5% for the week through August 11, raising its year-to-date gain to a healthy 16.2% (returns in U.S. dollar terms).

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

Fixed income

U.S. Treasury yields fell. After inching down from 1.59% at the start of the week to 1.57% on August 11, the yield on the bellwether 10-year note closed at 1.51% on August 12 in the wake of July's below-forecast retail sales data. (Yield and price move in opposite directions.)

With some $12 trillion worth of global bonds yielding less than zero, the search for yield intensified following the Bank of England's recent decision to cut interest rates and restore its quantitative easing program. High- and lower-quality corporate bonds are in demand from both foreign and U.S. buyers. Against this backdrop, returns for non-Treasury "spread" sectors ranged from modestly to strongly positive, led by high-yield bonds.

U.S. economic data fails to inspire

There were some relative bright spots in the past week's data releases, but none suggest an upward shift in the economy's slow, deliberate pace. Retail sales were a notable disappointment.

Among the week's reports:

- **Retail sales** were unchanged in July, well below forecasts, while June's pace was revised higher, to a robust 0.8%. July's flat reading doesn't surprise us, as such weakness often follows upbeat reports. This metric is closely watched, as retail sales have been key supports for growth and job creation.

- **First-time unemployment claims** dipped by 1,000, to 266,000, and the less-volatile four-week moving average rose by 3,000, to 262,750. In addition, job openings increased in June, according to the JOLTS report.

- Although **small-business sentiment** inched up in July to its highest level of the year, as measured by the NFIB index, it stayed well below this economic cycle's mid-2014 peak. Business owners' optimism over the direction of the economy was matched by their reluctance to boost investment spending

- **Consumer confidence** also improved, based on the preliminary August reading of the University of Michigan index. More favorable prospects for the overall economy offset concerns over personal finances.

Outlook

For the U.S. economy, annual GDP growth is holding steady, at 1.75%-2.25%, with little evidence to suggest a breakout in either direction. A pickup in wages, which translated into strong consumer spending—at least in the second quarter—has provided a dose of optimism. However, before we can express confidence that GDP will accelerate from current levels, we will need to see a steady stream of significantly positive consumer data. We are not concerned about consumer spending overall, despite July's weak retail sales. While personal consumption is not likely to grow at last quarter's 4.2% pace, we still expect a 2.8% increase in the third quarter.

In fixed-income markets, fundamental factors remain solid. The risk of a U.S. recession is low, financing costs are still inexpensive, and business conditions overall are stable. That said, an equity correction or a dramatic change in global bond-buying patterns—triggered, for example, by a reversal of negative interest rates abroad or a shift in currency markets—could spark fixed-income volatility. In the current environment, we continue to favor investment-grade corporate bonds, emerging-market debt, and asset-backed securities.