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With a strong July, equity markets continue to put Brexit in their rear-view mirror

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Article Highlights

- The S&P 500 finishes essentially flat for the week, while European stocks post a modest gain.
- A still-patient Fed and disappointing Q2 growth support a Treasury rally.
- Despite the underwhelming GDP number, robust consumer spending remains a bright spot.
- Emerging-markets equities continue to shine and offer compelling opportunities.
- Given the length of the rally among fixed-income “spread sectors,” we feel it is prudent to pare risk and focus on higher-quality asset

Equities

Global equity markets cautiously approached this last trading week of July. On tap were key policy meetings by the Federal Reserve (July 26-27) and Bank of Japan (July 28-29), along with a full slate of U.S. and European corporate earnings releases and economic reports.

The S&P 500 Index edged sideways during the week, taking a breather after rising from June’s post-Brexit lows. Better-than-expected corporate earnings, along with a series of upward earnings revisions, helped the index return about 3.7% in July.

Europe’s broad STOXX 600 Index gained 0.5% (in local currency terms) for the week, capping its best one-month return (+3.6%) since October. For the Eurozone, second-quarter GDP growth (+0.3%) was in line with expectations, but on a yearly basis, the region topped forecasts by expanding at a 1.6% clip, the likely result of accelerating economic activity from Germany and little or no Brexit-induced weakness outside of the U.K. In addition, the Eurozone’s preliminary inflation reading for July was a better-than-expected +0.2%, and economic sentiment improved.

In Asia, the Bank of Japan (BoJ) failed to impress markets by declining to cut its benchmark lending rate of -0.1% and leaving unchanged its yearly target of buying ¥80 trillion (about $770 billion) of Japanese government bonds. The BoJ did, however, commit to raising its annual purchases of exchange-traded funds from ¥3.3 trillion to ¥6 trillion and left open the possibility of further monetary easing at its September meeting. Japan’s Nikkei 225 Index lost about 0.3% (in local currency terms) for the week. Chinese equities fell about 1%, while more broadly, emerging-market shares continued to rally. Year to date through July 28, the MSCI Emerging Markets Index has gained 12%.

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

Fixed income

With the Fed holding the line on interest rates—even as it essentially acknowledged a desire to tighten policy by noting that near-term risks to the U.S. economy "have diminished"—the yield on the bellwether 10-year Treasury note dipped from 1.57% at the start of the week to 1.52% on July 28. (Yield and price move in opposite directions.) Treasuries rallied further following the release of the GDP report, touching 1.46% on July 29.

Returns for non-Treasury "spread" sectors were broadly positive amid falling Treasury yields and the ongoing global search for income. Strong demand for higher-quality, higher-yielding assets, coupled with the week's declining oil prices, weighed on high-yield corporate bonds, which are still up over 12% year to date through July 28.

U.S. GDP underwhelms in the second quarter

The U.S. economy grew at a much slower-than-expected 1.2% annual rate in the second quarter, according to the government's advance estimate. A surge in consumer spending was tempered by the steepest decline in business investment since 2009 and a reduction in business inventories. Additionally, first-quarter GDP growth was reduced to a 0.8% annual rate from the prior estimate of 1.1%.

Among the week's other releases:

- **U.S. home prices** increased 0.9% in May and 5.2% compared to a year ago, according to the S&P/Case-Shiller 20-City Index, and **new home sales** rose 3.5% in June, to their fastest pace since February 2008. **Pending home sales** edged up 0.2% in June and 1% versus last year.

- **Consumers' outlooks** were muted in July, as The Conference Board's consumer confidence index remained relatively unchanged, and the University of Michigan's consumer sentiment gauge fell.

- **First-time unemployment claims** climbed by 14,000, to 266,000, while the less-volatile four-week moving average ticked down, by 1,250, to 256,500.

- **U.S. service-sector activity** dipped to 50.9 in July, just above the 50 mark separating expansion from contraction, according to the "flash" (preliminary) reading of Markit's Purchasing Managers' Index (PMI).

- **Durable goods orders** (aircraft, machinery, computer equipment, and other big-ticket items) sank 4% in June, their biggest drop in almost two years. May's orders were revised down slightly.

Outlook

Despite the below-consensus GDP result, we see bright spots for the U.S. economy. Consumers are finally spending their windfall from lower gas prices, and the business inventory drag appears to be fading, which bodes well for corporate bottom lines in coming quarters. Additionally, global retail sales have risen 6% over the past three months—an indication that demand worldwide is holding up.

While we remain constructive on U.S. equities, there are some signals that bear watching. On one hand, hedge funds have begun to increase their net equity exposure to U.S. stocks, which indicates a lessening in their bearish disposition. That said, other measures of investor sentiment are still negative— reassuring contrarian indicators that often presage a market upturn. Also of concern is the dollar's recent strengthening. This may put pressure on U.S. corporate earnings and has contributed to weakness in oil prices, a condition we believe is temporary. If our view proves correct, we anticipate better equity returns, in line with our expectation for the S&P 500 Index to move higher by year-end.

Meanwhile, emerging-markets equities offer significant opportunities, in our view. Currencies across the developing world are strengthening, valuations are attractive, and profit margins are well below their peaks reached before the 2008 financial crisis.

Given the length of the rally among fixed-income "spread sectors," we believe it is prudent to pare risk and focus on higher-quality assets. We are also further diversifying our portfolios, focusing on less-correlated sectors such as municipal bonds, asset-backed securities, emerging-markets debt (both sovereign and corporate) and U.S. corporate bonds, which remain especially attractive on a relative basis.

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