

# THE OMNIVEST MARKET VIEW

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## June Market Commentary

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US equities turned in another positive month in May, trading higher by nearly 1% on the S&P 500. The euro zone and emerging markets outperformed the US by over 300 basis points and 120 basis points respectively. Much of the rally in Europe was sparked by a secured victory by Macron in France in the run-off election in early May. European equities and the euro rallied strongly following the election results. In the case of the euro, it rallied from nearly 1.08 to over 1.12, clearly solidifying the weaker trend in the US dollar that began in early January. Short contracts on the euro declined drastically as a result of the recent rally, down to nearly 1,500 contracts from a peak of over 125,000 contracts in November of 2016.

European stocks are also reflecting a better economic tone in Europe generally. German GDP grew at a 1.7% annual rate in Q1, significantly better than the US and up from 1.3% in Q4 2016. German business sentiment figures as measured by the German IFO Index hit its highest level since 1991 in May. In France, the PMI index hit a six-year high of 57.6, nearly the same level as that of Germany. Fund flows remain strong into European equities as investors finally work to right-size their allocations to European equities. Investors are still looking for the ECB to announce some form of tapering of their ongoing QE program, possibly as soon as this month. The ECB has preferred to remain cautious up and through the French elections in an effort to show support for a tail-risk outcome following the surprise Brexit vote in the UK last year. However, the election of Macron in France will not do away with populist sentiment in Europe generally. Italy must call a national election prior to May 2018 and anti-euro candidates will likely re-appear especially given the economic challenges that Italy still faces today many years after the economic crisis.

In the US, equity gains have been driven largely by earnings results that have come in strong in Q1. US equity earnings grew nearly 14% in Q1, the highest level of growth seen since Q3 of 2011. Results were driven primarily by revenue growth as opposed to stock buy-backs. Revenues grew almost 8% in the quarter. Sixty-four percent of companies beat their top line expectations, well above the five-year average of 53%. Also, share buy backs are down 18% from the year-ago period. The strong earnings gains in Q1 are the third such quarter of earnings gains following five consecutive quarters of earnings declines. Analysts are still expecting 11% growth in year over year earnings for all of 2017.

The US economy is showing signs of better growth in Q2, backing up the earnings trends in Q1. US Industrial production rose 1% in April, after a 0.4% drop in March. Capacity utilization climbed to 76.7%, up from 76.1%. US car production and mining output made up most of the recent gains. Despite the poor results at a number of brick and mortar stores reported recently, overall US retail sales grew 0.4% over the previous month, the largest gain in three months. Online sales continue to outpace brick and mortar stores. Over the past year non-store based sales which includes all online activity grew by almost 12% while department store sales fell by nearly 4%. Finally, the US labor market remains strong having added over 500,000 new jobs in Q1, matching gains seen in 2015, and 2016. Just today the US Labor Department announced that 138K new jobs were created in May, slightly down from estimates of nearly 180K. The overall unemployment rate dropped again to 4.3%, a 16-year low. Concerns over slowing growth in China have recently resurfaced following a number of weaker-than-expected economic reports. While China's economic growth came in

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at a respectable 6.9% in Q1 recent weakness in industrial production, and retail sales point to a slower Q2, likely in the range of 6.2-6.5%. Two vexing issues facing policy makers in China include soaring property values coupled with debt levels that recently reached close to 250% of GDP. On May 24<sup>th</sup>, Moody's Investor Service downgraded China's sovereign credit rating. While Chinese leaders continue to talk about the need to reduce overall debt levels, maintaining growth at 6.5% remains a priority, and using debt to finance growth remains a key driver of China's growing leverage. China remains in a unique position however to support such policies considering that their economy is largely walled-off with capital controls in place and little need for outside funding, unlike many other EM countries. Also, the risk of a sovereign credit event will have little impact on foreign investors as only 3% of China's overall debt is currently held by investors outside of the country. Still the latest warning from Moody's should not be taken lightly and should clearly encourage policy makers to implement much-needed albeit painful economic reforms.

While we remain positive on US equities we have been adding exposure to European and EM equities on a non-hedged basis. We continue to believe the US FED will remain on track for an added two rate hikes in 2017, and that economic growth for the rest of year will prove to be stronger than Q1. However, we also remain aware of the geopolitical risks that could cause volatility in risk assets to rise with ongoing concerns over Russia/ Syria, and North Korea. Also, domestically President Trump has his fair share of challenges within his administration that continue to put his growth agenda at risk. Finally, US stocks remain priced for near perfection, but remain well supported by better overall earnings and low bond yields. Within fixed income we remain hedged against a rise in longer dated maturities against long exposure to US corporate credit, floating rate notes, and US TIPS. We no longer see the reward for holding high yield US debt relative to how far spreads have compressed. For those willing to take on EM risk, EM bonds still offer value relative to lower yields around the globe.

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