Investors Feeling Optimistic as the Fed Takes a Dovish Tone

Stocks enjoyed their best week in six months, spurred on by dovish remarks by Fed Chairman Powell. The S&P 500 rose 4.2 percent, led by a 9 percent surge in materials stocks, albeit the smallest sector in the index with a less than 3 percent weight. Other groups outperforming the total index included a diversified mix of technology, consumer staples, industrials, consumer discretionary, financials, healthcare and energy stocks. Every sector was positive.

In his opening remarks to a monetary policy conference in Chicago on Tuesday, in reference to the economic implications of “trade negotiations and other matters,” Chairman Powell said, “We will act as appropriate to sustain the expansion.” One week ago, Fed funds futures were pricing in a 45 percent chance of a rate cut in July. Those odds quickly climbed to 66 percent. And the odds of two rate cuts by September rose from 27 to 50 percent. Stocks climbed more than 2 percent on the day on Tuesday and never looked back, continuing to rise throughout the week. Stocks even got a boost from the disappointing jobs report on Friday, as it was viewed as reinforcing the case for lower interest rates. The dollar fell, and gold rose.

As welcome as Powell’s remarks were, they were not entirely unexpected. The recent plunge in bond yields was already foreshadowing a Fed response to growing evidence of slowing economic activity. In less than three weeks from May 21, the yield on the ten-year Treasury note has fallen from 2.43 to 2.08 percent. The more Fed-sensitive two-year yield has declined even further, from 2.25 to 1.85 percent, while the current target Fed funds rate is 2.25-2.50 percent.

The May Jobs Report Shows the Employment Situation may be Slowing

Just 75,000 new non-farm jobs were created in May, fully 100,000 fewer than expected. It was the slowest growth since February’s 56,000 total. But with a -75,000 revision to the prior two-month total, the net gain was zero. The three-month average gain fell to 118,000 from 197,000 in April. That is still strong enough to absorb whatever slack remains in the labor market, but a clear slowdown nevertheless. And it follows other recent soft reports, especially in manufacturing activity, both at home and abroad, prompting easing moves by other central banks, including in Australia and India.

Powell’s remarks also arrested to the widening of credit spreads. While Treasury yields were plunging over the past three weeks, spreads were also widening. From May 21 to June 3 the spread between the Bank of America Merrill Lynch High Yield index and the ten-year note had surged wider by 71 basis points to 470 but ended the week at 437 (a basis point is 1/100th of a percent).
Markets React to the Pause on Mexico Tariffs

Markets are likely to get at least a modest boost this week from the administration’s decision not to impose a 5 percent tariff on Mexican imports that were scheduled to take effect on Monday of this week, ostensibly due to progress on talks to stem the flow of immigrants from Central America.

Retail sales and inflation readings headline this week’s domestic economic calendar. But it also includes the latest reading on small business sentiment from the National Federation of Independent Business (NFIB), which could provide some insight into whether the gloomy sentiment among larger businesses, especially those more exposed to trade, is beginning to appear among their smaller, more domestically focused counterparts. The preliminary June consumer sentiment report from the University of Michigan on Friday will also provide the same insight regarding individuals.

Overseas, the Eurozone report of industrial production for April is scheduled, and in China scheduled reports include consumer prices, retail sales, trade and industrial production. The Organization for Economic Co-operation and Development (OECD)’s index of business confidence, which has been declining since January 2018 is also scheduled for release this week, on Wednesday.

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The S&P 500 is an index containing the stocks of 500 large-cap corporations, most of which are American. The index is the most notable of the many indices owned and maintained by Standard & Poor’s, a division of McGraw-Hill.

The Bank of America Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

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