MADISON PARK
CAPITAL ADVISORS

Weekly Market Update

May 14, 2018

What if?

Summer is almost here, yet the headlines had a bit of a Halloween feel this past week. Stocks finished the week modestly higher after quickly recovering from a post-Memorial Day sell-off amid worries about Italian politics and the stability of the Eurozone. The small-cap Russell 2000 Index outperformed the broad market, reaching record highs, as did the tech-heavy Nasdaq Composite Index. On the negative side, the blue-chip Dow Jones Industrial Average declined. Technology shares performed well, while financial stocks struggled as a sharp decrease in longer-term Treasury yields led to investor worries about bank profitability.

A variety of factors affected the week's market action, ranging from European politics to trade worries as the U.S. imposed tariffs on steel and aluminum from the European Union, Canada, and Mexico. Continued volatility in oil prices and month-end positioning activity also played roles. Despite these factors, the S&P 500 Index has traded in a narrow range since May 9.

The price of West Texas Intermediate oil, the U.S. crude benchmark, continued to decline following OPEC's pre-Memorial Day decision to increase its output, finishing the week below $66 per barrel. News reports about strife among OPEC members contributed to further price declines. Oil prices did not fall steadily, however, as a sharp midweek rally pared earlier losses.

Friday's release of the May employment report showed continuing strength in the labor market and supported stocks. The government report said that the economy added a better-than-expected 223,000 jobs last month. **The unemployment rate declined to 3.8%—an 18-year low—from 3.9% in April.** The unemployment rate is now only narrowly above the median year-end forecast in the Federal Reserve's latest Summary of Economic Projections. **Many expect the Fed to continue raising the federal funds rate in quarterly increments of 0.25 percentage points until the job growth trend weakens substantially.**

The government also revised its initial estimate of first-quarter gross domestic product (GDP) growth to 2.2% from an initial estimate of 2.3%. Despite the slight downward revision in the headline growth figure, **the revised estimate showed a**

meaningful increase in business fixed investment, which should lend support to second-quarter GDP expansion.

Our old friends in southern Europe were heard from again this week, reviving memories of previous trauma. Evolving political developments in Italy and, to a lesser degree, in Spain were the primary drivers in a volatile week for European equities. The pan-European index STOXX 600 and Italy's and Spain's main benchmark indexes—the FTSE MIB and IBEX 35, respectively—ended the week lower. **But investors appeared more confident as the week came to a close, and stocks across most of Europe, buoyed by a positive U.S. monthly jobs report, began to recover some earlier losses.**

For interested readers, the following is a quick summary of the political situation in Italy.

Italy's populist Five Star Movement and far-right League party formed a coalition government, naming an academic and political novice, Giuseppe Conte, as prime minister. It was a week characterized by investor uncertainty amid political deal making and calls for impeaching Italian President Sergio Mattarella by coalition members angry that their plans for a nascent government were being blocked. Investors fled Italian stocks, and bond spreads widened as a result, with **much of the concern centered on whether Italy, one of the Eurozone's largest economies, would abandon the euro and how the country would handle its vast public debt (third highest in the world, behind the U.S. and Japan).** Investors were also seemingly concerned that populist sentiment elsewhere in the Eurozone, strengthened by the events in Italy, could threaten the long-term survival of the currency bloc.

The political situation in Italy is likely to remain relatively calm for the next few months, but the key risks have not gone away. The new government's signals that it wanted to increase welfare spending may breach European Union (EU) spending rules, while calls for tough anti-immigration measures could lead to further clashes with the EU. Additionally, if the current government coalition breaks down and new elections are held, League could significantly consolidate its position in parliament, enabling it to form a government with other right-wing backers who can help push through a more radical agenda. **In the worst-case scenario, Italian banks could see major deposit outflows, potentially resulting in Italy finding itself in the same situation as Greece in 2015.**

Political fears were offset by positive economic news. In spite of political developments in Italy and Spain, the Eurozone manufacturing purchasing managers' index (PMI) came in as expected at 55.5, matching the previous month's figure. Readings above 50 signal expansion, while readings below 50 signal contraction. The current reading remains solidly in expansion territory.

Data from T. Rowe Price was used in the compilation of this report.

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