Weekly Market Update

U.S. stocks falter despite calmer global landscape

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Article Highlights

- U.S. equity markets post losses for the week.
- Investors sell growth and small-cap companies in favor of value and foreign revenue exposure.
- Non-U.S. equity indexes rise on Ukrainian status quo, Chinese calm and European optimism.
- Bond prices rise and yields fall as global concerns ease and U.S. data offers no major surprises.
- Equities will remain volatile, while bonds are unlikely to extend their year-to-date outperformance.

March 28, 2014

U.S. equities traded lower for most of the past week before staging a partial comeback on Friday, March 28. Beneath the market's broader movement was a sharp rotation out of growth stocks (particularly tech and biotech) and smaller-capitalization names in favor of value stocks and companies with higher foreign sales exposures. This rotation suggests that U.S. equities are adjusting to the notion that China's economy may yet avoid a "hard landing," while Europe's economic picture is improving and U.S. growth appears to be on track. This perception favored both developed- and emerging-market equities, which gained 1.6% and 3.3% for the week through March 27, based on MSCI indexes.

In fixed-income markets, investors generally took comfort from the lack of further escalation of the Ukrainian crisis, diminished concerns about risks to the Chinese economy, and U.S. economic releases absent of any signs of sharply accelerated growth that could lead to higher inflation and an imminent hike in interest rates. Flows into investment-grade corporate bond funds were positive, but emerging-market funds saw continued outflows.

Against this backdrop, fixed-income prices rose and yields fell across major sectors, including investment-grade and high-yield corporate bonds, emerging-market debt, mortgage-backed securities, and commercial mortgage-backed securities. The bellwether 10-year Treasury yield closed at 2.69% on March 27, down from 2.75% at the end of the prior week, although the yield was inching back up in midday trading on March 28.

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Current market updates are available here.

Mixed U.S. economic releases still point to post-winter strengthening

U.S. data releases during the week were mixed to favorable, providing some signs of resilience following the unusually severe winter.

Employment and consumer measures were mostly encouraging:

- **First-time jobless claims** fell by 10,000, to a seasonally adjusted 311,000—a level well below their 30- and 60-day moving averages.
- **Consumer spending** rose 0.3% in February, the fastest pace since November. Most of the increase, however, came from spending on healthcare and utilities. Purchases of big-ticket items declined for the third month in a row.
- **Personal income** kept pace with spending, rising 0.3% in February, while inflation-adjusted disposable income (money available after taxes) rose 0.3%, the biggest gain in five months.
- **Consumer confidence** jumped in March, according to The Conference Board's monthly gauge. Another indicator, however, the Thomson Reuters/University of Michigan Consumer Sentiment Index, dipped modestly.

Housing indicators, while modestly downbeat, were generally in line with expectations:

- **Home price appreciation** continued to slow for the third month in a row, as measured by the S&P/Case Shiller 20-City Composite Index.
- Hampered in part by higher mortgage rates and cold weather, **new home sales** were down 3.3% in February, according to the Commerce Department.
- **Pending home sales** fell 0.8% in February, to their lowest level in more than two years, based on National Association of Realtors data.

Meanwhile, U.S. GDP growth for the fourth quarter of 2013 was revised upward, from 2.4% to 2.6%, largely in line with consensus forecasts.

European stocks gain on consumer outlook and prospects for monetary stimulus

After losing 3% in the first half of March, European equities advanced for the second consecutive week. Markets were supported by stronger consumer confidence in the eurozone, along with comments from European Central Bank officials conceding that more aggressive monetary stimulus is needed to fend off deflation. With regard to Ukraine, markets in Europe and globally have apparently concluded that both Russia and the West have too much to lose to allow tensions to escalate much further.

Worries over China and the emerging markets show signs of easing

Because commodity prices and Chinese economic growth are closely correlated, further strengthening in commodity-intensive currencies such as the Australian and New Zealand dollars— along with what appears to be a bottoming of copper prices after a steep decline—may be signs that China is beginning to address its decelerating pace of growth. Additionally, for now the Chinese government seems willing to take a gradual approach to resolving bad loans in the banking system, which may reduce the risk of an abrupt "hard landing" for the Chinese economy.

A calmer view of China has helped local equity markets stabilize or post gains while also supporting the broader emerging-market universe. Currency volatility in these markets has subsided, current account deficits are shrinking, and equities have responded. The MSCI Emerging Markets Index surged 3.3% for the week through March 27, with India and Korea reaching new highs.

Outlook

The current volatility in the U.S. equity market, though painful, is not unexpected. While we remain confident that the S&P 500 Index can breach the 1900 level by summer, the market will likely remain volatile. A stronger economy will trigger fears of the first Federal Reserve interest-rate hike—historically a headwind, with the market peaking and falling six months ahead of the Fed's initial move. (Notably, this pattern usually favors growth over value.) Based on the Fed's current guidance that first rate increase could occur in mid to late 2015, which in turn would make the U.S. market more vulnerable during or after the fourth quarter of 2014.

In fixed-income markets, we continue to believe that warmer weather will unmask a U.S. economy that is stronger than the consensus view assumes. Although bonds have outperformed expectations since year-end 2013, they are unlikely to continue this path as the year progresses. We expect interest rates to rise, particularly for shorter-maturity Treasuries, as the Fed's anticipated rate hike is further priced into the market. In the meantime, we remain focused on employment data and other broad measures of economic activity to assess the likely timing of changes in the direction of interest rates.