Weekly Market Update

Equity markets are volatile as U.S. economy offers few upside surprises

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Article Highlights

- For U.S. equities, a Friday decline erases much of the week's earlier gains.
- Monthly payrolls and other U.S. data are positive but slightly below expectations.
- European stocks advance for the third consecutive week.
- Emerging-market debt is buoyed by positive fund flows and improving sentiment.
- First-quarter U.S. GDP growth could come in below our already lowered 1.8% forecast.

April 4, 2014

U.S. equities sold off on April 4 after moving higher for much of the week. Stocks had been supported by solid if unspectacular U.S. economic indicators, modest stimulus efforts in China, and further signs that the European Central Bank (ECB) may be closer to enacting some form of quantitative easing (QE) to counteract a slide toward deflation.

At the same time, however, the recent rotation out of growth stocks into value and from small caps into large caps continued apace, implying a market that is expecting faster economic growth in both the U.S. and internationally, along with higher interest rates. The S&P 500 Index, which closed at a new record high on April 2, eked out only a slight gain for the week. Foreign developed- and emerging-market equities posted gains for the week, based on MSCI indexes.

Bond markets were mixed. Prices fell and yields rose on U.S. Treasuries and other high-quality fixed-income sectors as the week progressed, while high-yield corporate bonds posted positive returns. However, following the release of a "good but not great" March jobs report, Treasuries rallied, with the yield on the bellwether 10-year note falling from 2.80% to 2.73% in midday trading. Emerging-market debt outperformed for the week, buoyed by positive fund flows and improving sentiment.

Financial Services

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Job creation and other U.S. growth indicators have yet to reach breakout levels

Although U.S. economic signals continue to move in the right direction, data releases are not exceeding expectations. The economy is thawing from the winter's deep freeze, but at a slightly slower pace than we expected, in line with an average GDP growth rate of about 2.5%. Data released during the past week generally confirms this trajectory.

- **Employment growth.** The economy added 192,000 jobs in March, while January and February payrolls were revised upward by a combined 37,000. The March total was slightly below or, at best, in line with most forecasts—not robust enough to signal a strong rebound for the nation's labor markets.
- **Manufacturing and service-sector activity.** Various Purchasing Manager's Indexes (PMIs)—monthly gauges of activity in the manufacturing and nonmanufacturing sectors of the economy—showed that both sectors were still expanding in March, although readings were slightly below expectations.
- **Auto sales.** Auto sales jumped to an annualized rate of 16.4 million in March, from 15.3 million in February. Consumers are still spending more on cars and homes than on anything else. Their spending needs to expand to other categories before we see a significant pickup in growth. Business spending, which was muted in the first quarter, also needs to rise.

European equities continue to shine

The ECB's continued musing about enacting some form of QE was well received by European equity markets, which posted their third consecutive weekly gain. Whether the ECB's language is merely "talk" designed to weaken the euro or a preface to actual QE remains to be seen. Genuine QE would provide a lift to European stocks, particularly those in cyclical (economically sensitive) sectors.

A weaker euro could spur growth by boosting exports and averting potential deflation in Europe's flat economy. We believe the threat of deflation remains small, but European policymakers must be vigilant to ensure that expectations of falling prices do not become entrenched among the region's producers and consumers.

Japanese equities rise, business outlook survey falls

The Bank of Japan's closely watched *Tankan* survey showed that Japanese companies expect business conditions to deteriorate sharply in the next three months, largely due to the impact of the consumption tax hike that took effect on April 1. In the meantime, there is considerable debate as to whether the BOJ will ease monetary policy in April or in June. If easing happens sooner rather than later, we could see a resumption of last year's Japanese bull market.

Emerging markets extend rally as China enacts mini stimulus measures

Emerging-market equities extended their gains on improving current-account deficits, lower currency volatility, and rising confidence in Chinese growth prospects. China announced a series of government programs aimed at expanding the country's rail system—a small dose of economic stimulus to help prevent growth from slowing too much as policymakers seek to rebalance the economy. The government's announced goal for GDP growth is between 7% and 7.5%, and for the first quarter it may be closer to the lower end of that range. We do not believe this slower growth will result in a "hard" landing for the Chinese economy.

Outlook

The U.S. economy is improving, but not as quickly as the equity markets think. We have already reduced our first-quarter GDP forecast to 1.8%, but given much weaker-than-expected export data, we believe growth could come in closer to 1.4%.

Despite the 1.3% drop in the S&P 500 Index on April 4, we still think the index will breach the 1900 level before we see a correction of any magnitude. Moreover, we do not expect a downturn of greater than 10% and therefore would view a correction as a buying opportunity, anticipating the market will rise to higher levels later in 2014.

In U.S. fixed-income markets, we continue to expect higher-risk assets to generate modestly positive returns in coming months. Emerging-market debt is likely to come under additional pressure later in the year as U.S. interest rates rise, attracting inflows to the U.S. that might otherwise go to emerging markets. In this environment, country and credit selection will be key to outperformance in the emerging-markets space.

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