Weekly Market Update

Geopolitical concerns dominate another volatile week

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ARTICLE HIGHLIGHTS

- Markets tumbled on news of a potential U.S.-led attack on Syria.
- Second-quarter GDP revision shows the U.S. economy grew 2.5%, in line with our forecast.
- Weaker-than-expected industrial, housing, and consumer indicators temper third-quarter outlook.
- Improving signals from China may offer needed relief to beleaguered emerging markets.
- Falling stock prices and increasingly negative sentiment have set the stage for a likely rebound.

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Geopolitical events overshadowed economic data during the past week, adding another dimension of volatility to equity markets. The threat of a possible U.S.-led airstrike against Syria was the primary driver of market action. Oil prices spiked, and investors generally shed riskier assets in favor of safe-haven investments. Trading remained light in advance of the Labor Day holiday weekend.

For the week through August 29, the S&P 500 Index was down roughly 1.5%. Equity returns were also negative in foreign developed (-2.40%) and emerging markets (-1.26%), based on MSCI indexes. Bond markets fared better, with the Barclays U.S. Aggregate Bond Index posting a small gain (+0.41%) and the yield on the 10-year Treasury closing at 2.75% on August 29, down from a two-year high of 2.90% the week before. Current market updates are available here.

Syrian tensions claim the spotlight

Markets tumbled on headlines that a Western military response to events in Syria was imminent. However, the picture was muddled by breaking news that the United Kingdom—faced with intense political opposition at home—would not be joining in any such action. It is too early to determine what impact a military strike against Syria would ultimately have on the U.S. economy. In the short term, the greatest threat would come from sharply higher oil prices, which could put the brakes on growth.

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In terms of market impact, history shows that the threat of action in past U.S.-led airstrikes (e.g., Libya, Serbia, Sudan, and Iraq) has triggered market declines, followed by rallies on or just before the actual strikes. In our view, a key risk is the potential for a retaliatory attack against Saudi or Iraqi oil facilities. That could cause oil prices to spike from roughly $109 to the key $125 per barrel mark. This price level sparked market corrections in 2008, 2010, and 2011.

Second-quarter GDP growth is revised up, but latest economic indicators are softer

The government raised its estimate of second-quarter GDP growth to 2.5%, from an initial estimate of 1.7%, mainly due to positive trade data (more exports, fewer imports). This revision was closely in line with our expectation of 2.4% growth. The private sector grew 3.3% in the quarter, up from 2.4% in the first quarter of 2013 and 1.8% in the fourth quarter of 2012. Government spending cuts have progressively diminished and could disappear in future quarters absent further fiscal tightening measures.

Although the upward revision to overall GDP growth was welcome, estimated growth in consumer spending remained lackluster at 1.8%, versus 2.3% in the first quarter. Similarly, we saw weaker-than-expected activity in the latest monthly consumer spending data and in other key indicators:

- **Consumer spending and personal incomes** in July were essentially flat (+0.1%), suggesting a less-than-inspiring start to the third quarter.

- **Orders for durable goods** (e.g., appliances, machinery, and other equipment intended for long periods of use) fell 7.3% in July. Much of this decline was due to a drop in aircraft orders. Durable goods orders are still running 3.3% higher compared with a year ago, but in a typical recovery we would expect to see growth north of 5%.

- **Pending home sales** dipped 1.3% in July, the second consecutive month of declines, while **weekly mortgage applications** also fell and **home price appreciation** decelerated slightly, to 2.2% in June from 2.5% in May, based on the Case-Shiller/S&P Home Price Index. Together these indicators support the notion that the housing sector is taking a breather.

A mixed week for Europe and China

European equity markets were down 2.73% for the week through August 29, in part reflecting political uncertainty in Italy. In contrast, China's Shanghai "A" Share index was the best-performing market during the past week, amid signs of economic improvement. Extreme currency volatility in emerging markets, particularly India and Indonesia, has raised concerns of renewed capital controls and turmoil in these beleaguered markets. That said, select emerging equity markets may be setting up for a tactical rally after extended underperformance.

Outlook

The U.S. economy continues along the same modest-growth trajectory it has been on for the past several months. Our current forecast calls for 3.1% GDP growth in the third quarter and 3.4% in the fourth. The major risk to our forecast remains the speed at which interest rates rise, as the ultimate timing and scope of the Federal Reserve's "tapering"—and how the markets react to it—will have an impact on growth going forward.

Markets will get greater clarity on the Fed's tapering intentions when the central bank meets again on September 18. Given the recent oil price spike, instability in the emerging markets, uneven U.S. growth, and the current geopolitical landscape, the odds almost certainly favor "taper lite" (an extremely modest, initial scaling back of the Fed's open-market asset purchases), which may be a market booster.

In U.S. equity markets, short-term sentiment has moved back to bearish, and the percentage of stocks trading below their 50-day moving average is now close to the 25% threshold that usually marks an important buy signal. We think the recent correction, which has brought the S&P 500 5% below its recent peak, has set the stage for another rally, potentially culminating in a new high before year-end. We remain similarly optimistic in Europe. Emerging markets are now trading at a discount to developed markets and, taking their cue from the Fed's tapering announcement and a better Chinese economy, could be poised to rise.

In fixed-income markets, the past week's events brought some support to Treasuries and created some weakness in higher-yielding, non-Treasury sectors. Negative fund flows continue to put pressure on emerging markets, and fixed-income assets in general remain wary and unlikely to rally meaningfully in the near future.

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