Weekly Market Update

Fed meeting minutes show a conflicted central bank

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ARTICLE HIGHLIGHTS

- The Fed offers mixed signals on tapering and discusses other ways to support the economy.
- The S&P 500 and small-cap stocks reach new highs; overseas markets are mixed.
- Fixed-income markets lose ground.
- The stock market appears vulnerable to a potential correction.
- We are focused on the outcome of the current budget talks in Washington.

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The week's big news was the release of the minutes from the October Federal Open Market Committee (FOMC) meeting, which revealed a conflicted central bank. On one hand, Fed board members are increasingly uncomfortable with continuing their quantitative easing bond purchases. On the other hand, they are equally concerned about the slow pace of the economy's recovery.

While the Fed's meeting details didn't generate headlines until Wednesday afternoon, the S&P 500 Index made an early splash on Monday morning by breaking through the 1,800 mark for the first time. But stocks failed to hold those early gains and fell for the week's first three days before bouncing back on Thursday and Friday. This rally was helped by some positive economic data that followed soft numbers reported earlier in the week. The small-cap Russell 2000 Index led the advance. Overseas markets were mixed, based on MSCI indexes.

Communications from the Fed about when tapering might begin, coupled with a stronger-than-expected unemployment claims report, served to push up yields (and depress prices) across fixed-income sectors. There was, however, some good news for bond investors. The difference, or spread, between yields of higher-yielding, non-Treasury securities and Treasuries remained reasonably tight. This suggests that fixed-income markets overall are more prepared for the eventual Fed taper than they were during the summer, when bonds sold off broadly and credit spreads hit their widest levels of the year. Additionally, the Fed appears to have succeeded in anchoring short-term rates, which has led to a steepening of the yield curve.

Financial Services

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Soft economic data mixes with some positive numbers

This week's lineup included both uninspiring and hopeful data. Disappointing news included the following:

- **Sales of existing homes** fell 3.2% in October, to the slowest pace in four months.
- **Mortgage applications** dropped 2.3% for the week ending November 15**,** in part reflecting the impact of higher interest rates. The 10-year Treasury's rise to 2.79% on Thursday (up from 2.67% on Monday) could put further pressure on mortgage activity.
- **Retail sales** increased by a seasonally adjusted 0.4% in October but a look behind the headline number revealed a gain of only 0.2% if auto sales are excluded.

On the positive side:

- Although only an estimate, the **preliminary November Markit PMI** offered an upbeat outlook for manufacturing. The 54.3 reading, up from 51.8 in October and ahead of the 52.3 consensus, represented an eight-month high. (Readings above 50 indicate expansion.)
- **First-time unemployment claims** fell by 21,000 to a seasonally adjusted 323,000 in the seven days ended November 16. While encouraging, this figure may have been lowered by the Veteran's Day holiday.
- Surveys of **U.S. corporate activity** turned up, as did a key survey of **consumer confidence.**

Meanwhile, U.S. prices fell slightly in October because of a decline in energy costs, pulling down the annual pace of inflation to the lowest rate since 2009.

Europe remains in a holding pattern

Eurozone stocks have traded sideways for the last two weeks after reaching a new 52-week high on November 7. Since June 2012, these shares have soared almost 50%. We see caution flags ahead, however. There have been no changes in earnings expectations, and the region's economies, though likely to perform better, in our view, have experienced slow, uneven growth. France, the Eurozone's second-largest economy, looks especially weak.

Outlook

Based on the October FOMC minutes, a majority of the Federal Reserve Board wants to begin tapering sooner rather than later. What will be used in place of current policy is unclear. Various Fed governors have suggested communicating their commitment to keeping interest rates low for as long as possible (thereby providing so-called "forward guidance"), using specific data targets to mark the point at which interest rates would be raised, and reducing the interest rate paid on excess bank reserves held by the Fed (which would encourage lending).

But what about tapering? The minutes tell us that tapering will begin only “if the data confirm the need.” They also tell us that the Fed may taper without “unambiguous evidence.” In spite of these mixed messages, we believe the earliest the Fed will begin reducing its bond purchases is sometime during, if not before, the first quarter. However at this point, the market seems to have digested this likelihood. The key now is how long the market will keep short rates low in the face of tapering and a strengthening economy. That, in turn, will depend on the economic data and the level of inflation.

On the equity front, we are concerned about the market’s vulnerability to a correction given elevated levels of short-term sentiment and the high percentage of S&P 500 Index stocks trading above their 50-day moving average. However, we are in a seasonally strong period for stocks, and the Fed’s clear success in introducing taper language without increasing short-rate volatility has helped pave the way for a higher market. That said, future gains are likely to be accompanied by more volatility than we’ve seen this year. Additionally, we are focused on the outcome of the current budget talks in Washington, which face a December 13 deadline. If the negotiators again emerge without an agreement, we may well see the market trade down.

In the fixed-income space, it is less likely that credit spreads will widen significantly if and when Treasury rates rise even further. This would help spread-sector performance. Additionally, while retail investors are boosting their equity allocations, institutional investors such as pension funds continue to buy bonds to fund long-term employee obligations, potentially supporting corporate bond prices. Looking into next year, we see more capital spending and increased shareholder- friendly activities (such as buybacks), but not at the expense of a material reduction in credit quality for bonds of the issuing corporations.