WEEKLY MARKET UPDATE

Markets surge on positive employment data

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ARTICLE HIGHLIGHTS

- Better-than-forecast April payrolls lift U.S. market indexes to new record highs.
- Upward revisions to March and February job totals are the real surprise.
- Treasury rally abruptly reverses as demand for safe havens plunges.
- Europe hopes to benefit from central bank rate cut, while China remains a puzzle.
- Market resilience suggests any potential correction will be a "reset" for further gains into year-end.

Mixed economic data releases earlier in the week fed fears that the U.S. economy was heading into another "spring swoon," but equity markets again proved resilient. In the wake of a surprisingly upbeat jobs report released on the morning of May 3, resilience turned to unfettered optimism: the S&P 500 Index and Dow Jones Industrials Average powered higher to milestones of 1,600 and 15,000, respectively. European stocks joined the rally, highlighted by Germany's DAX index hitting a new record high.

Until the release of the April jobs report, U.S. Treasury prices rose during the week. Most categories of higher-yielding, non-Treasury fixed-income securities ("spread products") also performed well, including emerging-market bonds, high-yield and investment-grade corporate issues, and commercial mortgage-backed securities (CMBS) —indicating continued strong demand for yield. Following the favorable employment headlines, the yield on the bellwether 10-year Treasury (which moves inversely to its price) had backed up to 1.73% as of midday on May 3, after closing at a new low for the year (1.63%) earlier in the week.

A revealing look beyond the headline employment numbers

While headlines focused on the higher-than-forecast 165,000 jobs created in April and a drop in the unemployment rate to 7.5%, the more surprising news was the major upward revision in payrolls for February and March. Job creation in March was revised up to 138,000 from 88,000, and in February to a stunning 332,000 from 268,000. These revisions helped drive the week-ending rally as much as the April number itself. That the slowdown in employment was not as pronounced as

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originally reported has likely altered investor perceptions and expectations of future growth and market gains.

However, as much as the markets may welcome “revisionist history,” we caution that adjustments of this scope present a potential problem in their own right, to the extent that they call the credibility of the original estimates into question—estimates that, like the 165,000 total reported for April, can disproportionately influence market reactions.

At issue is the model the Labor Department uses for its preliminary calculations, which is based on a relatively small sample and incomplete information. These limitations make it difficult to capture changes in the trajectory of job growth until well after the fact—and long after the markets have already reacted to the original numbers. This phenomenon is heightened during periods when the economy appears to be at critical turning points. We believe the economy is at or near such a turning point, and that the initial monthly payroll numbers are probably underreporting net job creation.

Housing, other U.S. data continue to align with a moderate growth outlook

U.S. data releases were mixed during the week, with the fiscal drag caused by the federal budget sequester continuing to weigh on manufacturing activity in particular. Despite some softer indicators that contributed to mid-week market volatility, we saw no readings that would lead us to alter our fundamental view of an economy that remains largely on track.

- Growth in **personal income** and **consumer spending** stayed positive in March, contributing to a rebound in **consumer confidence** in April, based on The Conference Board’s widely cited index.
- **Housing** remained a bright spot. In February, **home prices** posted their largest year-over-year gain (+9.3%) since May 2006, based on the S&P/Case-Shiller Home Price Index. Meanwhile, pending home sales edged higher in March, after February’s slight decline.
- **Weekly unemployment claims saw an unexpectedly sharp** drop to 324,000, their lowest level since January 2008. The four-week moving average of claims, which is less volatile, also declined.
- **Auto sales** dipped to an annualized rate of 14.9 million in April, from 15.3 million in March, primarily due to a relatively weak month for Toyota.

A rate cut in Europe, a potential crossroads in China

The European economy remains weak, but we may be seeing the beginning of a bottoming process at last. In a move perceived to be long overdue, the European Central Bank (ECB) finally cut its benchmark interest rate by 25 basis points (0.25%), to an all-time low of 0.5%, and also alluded to the possibility of new bank-related programs to encourage or support lending activity in the eurozone. Although more policy actions are needed, European equity markets welcomed the ECB moves, with financial stocks leading the rally.

China, meanwhile, remains a puzzle. Economic data appears weak, but the anecdotal observations look promising. The Shanghai Stock Exchange "A" Share Market Index—our primary point of reference for the health of the Chinese economy—is at a critical technical juncture. An upward move from this level would augur very well for economic activity in the second half of 2013.

Outlook

The picture of the global economy is one that is limping along. In the U.S., we believe that housing strength, fueled partly by cheap mortgages and asset appreciation, will bolster consumer spending in the second half of the year. We are also watching gas prices, which depending on their direction, could exacerbate or ease the ongoing effects of the sequester and this year's payroll tax increase.

The recent rotation away from the defensive Consumer Staples sector and back into cyclical, economically sensitive stocks signals the market's expectation for a better second half of 2013. Overall, the U.S. equity market's rise has been led more by a search for yield than by anything else, regardless of whether "safer" or "riskier" sectors happen to be in the lead at any given time.

Likewise, in fixed-income markets, the hunt for yield is ongoing. In fact, a recent news report indicated that a large proportion of bond mutual funds now have significant equity exposure. Even with the past week's Treasury rally evaporating on April's surprising employment data, yields at current levels do not incorporate much in the way of upside economic surprises. We think higher-yielding spread sectors are poised for continued strong performance in this environment.

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