Weekly Market Update

Optimistic signals outweigh softer April data, leading markets higher

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Mixed week for data ends with upside surprises in consumer sentiment and leading indicators.
- U.S. equity markets expect growth to strengthen when effects of global monetary easing kick in.
- Bond markets seek direction amid uncertainty on when the Fed's asset purchases will end.
- Japan's GDP growth exceeds forecasts; Europe's falls short but other measures are stabilizing.
- We continue to expect the U.S. economy to pick up steam in the second half of 2013.

While a number of the week's U.S. economic releases were disappointing, upside surprises in consumer sentiment and the index of leading economic indicators provided cause for optimism. In addition, real-time surveys of U.S. companies showed sharply higher economic activity by industry sector. This strength aligns with a modestly better picture globally, evidenced by positive moves in Citigroup's Economic Surprise Index for Europe and an uptick in the OECD's lead indicator of global growth for March. Moreover, these improving signals have been accompanied by lower inflation, freeing up central banks to continue aggressive monetary easing programs that have been pursued for the past 18 months. Because monetary policy often works with a lag, we think now is the time when growth will begin to respond to those policies.

U.S. equities certainly reflected such expectations during the past week, enjoying more momentum than bonds. For the week through May 16, the S&P 500 Index was up 1%, adding to the year's gains. Among non-U.S. markets, Japan (+3.3%) remained the star performer, as the yen continued to weaken and first-quarter Japanese GDP growth was stronger than expected.

In fixed-income markets, "spread products" (higher-yielding, non-U.S. Treasury securities), including emerging-market debt and investment-grade and high-yield corporate bonds, wavered in response to the week's economic releases and to comments by some regional Federal Reserve members about a potential time frame for winding down the Fed's long-running asset purchases. Meanwhile, the

Financial Services

yield on the bellwether 10-year Treasury yield was volatile, benefiting when weak economic data was released but rising well above 1.9% on May 17.

Softer U.S. data gives markets pause, but forward-looking indicators are positive

Retail sales were uninspiring for a second month in a row and are now up less than 4% year-over-year. This indicates that tax hikes are taking a bigger bite out of the consumer sector than originally expected. Given still-unimpressive job growth (which translates into tepid wage growth), we are likely to see this trend continue for another month or two.

Weak industrial production, capacity utilization and regional Fed survey data suggest that May could also be an underwhelming month for economic activity. Although the week's sharp increase in first-time unemployment claims was a setback, this particular indicator is volatile, and we caution against reading too much into a single week's data point.

Housing starts pulled back in April, to their lowest annualized rate since last November, but building permits (a good indicator of future starts) jumped. We expect next month's readings to improve as the weather warms and the building season gets fully underway.

Europe, China and Japan face varying issues

Outside the U.S., much of the story continues on course.

- In Europe, first-quarter GDP growth was disappointing, but other measures appear to be stabilizing. We do not expect conditions to deteriorate further.
- Relatively subdued growth in China has depressed commodity prices and given central banks flexibility to continue monetary easing. That trend could reverse if China's economy reaccelerates and fuels inflation fears.
- Japan's first-quarter GDP growth was surprisingly strong (+3.5%). Other measures have also improved, including industrial production and even housing activity—a perpetually depressed sector of the Japanese economy.

Meanwhile, Japan's aggressive campaign to weaken the yen has done wonders for the equity market, but the Japanese government bond market has been hit hard, with the 10-year yield nearly doubling in a week as inflation expectations surged.

Outlook

We think accommodative monetary conditions will continue to support financial markets, with more easing in store from certain central banks. We expect the U.S. consumer to absorb this year's tax increases over the next few months, leading to higher spending. Moderate job growth should continue, and the drag from the slowdown in fiscal spending should dissipate during the third and fourth quarters. The net result will be a resumption of stronger GDP growth in the second half of this year, after a brief pause during the second quarter.

Optimistic signals outweigh softer April data, leading markets higher

Our chief concern remains how strong growth becomes. If GDP expands faster than 3% and monthly payrolls begin to top 300,000, then fear of the Fed “tapering” its stimulative bond purchases could push long-term market rates higher and intensify fears of Fed tightening.

The Fed has already indicated that it will scale its purchases of Treasury and mortgage securities up or down as economic conditions warrant. If we experience more upside economic surprises, the Fed will reduce its purchases late in the year. On the other hand, if economic weakness manifests in the weeks and months ahead, either as a result of fiscal austerity or global economic weakness, the Fed will continue its buying activities for some time.

On balance, given this backdrop, the greater return momentum is likely to be with equities rather than fixed income as the year progresses. In the meantime, some indicators suggest that U.S. equities are now close to being “overbought.” Almost 90% of stocks in the S&P 500 are trading above their 50-day moving averages, margin debt is back up to October 2007 levels, and short-term trading sentiment is decidedly bullish. These statistics are in “danger zones” that usually precede market corrections, and we remain vigilant. However, we continue to believe that if we do see a correction, it will likely be mild.