Weekly Market Update

Macro concerns drive market volatility, with Japan and the Fed in focus

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ARTICLE HIGHLIGHTS

- Markets are rattled by fears the Fed will "taper" its bond purchases sooner than expected.
- Sharp volatility in Japanese bond market triggers equity sell-off in Japan.
- U.S. Treasuries turn volatile, with 10-year yield closing at highest level since March.
- Our expectation of 1.5%-2% GDP growth in the second quarter remains unchanged.
- We maintain a favorable long-term outlook for U.S. equities.

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Equity markets swung widely during the past week. In the U.S., testimony by Federal Reserve Board Chairman Ben Bernanke ignited fears that the Fed could begin tapering its quantitative easing (QE) program far sooner than expected. This provoked an immediate sharp decline in the S&P 500 Index, which was down 1% for the week to date through May 23. Foreign developed- and emerging-market equities fell 1.6% and 1.9%, respectively, during the same period, based on MSCI Indexes.

The week in equities was dominated by a 7.3% plunge in Japan's Nikkei 225 Index on May 23—its worst one-day decline since the earthquake and tsunami of March 2011. A spike in Japanese government bond (JGB) volatility, coupled with disappointing manufacturing data out of China, had Japanese retail investors rushing for the exits. The yield on the 10-year JGB surged above 1% from 0.8% before settling lower, but has generally been climbing higher as the government pursues its aggressive new monetary easing policies.

In fixed-income markets, "spread products" (higher-yielding, non-U.S. Treasury sectors) such as mortgage-backed, commercial-mortgage-backed, high-yield, and emerging-market debt securities saw their yields widen relative to Treasuries on concerns about Fed tapering. Treasury markets were also unnerved by the possibility of curtailed Fed asset purchases. Despite unsettled markets, flows into nearly all categories of fixed-income funds remained positive.

Bernanke comments, U.S. data put spotlight on Fed policy

With relatively little U.S. economic news to digest, the focus was on Chairman Bernanke's testimony that the Fed could begin slowing its bond purchases in "the next few meetings." The Fed has previously emphasized that it will not end its QE program until there is significant improvement in the economy. That said, the Fed has noted that the private sector has improved over the past year and continues to show gains.

Among the few U.S. data points released during the week were favorable readings that included:

- **First-time unemployment claims** that fell by 23,000, with the four-week moving average edging down to near a five-year low.
- **Durable goods orders,** which came in stronger than expected for April and were revised upward for March. This is a good sign for business investment spending.
- **Home prices,** which were up 7.2% in March versus a year ago, based on the FHFA House Price Index.
- **New home sales** at an annualized rate of 454,000 in April, a 2.3% gain from March's upwardly revised figure and the second-highest level since the "Great Recession."
- **Existing home sales** for April that reached their highest level since March 2009 and were nearly 10% above the year-ago figure.

The housing data signify continued growth in that sector and imply improving consumer balance sheets and spending going forward. Tempering this news were some signs of weakness elsewhere in the economy, including a disappointing drop in the Chicago Fed's national activity index and a decline in the national Purchasing Managers' Index (PMI) published by Markit.

All eyes are on Japan as bond yields spike and equities tumble

After surging 68% year-over-year (in yen terms) before its May 23 plunge, there was no question that the Japanese equity market was vulnerable to a pullback. In fact, some key groups have been correcting for some time, including Japanese small-cap stocks and financials. While the Japanese correction probably has further to go, a trigger for a new advance may be the government's proposed economic reforms that are anticipated for June.

Minimizing bond market volatility should also help. The scale of the government's bond-purchasing program appears to have shut marginal buyers out of the market, leading to a "buyers' strike" and dramatic yield swings. One solution might be for the government to slow its purchases of JGBs to enable a consistent source of non-government demand. If Japan is unable to control bond market volatility, Prime Minister Shinzo Abe's objective of better economic activity will be compromised.

Outlook

We continue to expect U.S. GDP growth of 1.5%-2% in the second quarter, as the economy feels the drag from fiscal spending cuts, while housing, personal consumption, and investment spending will be additive. Despite signs of overall improvement, there is still slack in the economy, and we believe the Fed's tapering is likely to happen no sooner than the fourth quarter.

What is harder to assess is the market's mentality. The Fed still has tools at its disposal to manage the markets, notably the ability to adjust purchases upward or downward on a monthly basis as the economy warrants. Eventually, of course, the tapering of QE and the "handover" from Fed support to market fundamentals will occur. However, we believe the process will be more gradual and controlled than the markets' behavior during the past week would suggest.

In U.S. equity markets, we are not convinced that the pullback induced by Bernanke's comments has started the long-anticipated correction. Our trading desk reports that the past week's selling was orderly, and that many investors see the decline as an opportunity to "buy the dip" in expectation of a rebound in prices.

Nonetheless, U.S. equities remain vulnerable, given this year's extended rally and extremely bullish sentiment. Unlike the Japanese market, however, where underperformance among specific groups (such as small caps and financials) has been evident for several weeks, the U.S. market shows few signs of sector or market-cap divergence that would signal a broader downturn. The strong likelihood is that U.S. stocks will move higher before we see a general correction.