Weekly Market Update

Markets remain volatile as U.S. growth inspires both hope and fear

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ARTICLE HIGHLIGHTS

- Improving U.S. economic indicators fuel more fears of imminent Fed "tapering."
- Fixed-income markets and interest-rate-sensitive stocks endure a tough week.
- Latest GDP numbers confirm our view of a strengthening private sector.
- While markets focus on Japan, Europe is a more likely source of global macro concern.
- We think the Fed's eventual exit strategy will lead to only modestly higher interest rates.

MAY 31, 2013

Market volatility spiked in the final week of May, amid global fears that stronger U.S. growth would lead to an earlier-than-expected end to the Federal Reserve's quantitative easing (QE) program. In the U.S., the S&P 500 Index gyrated in a trading week shortened by the Memorial Day holiday. International stock market indexes generally moved lower, led by increasingly volatile Japanese equities.

Fixed-income markets also reacted strongly. With Treasury prices falling, the yield on the bellwether 10-year security briefly surged to 2.22% and remained volatile during the week. Meanwhile, "spread products" (higher-yielding, non-Treasury instruments), including high-yield and investment-grade corporate bonds, commercial mortgage-backed securities (CMBS), and emerging-market debt, also fluctuated.

Improving U.S. economy sparks concern over the Fed's "exit strategy"

On balance, data released during the past week showed the U.S. economy is on firmer footing. This had the dual effect of boosting optimism about future growth while aggravating market fears that the Fed will begin tapering its asset purchases sooner rather than later. Anxiety was evident in both fixed income and equities, as many interest-rate-sensitive stock sectors sold off, including utilities, telecommunications, real estate investment trusts (REITs) and lumber.

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Among the favorable economic readings:

- **Home prices** rose nearly 11% year-over-year in March, the fastest annual growth rate since April 2006, based on the Case-Shiller 20-city composite index.
- **Pending home sales** increased more than 10% from April 2012, hitting the highest level in three years. This is a sign that home prices will accelerate further next month, as the inventory of available homes is not sufficient to meet demand.
- **Consumer confidence** jumped to multi-year highs in May, according to both The Conference Board and the Thomson Reuters/University of Michigan indexes.
- **Regional manufacturing activity**, evidenced by the Chicago Purchasing Managers' Index (PMI), surged in May, echoing consumer sentiment gauges and pointing to improved wages, employment, income and spending in the near term.

While first-quarter real GDP growth was revised slightly downward, to 2.4% from 2.5%, details beyond the headline figure—including an upwardly revised 3.4% increase in consumer spending—confirmed our view of a strengthening private sector. In fact, private real GDP is now growing faster than overall real GDP. This healthier private-sector growth will ultimately outweigh the drag from lower public spending, an impact we will see clearly in the second half of this year. In the meantime, tax increases and federal spending cuts will continue to work their way through the economy, slowing headline growth during the second quarter.

Assessing macro risks posed by Japan and Europe

Some investors now see Japan as perhaps the world's greatest "tail risk." As we have noted previously, spikes in Japanese government bond (JGB) yields have led to sharp volatility in equity markets. In the short run, we expect the Bank of Japan will be able to prevent yields from spiraling, which in turn should help calm macro concerns and set the stage for another equity market rise.

In the long run, however, market fears are relevant because the aim of Prime Minister Shinzo Abe's program is to create inflation. The risk is that he gets what he's wishing for but without real economic growth. Because Japan's debt load is so heavy and growing, higher JGB rates will almost certainly lead to funding problems.

While developments in Japan could pose risks, we think Europe is a more likely source of renewed macro fears due to political uncertainty. Among the looming issues are:

- the European Union (EU) summit in June, where the risk is that Franco-German disagreements over banking reforms may spill out and rattle markets;
- local elections in Portugal, which could destabilize the central government if outcomes tilt toward anti-austerity parties; and

- German elections in September, in which it appears certain that Chancellor Angela Merkel will need to find a new partner to form a coalition government.

Meanwhile, the eurozone remains in recession, and economic indicators have been bouncing along the bottom in a directionless way for some time. We do not expect much more than that until after Germany's elections.

Outlook: Our view on the pace and impact of Fed "tapering"

Fixed-income investors fear that Fed tapering will result in a disorderly rise in interest rates and are uncertain about how the Fed's withdrawal from open-market asset purchases will affect the valuation of riskier assets. Moreover, as rates rise, flows out of fixed-income funds may increase, forcing sales of bonds, which in turn would drive yields still higher.

Although this remains a risk, for now we believe it is small. The Fed has been clear that it would be slow to reduce the pace of its purchases until the economy delivers multiple months of job additions in the 200,000 range. Unemployment claims, while indicative of expansion, are not aligned with that pace of job growth.

That said, as growth continues to pick up, as we hope and believe it will, then the potential for monetary tightening is increasing. The issue is pace. Markets are fearful of reacceleration and have rushed to judgment.

Our perspective remains that the Fed's gradual unwinding, along with the sheer size of the QE program, will translate into an increase in rates that is modest rather than precipitous. In addition, the impact of any increases may be greater on consumer mortgage and other direct lending rates than on rates in securitized markets, where the Fed has more influence. In addition, the impact may be felt more in mortgage and other direct lending rates than in traded markets where the Fed's influence is larger. Given this outlook, we continue to believe that equities can move higher from here before encountering new headwinds.

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