Weekly Market Update

Markets sing a familiar tune as volatility persists

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Improving U.S. economy and fears of Fed “tapering” vie for greatest market impact.
- Emerging-market equity and debt are among the hardest-hit asset classes.
- May’s U.S. economic releases show a pick-up in activity after April’s slowdown.
- China and Japan continue to grapple with economic challenges.
- Our forecast calls for second-quarter GDP growth of approximately 1.7%.

JUNE 14, 2013

Volatility continued to rule equities during the past week, with sharp fluctuations across many markets. Although data releases again indicated an improving U.S. economic backdrop, investors remained conflicted about the favorable growth trajectory. They fear it will hasten the Federal Reserve’s “tapering” of asset purchases and lead to higher interest rates and lower risk premiums (i.e., a narrowing in the expected excess return of equities versus a risk-free alternative such as Treasury bills). The S&P 500 Index lost 0.4% for the week through June 13, while foreign developed and emerging markets were down 0.3% and 3.7%, respectively, based on MSCI indexes.

In fixed-income markets, most “spread products” (higher-yielding, non-U.S. Treasury securities) posted negative returns, with investors continuing to position for a gradual withdrawal of Fed liquidity from the markets. Emerging-market debt was particularly hard hit, as issuers face the prospect of competing with Treasuries for buyers. Treasury yields and the value of the dollar have risen on firming U.S. economic data, while growth has been slowing in many developing economies, making their debt issues less attractive on a relative basis. All categories of fixed-income funds experienced outflows for the week except leveraged loans, which are floating-rate instruments that offer a degree of protection from rising interest rates.

Financial Services

U.S. economic releases show moderate strengthening in May

So far, a number of key economic indicators released for May show a pick-up in activity following April's slowdown, in line with our expectations.

- **Retail sales** increased in May by 0.6% (0.3% excluding autos), measurably better than April's reading and indicative of continued growth in spending.
- **Weekly jobless claims** fell to 334,000, and the more important four-week moving average declined to 345,000. These measures confirm further stability in job creation but not necessarily structural improvement. We need to see a sustained shift in the moving average to below 330,000 before we can expect consistent monthly payrolls to rise in excess of 200,000.
- **Small business sentiment** jumped to its highest level in a year and the second-highest level since the 2007-2009 recession, according to the National Federation of Independent Business (NFIB).
- **Industrial production** was flat in May, but this is an improvement from April, when it was down 0.4%.

Meanwhile, consumer confidence dipped slightly in June from May's six-year high, as measured by the Thomson Reuters/University of Michigan index. The June number is a preliminary reading, and we do not consider it a change in the significant uptrend we have seen this spring.

China and Japan continue to face challenges

China's economic picture remains mixed, as reflected in the decline in the Shanghai Stock Exchange "A" Share Market Index. Producer prices have declined, overall borrowing has decelerated, and the SHIBOR (Shanghai Interbank Offered Rate)—the interest rate Chinese banks charge each other on overnight loans—spiked during the week. It is unclear why this spike occurred, but there is speculation that regulators are cracking down on wealth management products, which in turn constricts interbank liquidity. Such a development would be consistent with slower credit growth and may reflect the government's focus on structural reforms and economic rebalancing.

That economic rebalancing has major implications for growth in China and over the long run may create attractive market opportunities. In the short run, however, uncertainty in China has negative implications for emerging equity markets, whose year-to-date decline has accelerated sharply over the past four weeks. A sluggish Chinese economy may also hinder Japan's attempts to export its way back to economic health.

Japanese equity and bond market volatility has been extreme, with a nearly 30% drop in the Nikkei 225 Index since its peak in May. Much of the pessimism is based on fears that Prime Minister Shinzo Abe's economic program will fail due to a lack of credible structural reforms, the third leg of the "Abenomics" stool. A contrarian view suggests putting less emphasis on immediate reforms and giving time for the current amount of monetary stimulus to affect prices in Japan. So far, the program has succeeded in raising inflation expectations, but it will take time before these expectations translate into the inflation needed to spur growth.

Outlook

A substantial segment of the equity market expects the Fed to articulate an “exit plan” from its open-market asset purchases, and the fear of that exit happening sooner rather than later has intensified sharply in recent weeks. No matter what language the Fed uses in its next statement, however, there is little evidence of an imminent shift in Fed policy. Moreover, history shows that increases in the federal funds rate are typically the main driver of higher equity market volatility, but usually only 6 to 12 months after the Fed raises its target for this rate. Because we are likely a long way from such an event, we think current market volatility is higher than warranted and may begin to subside.

In fixed-income markets, we believe the rise in yields experienced over the past two weeks was an overreaction relative to the Fed’s desire to affect markets only gradually. The Fed retains the ability to fine tune markets by adjusting its purchases or sales of securities on a monthly basis as economic conditions warrant. This leaves markets to focus on leading economic indicators for guidance on the future direction of interest rates.

The U.S. economy continues to improve and looks to be on firmer footing than most of its global counterparts, but growth is not yet robust. We still expect a modest improvement in second-quarter GDP relative to the first quarter. Our forecast is for growth in the 1.5%-2% range, with the latest data suggesting a rate closer to 1.7%.