Weekly Market Update

Fed's "taper talk" trumps economic data as markets tumble

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ARTICLE HIGHLIGHTS

- The Fed sends its clearest signal yet that QE3 could begin to wind down soon.
- Equity and fixed-income markets sell off following Chairman Bernanke's comments.
- Long-term interest rates rise, with the 10-year Treasury yield spiking above 2.5%.
- We do not expect interest rates to reach levels that would stifle growth.
- Our forecasts for U.S. GDP growth remain unchanged.

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Equity markets around the world tumbled in the wake of Federal Reserve Chairman Ben Bernanke's June 19 press conference, in which he expressed a view of stronger-than-consensus expected growth for the U.S. economy. He indicated that the pace of quantitative easing (QE3) asset purchases would likely begin to wind down sooner rather than later, possibly before year-end. Although emerging-market equities have been the hardest hit by the prospect of Fed "tapering" and a spike in U.S. interest rates, U.S. and foreign developed equity markets are also experiencing significant corrections.

Fixed-income markets sold off as well, with no sectors spared. The yield on the bellwether 10-year Treasury yield surged more than 30 basis points during the past week, breaching the 2.5% threshold for the first time since 2011. Longer-duration "spread products" (higher-yielding, non-Treasury securities) were especially hard-hit due to interest-rate fears, while emerging-market debt suffered because a portion of assets that would have flowed to this sector will likely go to the U.S. instead to take advantage of higher Treasury rates. Fund flows remained negative for emerging-market and high-yield bond categories.

Our view on the Fed's intentions

In last week's commentary, we noted that equity markets have long been expecting the Fed to articulate an "exit plan" from its open-market asset purchases. Time will tell whether the market's response to Bernanke's June 19

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remarks is an overreaction. However, in the broader context of the run-up in equities since late last year, the market's initial response looks to be a textbook example of "buy the rumor, sell the news."

We interpret the Fed's commentary as follows:

- Assuming monthly job creation remains in its current range (about 200,000), inflation stays within recent levels, and the unemployment rate ticks down by between 0.1% and 0.3%, then tapering is likely to begin.
- If the economy continues to grow through that tapering, we should expect the QE3 program to end within two to three quarters.
- If we assume further that the economy continues to gradually improve even after the end of QE3, then we should expect the first hike in the target federal funds rate approximately three to four quarters from that point.

Of course, if at any point during this process there are significant negative changes to economic growth due to a lack of stimulus or external factors, the Fed explicitly reserves the right to restart QE3. That said, Bernanke's message was clear: The Fed intends to end the easing cycle as expeditiously as possible.

Continued signs of U.S. economic progress

The Fed's positive outlook on the economy was supported by some encouraging U.S. data during the past week. Rising estimates for corporate earnings in the second half of the year reflect these and other recent releases.

- Regional manufacturing indicators, including the Empire State and Philly Fed indexes, showed significant improvement.
- Homebuilder sentiment jumped in May, and existing home sales hit their highest annualized rate since November 2009.
- The Conference Board's index of leading economic indicators, while up slightly less than expected, continued to point to potential upside for the economy later in 2013.

Meanwhile, housing starts rose modestly and building permits were down for the month. This indicates that there are supply constraints both in the "for sale" market and in builders' ability to add to new home inventory in the near term. This should lead to an acceleration in home prices in the near term.

Europe and China continue to send mixed signals

European equity markets took the Fed's tapering message badly and traded down despite a set of much-better-than-expected Purchasing Managers' Index (PMI) readings across the eurozone. The favorable PMIs, a gauge of manufacturing activity, followed a string of recent upside surprises in economic data for Europe, which in turn has led to rising earnings expectations for the second half of 2013. We remain cautiously optimistic about European equities but note that yields on sovereign debt issued by Spain and Italy have risen from their early May lows, largely on fears related to Fed tapering and new concerns out of Greece due to the departure of a junior member of the coalition government.

China's growth picture is still clouded. Chinese PMI for May disappointed, and short-term interest rates remained elevated with no consistent policy rationale offered by the government, leaving markets baffled. The Shanghai "A Share" Stock Market Index fell below its 200-day moving average.

Outlook

Equity markets have been shaken by the rapidity of the rise in the 10-year Treasury yield, and the uncertainty this creates for the second half of 2013. Among the chief concerns:

- a lower risk premium for equities versus bonds as interest rates rise
- the potential impact of higher mortgage rates on U.S housing
- slower-than-expected activity in China and emerging markets
- renewed threats to European sovereign debt financing for fiscally challenged nations.

If the S&P 500 Index holds at key support levels, we may well see a further advance to new market highs. However, if these levels are breached, a downside move to the 200-day moving average is possible, prompting us to reassess our economic expectations and market projections for the latter half of the year.

We are gradually approaching a more normalized investing environment in which actual data, rather than Fed expectations, will take on greater importance. On balance, while the U.S. economy continues to expand, the pace of expansion is not likely to push interest rates up to levels that would stifle growth. We have seen no recent data that would lead us to alter this fundamental view. Our forecast for second-quarter GDP growth remains at approximately 1.7%. We expect third-quarter growth of 2.5%-3.5% and fourth-quarter growth of 3%-4.0%, in both cases with a bias toward the lower end of the range.

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