Weekly Market Update

Markets recover from previous week's tailspin

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ARTICLE HIGHLIGHTS

- Markets are calmer following further Fed comments and positive economic news.
- Lowered consumer spending drives downward revision in first-quarter GDP.
- Housing data and consumer outlook continue to improve.
- Europe, Japan and China enjoy market rallies, but each faces unique challenges.
- We have trimmed our Q2 GDP forecast but remain confident about the rest of 2013.

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Equity markets generally rallied from oversold levels during the past week. Clarifying comments by the Federal Reserve and other central banks around the globe soothed market fears about the potential timing of asset-purchase "tapering" and/or short-term interest-rate hikes. Calmer bond markets and a batch of favorable U.S. economic data also helped markets recover from what one observer called the previous week's "taper tantrums." However, markets appeared to be wavering on June 28, the last trading day of the week, the month, and the volatile second quarter.

In fixed-income markets, the recent spike in the 10-year Treasury yield moderated. Credit spreads—the difference between yields on higher-yielding, non-Treasury securities and the 10-year Treasury note—stabilized at their widest levels of the year. (Widening spreads indicate that investors in riskier assets are demanding a higher yield as compensation for the added risk they are taking on, relative to Treasuries.) Meanwhile, outflows from fixed-income funds continued across most categories. A number of fixed-income sectors have posted negative year-to-date returns for the first time in many years, although at this point some have now "corrected" to reflect spreads that are consistent with expectations of reduced Fed asset purchases.

Financial Services

Housing and consumer spending lead U.S. economic gains

Despite a downward revision in the government's final estimate of first-quarter GDP growth (from 2.4% to 1.8%), economic data released during the week remained largely favorable. Consumers spent much less than originally thought in April, driving the GDP estimate lower, but May saw a good bounce in activity, and early indications are that June will turn out to be at least as strong, especially in housing and related consumption categories.

- Home prices were up more than 12% in April compared with a year ago, based on the S&P/Case-Shiller 20-city composite index.
- New home sales in May jumped to an annualized rate of 476,000, a five-year high, while pending home sales climbed to a six-year high.
- Personal income and consumer spending moved higher in May, indicating gathering momentum.

Consumer confidence, as measured by The Conference Board Index, rose to its highest level since January 2008.

Overall, we view the second quarter as one that started very slow but picked up steam. Momentum on the private side of the economy remains strong and should carry into the third quarter, provided interest rates don't rise too much and too soon. The drag from the public sector will continue to be reflected in second-quarter data but should begin to ease during the second half of the year.

Europe's market environment is mixed

Although Europe's market recovery has been ragged, economic data has been improving, and there is hope for even better results in the second half of 2013. What concerns us is some deterioration in European bond markets, where spreads on sovereign debt issued by countries such as Spain and Italy have again moved higher. This development may be due to fund flow issues similar to those that have bedeviled the U.S., but if European economic progress falters and reforms do not materialize, we risk another period of fear and volatility in financial markets.

Japanese jumpstart in question

The Japanese equity market has rallied 10% from its recent low in response to better economic headlines. In our view, however, data releases have been mixed. For example, Japan's consumer price index (CPI)—which the government is trying to prod higher from deflationary levels—was flat, but this primarily reflected higher import prices. Actual consumer consumption was weak. This will need to improve in order to truly jumpstart Japanese growth.

China remains unsettled and enigmatic

The Chinese equity market finally rallied after eight straight down days, as the central bank continued to inject liquidity into the banking system to rein in elevated short-term interest rates. Meanwhile, GDP forecasts have been cut, the health of the banking system is a topic of debate, and among those harboring alarmist views, there is an increased risk of a potential real estate crash. As always, China remains an enigma. At the very least, however, the recent weakness in the Shanghai Stock

Exchange “A Share” Market clearly signals a slower growth rate, which in turn is a negative for the emerging markets broadly.

Outlook

As we have noted in prior commentaries, the headline number for second-quarter GDP growth will be less than inspiring. The drag from cuts in fiscal spending will be significant, and personal consumption will be measurably lower thanks to the downward revision for April. As a result, we have lowered our forecast for second-quarter growth from 1.7% to 1.5%.

However, we are not concerned about momentum going into the second half of the year, because much of the fluctuation in income and consumption so far this year has been related to fiscal cliff events that led to sizable dislocations in earnings at the end of 2012 and the beginning of 2013. Data for May and June are tracking in patterns similar to what we saw last September, indicating that consumers are buying again and incomes are rising in a more stable fashion.

This past quarter produced the worst total return for U.S. bonds on record, surpassing selloffs in 1994 and 2004. The good news is that those periods were ones in which U.S. equities decoupled from bonds and went on to rally. We are therefore optimistic that equities may continue to rally into the third quarter and reach new highs for the year. In fixed-income markets, our view is that the 10-year Treasury yield will hold in the 2.25%-2.75% range over the next several months, providing an environment that supports housing, employment, and overall growth.

The information provided herein is as of June 28, 2013.

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