Weekly Market Update

Markets decline on renewed Fed tapering fears

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ARTICLE HIGHLIGHTS

- U.S. equities continue their short-term correction, but we believe the market remains in an uptrend.
- Treasury yields spike on improving unemployment claims and booming homebuilder confidence.
- Overall, fixed-income fund flows have been better than expected, given Fed tapering fears.
- Europe's return to positive growth pleases the markets, while Japan's GDP is disappointing.
- Despite market hand-wringing, the Fed's eventual tapering announcement could be a positive surprise.

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U.S. equity markets posted sizable losses during the past week, as the combined effects of mixed economic data, earnings disappointments, and rising bond yields triggered a correction in stock prices.

The S&P 500 Index was down 1.7% for the week through August 15, underperforming foreign developed markets (-0.6%) and emerging markets (+1.0%), based on MSCI indexes.

Fixed-income returns were broadly negative. The Barclays Aggregate U.S. Bond Index fell 0.8% for the week through August 15, with investment-grade corporate bonds (-1.1%) lagging mortgage-backed securities (-0.8%) and Treasuries (-0.7%). High-yield bonds (-0.3%) continued to hold up better than many other sectors. The closing yield on the bellwether 10-year Treasury note jumped 20 basis points (0.20%), from 2.57% on August 9 to 2.77% on August 15.

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Falling unemployment claims reignite tapering fears

U.S. economic data releases were mixed, but signs of further positive momentum in the employment and housing markets were enough to spark a two-day sell-off in U.S. equities, as markets refocused on the possibility that the Federal Reserve could begin tapering its open-market bond purchases as early as September.

- **First-time unemployment claims tumbled** to 320,000, their lowest level since October 2007, while the four-week moving average fell to 332,000. As we have noted in prior commentaries, if claims stay consistently at or near 325,000 for an extended period, then we would expect to see sustained improvement in job growth and in the economy overall.

- **Homebuilder confidence climbed** for the fourth consecutive month in August, surging to its highest level in nearly eight years, according to the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index. In addition, housing starts rose nearly 6% in July, led by apartment building.

On the down side, industrial production and regional manufacturing activity came in weaker than expected for July, and consumer sentiment fell, based on the preliminary August reading of the University of Michigan/Thomson Reuters index. Relatively sluggish growth in July retail sales, along with subpar earnings announcements by a number of large retailers, added to the cautious tone.

Europe's GDP growth turns positive

The eurozone finally returned to positive growth, with the region's GDP rising a modest 0.3% in the second quarter, fueled by better-than-expected economic performance in Germany and France. An August surge in the ZEW index, a closely watched gauge of German investor sentiment, also bolstered optimism. For the month to date through August 15, the MSCI Europe Index (+1.8%) has outperformed the S&P 500 (-1.3%). Although sovereign debt yields moved higher during the week, this was due more to the markets' perception that the European Central Bank (ECB) cannot be any more accommodative in its monetary policies, rather than to a deterioration in economic and fiscal conditions.

In Japan, evidence of economic progress remains elusive

Despite high hopes for Prime Minister Shinzo Abe's economic program at the beginning of the year, Japan has continued to struggle with growth and the direction of government policy. Japan's preliminary GDP data for the second quarter was well below consensus forecasts, adding to growing debate over a sales tax increase tentatively planned for next spring. Domestic demand is improving, but there is little evidence of a pickup in business investment. We remain bearish on the direction of this market.

China and emerging markets trend higher

China and the emerging markets have been trending higher. Recent Chinese economic releases reaffirm that a bottoming process is taking place, which in turn is

reflected in better performance by the Shanghai "A" Share Stock Market Index. This positive trend is likely to continue as bearish investors rush back into these markets to cover their dramatic underweights.

Outlook

Our primary view is that the U.S. equity market remains in an uptrend. The setbacks of the past two weeks represent a classic retreat that will correct elevated levels of sentiment. Moreover, despite the rise in interest rates, the equity risk premium—i.e., the expected excess return of equities versus a risk-free alternative such as Treasury bills—remains attractive.

That said, investors are still finding plenty to fret about besides the past week's earnings disappointments. Key concerns include the upheaval in Egypt and related oil price volatility, the pace of U.S. economic growth, uncertainty over who will succeed Fed Chairman Ben Bernanke when his term expires, and whether the Fed will announce a tapering decision following its September 17-18 meeting. Although the Fed is likely to articulate the need for tapering, we see no reason why it would have to begin immediately, or why the markets' initial reaction should be extreme. In fact, given the disproportionate anxiety that has been fueled by the mere thought of tapering, any signs of flexibility in the Fed's approach could actually result in a favorable surprise when the announcement comes.

In fixed-income markets, bond investors are increasingly convinced that tapering is imminent. Even so, fund flows overall have been better than one might expect. Funds that invest in high-yield bonds, loans, and investment-grade corporate securities saw inflows in the past week, while emerging-market debt funds continued to experience outflows. Pricing of emerging-market bonds now seems to fully incorporate the Fed's anticipated policy moves and a near-term future in which U.S. and developed foreign markets will outperform.

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