Weekly Market Update

Markets are calm with all eyes on the Fed

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ARTICLE HIGHLIGHTS

- Markets remain quiet ahead of the Fed's September 18 policy announcement.
- Emerging-market equities are bolstered by signs of better growth in China.
- Some cracks may be starting to appear in the U.S. housing recovery.
- U.S. retail sales and consumer sentiment disappoint.
- Our overall view of U.S. growth and scope of Fed tapering remains intact.

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U.S. stocks staged another early-week advance, with the S&P 500 Index up 2% through mid-week. Boosted by encouraging Chinese economic data, foreign emerging-market equities surged 3.7% for the week through September 12, outperforming foreign developed markets (+2.7%), based on MSCI indexes.

Fixed-income markets were relatively quiet, with returns in the 0.2% to 0.4% range across most sectors, based on Barclays indexes. Demand for new investment-grade and high-yield corporate bond issues remained healthy, and emerging-market debt rallied for the first time in many weeks, returning nearly 1%. The yield on the bellwether 10-year Treasury note generally stayed in a narrow range, hovering around 2.9%. Current market updates are available here.

Mixed U.S. economic releases include potential concerns about housing

The latest readings on retail sales, business inventories and consumer sentiment were weak. Overall, economic data released during the week did not change our view on growth, which calls for moderate GDP growth in the 3% range for the next two quarters, but two indicators stood out:

- **First-time unemployment claims** plunged to 292,000—the first time they have come in below 300,000 since 2006. However, reporting glitches in a number of states may have exaggerated the decline, which means the data could be subject to upward revision.

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- **Mortgage applications** dropped by 13.5% in response to higher interest rates. However, the bulk of that decline was in refinancing; purchase applications were off only 3%.

Mortgage applications tend to be volatile from week to week, but the trend now is definitely on the weak side. Meanwhile, although home prices and sales activity have generally held up through much of the summer, indications from homebuilder surveys suggest this may be changing. On the plus side, mortgage rates moved a bit lower during the past week.

Our premise remains one in which a continued recovery in housing supports broader economic growth, but this story will become less convincing if mortgage rates move significantly higher from current levels. For further insights into the linkages between housing and the broader economy, read our recent two-part series: Part I: Turning the corner in housing: An important step on the road to recovery, and Part II: Multiplier effects: Searching for an economic boost from the housing rebound.

European equity markets move higher amid some cautionary signs

It was a mixed week for Europe:

- The MSCI Europe Index gained 2.7% for the week through September 12. We are keeping a close eye on market sentiment, as investors now favor Europe by a wide margin over any other region.
- A weak industrial production number for the eurozone underscored European Central Bank (ECB) President Mario Draghi's statement that recent economic indicators are merely green shoots rather than full-flowered growth.
- Italy again deferred a decision on whether to expel former Prime Minister Silvio Berlusconi from the senate. Such a move could result in the collapse of Italy's coalition government— a risk reflected in rising Italian government bond yields, which edged higher than Spanish yields for the first time since 2011.

Positive Chinese data helps fuel emerging-markets rebound

China's economy continues to improve, helping drive emerging-market equities higher.

- Chinese manufacturing and service-sector output expanded in August for the first time in three months, accompanied by strong growth in rail cargo volumes and demand for iron ore.
- The Citi Economic Surprise Index for the BRIC nations (Brazil, Russia, India and China) has moved up sharply into positive territory over the last three weeks, indicating much-better-than-forecast economic releases.
- Emerging-market equities have now surged almost 10% from their late August low.

For now, we believe the advance in emerging markets is a classic bear-market rally with some months to run. However, China's high debt-to-GDP ratio, increased borrowing levels and slowdown in fiscal revenue suggest the recent Chinese growth spurt may be limited in scope. This would be a negative for emerging equity markets.

Also working against emerging markets is inflation. Many emerging-market economies are operating at or near full capacity, and additional growth would exacerbate inflationary pressures. This risk is reflected in emerging debt markets, which have not kept pace with the rally by their equity counterparts.

Japanese equities rise, but outlook is mixed

In Japan, equities jumped nearly 3% during the past week, measured by the MSCI Japan Index. Stock prices were lifted by the announcement that Tokyo had been selected to host the 2020 Summer Olympics. We remain leery of the market on technical grounds, although there are some glimmers of hope in Japanese domestic data, which—combined with an improving exports picture—could trigger a fourth-quarter rally. However, if this occurs, we believe the bounce will be off of lower levels.

Outlook

The week of September 16 will be dominated by the Fed's Open Market Committee meeting. The consensus is that on September 18 the Fed will announce a $10 billion to $15 billion reduction in its monthly rate of Treasury purchases. If the tapering is in that range, markets will be largely unmoved. A figure above $15 billion would lead to increased volatility. The odds that no tapering will be announced are very low.

Our focus has shifted away from the tapering decision per se and toward the message that Fed Chairman Ben Bernanke is expected to convey in the accompanying news conference. We believe his message will be dovish in tone, essentially communicating that the economy has strengthened over the course of the year but remains somewhat fragile—indicating a slower pace of tapering and a lengthened period before the Fed moves to hike short-term interest rates from their near 0% level.