Weekly Market Update

Fed tapering decision changes U.S. and global dynamics

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ARTICLE HIGHLIGHTS

- Equity markets surge, then reconsider, on surprise Fed decision to delay tapering
- Global markets benefit broadly, with emerging markets receiving the greatest boost
- Economic picture remains sound, with risks represented by housing, debt ceiling, and employment
- Positive outlook for markets, with short-term volatility representing possible buying opportunity

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Markets rose this week following Wednesday's surprise Federal Reserve decision to delay tapering its quantitative easing program. Although initial market reaction was strongly positive, early enthusiasm subsided somewhat later in the week as investors began to question the implications of the Fed's decision. Although U.S. stocks retreated from record highs, the S&P 500 Index ended the week up approximately 1%. International stocks also benefited from the Fed's signaling of a more dovish stance, as foreign developed-market equities rose 3.2% and emerging-market equities surged 3.6%, based on MSCI indexes. The mid-week announcement resulted in an immediate decline in fixed income yields and a narrowing of spreads (i.e., incremental yields of non-Treasury fixed income securities), with the yield on the bellwether 10-year Treasury note falling from 2.9% to the mid-2.7% range, and strong positive performance in corporate, structured, and particularly in emerging-markets debt securities.

Implications of the delayed taper

The Fed's decision not to taper proves that reversing current policy will be a difficult matter. By delaying the taper, the Fed recognized the recent backup in interest rates as jeopardizing the recovery. This action signals that the Fed wants growth and will not materially change policy until growth is evident and sustainable. The Fed's recognition of low inflation (or possible deflation) and concern over high real interest rates probably means that the Fed will not materially change policy until there are more pronounced pricing signals. Further, while conditions for budget and debt ceiling resolution are more hopeful, the Fed likely wants to preserve the flexibility to ease in case negotiations in coming weeks are not successful. Timing of the eventual taper will be dependent on economic data and will likely be pushed back to December or later. In the meantime, there may be a reprieve from upward pressure on interest rates, and financial markets should find a tailwind.

Economic releases during the week were mostly positive, representing encouraging signs. Notable developments included:

- An increase in August industrial production and an increase in factory output, a strong reversal from the weak summer.
- Unemployment claims of 309,000, which was below consensus and consistent with job growth in the neighborhood of 200,000. Weekly numbers, while volatile, remain a key metric for Fed policy.
- Stronger than expected August existing home sales, not yet reflecting the slowdown that will likely occur from the increase in mortgage rates and resultant curtailment of demand over the summer.

The delayed taper will support housing and other sectors, but an improvement in activity, if any, will not materialize in the data for a few more months.

Emerging markets receive a welcome breath of life

The greatest beneficiary of the Fed decision has been emerging markets, with equities outperforming developed markets during the week and fixed-income markets benefiting from lower interest rates, allowing for cheaper funding of debt. Additionally, pressure on foreign exchange has been relieved as upward pressure on the U.S. dollar has eased.

If the developed world continues to improve, then there should be a dramatic pull-through in emerging markets exports, which should move markets in that zone higher. Upside may be limited, however, by emerging economies, including India and China, which remain vulnerable to inflation. China, for example, while reaccelerating, may have only limited runway for higher growth, as property prices are edging further into bubble territory and as food prices remain a key concern for policy makers.

European equity markets maintain positive momentum

Following a 2.7% increase last week, the MSCI Europe Index gained an additional 3.3% for the week through September 19. This movement reflects positive tailwind from the Fed's decision, but also is a sign of an improving economic picture. A small easing of austerity has moved the Eurozone from recession to growth. This represents a tremendous swing for the global economy, and underscores the market's rotation to this region

Of course, many threats remain, although such threats seem navigable and may be largely offset by the relative cheapness of the markets.

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Outlook

While the delay in tapering potentially complicates Fed policy down the road and will require continued diligence in reading nuances in economic trajectory, we believe that the Fed's decision to delay tapering is generally supportive of equity markets. While we do not anticipate U.S. debt limit negotiations will represent a material impact on the economy, we could see a bumpy ride into October as these issues are ironed out. However, we would likely perceive any major correction in October as a buying opportunity.

In relation to fixed income markets, we see conditions in the wake of the tapering decision as bullish and to be enjoyed while they last. However, longer term, the U.S. economy is likely to improve at an increasing rate, causing interest rates to eventually drift higher.

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