Weekly Market Update

Anxious markets focus on fiscal debate in Washington

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ARTICLE HIGHLIGHTS

- Markets fret over prospects of a government shutdown as key deadlines approach.
- U.S. equities fall from the previous week's peak.
- Treasury markets benefit from investor demand for safe-haven assets amid the uncertainty.
- Economic data releases remain mixed, with little to alter our fundamental outlook for U.S. growth.
- The looming debt ceiling battle poses a greater risk than a short-term government shutdown.

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Markets were transfixed by the unfolding drama in the nation's capital, as debate intensified over a continuing resolution to fund the federal government and the subsequent need to raise the national debt ceiling. For the week through September 26, the S&P 500 Index returned -0.6%. Foreign developed- and emerging-market equities also lost ground, returning -0.1% and -1.0%, respectively, based on MSCI indexes.

In fixed-income markets, U.S. Treasuries rallied on increased demand for safer, high-quality assets. Treasury yields (which move in the opposite direction of prices) continued their decline from the previous week. The yield on the bellwether 10-year Treasury note closed at 2.66% on September 26, after spiking to nearly 3% earlier in the month. Meanwhile, net flows into fixed-income funds picked up in several categories, including high-yield and investment-grade corporate bonds, as well as emerging markets.

Current market updates are available here.

The U.S. economy remains in slow-growth mode

A batch of mixed U.S. economic data was released during the week, with little in the numbers to alter our fundamental outlook for a continued slow recovery.

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- The government's third and final estimate of **GDP growth** for the second quarter was unchanged at 2.5%.
- Weekly **first-time jobless claims** over the most recent four-week period averaged 308,000, the lowest level in more than six years.
- **Home prices** continued to rise in July but at a decelerating pace, according to the S&P/Case-Shiller composite index of 20 major housing markets.
- **New home sales** ticked up marginally in August, but overall remain relatively muted compared to the first half of the year. We expect to see increased activity in sales and mortgage applications given the drop in interest rates precipitated by the Fed's decision not to taper.
- **Consumer spending and personal income** readings were favorable for August, and July's spending number was revised upward—a development that may lead some forecasters to boost their third-quarter GDP projections. We are reserving judgment for now.
- Optimism over consumer spending may be tempered by falling **consumer confidence,** as measured by two well-known indicators—one published by The Conference Board and one by Thomson Reuters-University of Michigan. Both of these indexes declined in September.

Improving European equity returns remain in scope, despite some concerns

A baseline scenario of improving equity returns in Europe remains in place as the region continues to emerge from a two-year recession. However, there are caveats to this outlook:

- The political stalemate in Italy continues, with the party of former Prime Minister Silvio Berlusconi threatening to resign from the coalition government. The uncertainty has triggered a rise in Italian bond yields.
- We have seen a decline in money supply and loan growth across Europe, which could jeopardize the "green shoots" of growth recently touted by the European Central Bank.
- In Germany, Chancellor Angela Merkel won the September election as expected but now must find a suitable partner to form a government.

Elsewhere, recent strong equity performance in China and the emerging markets have cooled somewhat, in part reflecting concerns about the U.S. fiscal showdown. We would expect these markets to rally on any agreement reached in Washington.

Outlook

As of this writing, we believe Congress is more likely than not to pass a temporary extension of its continuing resolution to fund the federal government. The current resolution expires on September 30, and an extension, if passed, would be in effect through November 15. In our view, if no agreement is reached by the September 30

deadline, any government shutdown would be partial and short-lived, with a relatively limited short-term impact on GDP growth.

The debate over whether to raise the U.S. debt ceiling remains the more daunting and significant risk to the economy and markets. The debt limit is expected to be reached no later than October 17. It remains to be seen whether the political players in this debate have gleaned any lessons from the 2011 stalemate over the same issue. The prospect of the U.S. actually defaulting on its debt obligations is remote, but the longer the debate is drawn out, the greater the risk to the economy.

On the plus side, these risks are now generally well recognized by the equity markets, evidenced by the recent pullback in stock prices and declines in some overly optimistic measures of sentiment. For this reason, we believe any significant fall in the markets would represent a buying opportunity. However, we also recognize the risk that any budget- and debt-related solutions emanating from Congress may be incremental fixes that merely postpone the inevitable for a matter of months. This “incrementalist” scenario, if realized, could lead to an extended period of market uncertainty, limiting our bullish case for U.S. equities through year-end.

The outlook for fixed-income markets is also mixed. Following initial euphoria over the Fed’s delay in tapering its bond purchases, “spread products” (higher-yielding, non-U.S. Treasury sectors) have given back some of their gains Fixed-income investors recognize that the temporary hold on tapering is just that—temporary—and will eventually give way to a higher interest-rate environment when the Fed begins to wind down its quantitative easing (QE) program. On a positive note, new bond issuance continues at a brisk pace, demonstrating ample demand for fixed-rate investments at current yields.

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