Weekly Market Update

Equities peter out after Fed release and lackluster economic news

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ARTICLE HIGHLIGHTS

- U.S. equities cap off a volatile week, but the bond market is quiet.
- Lackluster economic data paints a weak third-quarter picture.
- European markets lose ground for the week but end the month higher.
- China and Japan both face reform challenges.
- Our third-quarter and fourth-quarter GDP growth forecasts remain at 1.8% and 2.0%, respectively.

November 1, 2013

U.S. markets finished essentially flat during a volatile week that began with record-high closes for the S&P 500 Index on October 28 and 29. During the latter half of the week, markets retreated as investors mulled over a batch of mixed economic releases and assessed the possibility of a pullback after the S&P 500's steep 2013 rise. With stocks losing ground, investors moved into the market's more defensive sectors, including utilities, telecommunications, consumer staples and healthcare.

Equity markets were also troubled by Wednesday's Federal Reserve release. Although the Fed maintained its wait-and-see approach to bond buying, it failed to assure investors that tapering will be delayed as much as had been suggested in previous statements.

Fixed-income markets were calm during the week, with most sectors trading within a narrow range. The 10-year Treasury yield inched higher during the week (from 2.54% to 2.61% as of early Friday trading), but it dipped slightly for the month as a whole (beginning at 2.65% as of October 1). Emerging-market bond prices fell during the week and emerging-market bond funds sustained outflows. In contrast, high-yield corporate bonds enjoyed additional inflows and posted gains.

Current market updates are available here.

Latest U.S. data reveals a weak third quarter

Financial Services

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The economic data released this week closed the books on a weak third quarter.

- **Pending home sales** fell 5.6% in September after August's 1.6% drop, a sign that the housing sector slowed precipitously.
- **Consumer confidence** in October plummeted to its lowest level in six months as the gridlock in Washington took its toll on consumer expectations, The Conference Board reported. We expect confidence measures to improve somewhat in November.
- **Job growth** was tepid. The private sector added only 130,000 jobs in October, as reported by the ADP employment survey. The Labor Department's official report, due out next Friday, would indicate significant uncertainty about future economic growth.

Still, there were some pleasant surprises.

- **Home prices** rose 0.93%, beating estimates, according to the S&P/Case Shiller composite index of 20 major housing markets.
- **Mortgage applications** have been trending up, which should signal a pickup in future sales.
- **U.S. manufacturing** remained strong in October, with the ISM Index climbing to 56.4—its highest level since April 2011. (A reading greater than 50 indicates expansion in the manufacturing sector.) Of note was the 65.9 mark notched by the Chicago Purchasing Manager Index—its best showing since March 2011.

European equities drop for the week but post a monthly gain

Despite returning -0.8% for the week, European stocks gained 4.3% in October and were up 21.1% for the year to date through October 31. Because they are still valued at 30% below their 2007 highs, they could have some room to run. Still, investors should be on guard. Corporate earnings have been disappointing and economic news has become decidedly more mixed. Furthermore, Europe is still vulnerable to the "tail risks" (unexpected events that could lead to severe market shocks) posed by the ongoing fiscal woes of countries such as Cyprus and Greece.

Japan and China seek to enact significant policy reforms

Although Asia's two largest economies are confronting different economic challenges, both need to enact meaningful government reforms.

In China, the long-awaited Party Congress will take place from November 9-12. While we expect only high-level pronouncements initially, the long list of proposed changes includes reforms designed to spur private investment growth, reduce subsidies for state-owned enterprises and cut taxes for business owners. In our view, the degree to which reform is enacted will not only dictate short- and long-term growth expectations but will reveal the degree to which the new administration has control of the government and whether its professed desire to reform is real or not.

Japan, in the meantime, seems unprepared for the implementation of structural reforms necessary to revive its economy. Some of Prime Minister Shinzo Abe's proposals have been shelved or delayed until later this month. Furthermore, it appears unlikely that those eventually passed will generate enough economic growth to offset the effects of next April's scheduled consumption tax hike. And in spite of their strong performance this year, Japanese stocks remain vulnerable over the long term.

Outlook

U.S. stocks are poised to move higher as we enter the fourth quarter. That said, a near-term correction, or at least a period of sideways movement, is just as likely, in our view.

The Fed's next move remains front and center. Investors will likely shift their focus from corporate earnings to future Fed releases and the upcoming negotiations in Washington in order to assess the pace and timing of tapering. Clearer signs of economic growth, if coupled with Congress's ability to develop a long-term plan to tackle federal spending and debt issues, could shorten the time to the first Fed taper. In contrast, another fiscal fight in Washington could disrupt the economy and extend the central bank's bond purchases.

While we are in no way predicting that the Fed will begin tapering this year, October's better-than- expected manufacturing reports could raise the possibility of an earlier taper than we previously anticipated.

Our expectations for economic growth haven't changed in the near term; we expect third-quarter growth to come in close to 1.8%. Although data for October is mixed so far, and it's too early to determine the full impact of the government shutdown, we still see GDP growth in the 2% range for the fourth quarter.