Weekly Market Update

Markets seek direction as economic releases confound expectations

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ARTICLE HIGHLIGHTS

- GDP and employment data releases show surprising strength.
- We remain cautious because of data distortions caused by the government shutdown.
- The European Central Bank surprises the markets with a short-term rate cut.
- It is too early to tell if a December timeframe for Fed tapering is back on the table.
- Our estimate of fourth-quarter GDP growth remains at 2%.

November 8, 2013

An unexpectedly resilient employment report for October capped a week of surprises that had financial markets puzzling over mixed economic signals. Investors weighed the positive implications of potentially improving labor markets against the likelihood that the better-than-expected data could prompt the Federal Reserve to begin tapering its bond purchases as early as next month.

The S&P 500 Index was down for the week through November 7 but turned sharply higher on November 8. Foreign developed- and emerging-market equities were also in modestly negative territory heading into the last trading day of the week, based on MSCI indexes.

Fixed-income markets were generally mixed amid confusion about the direction of interest rates. After trading within a relatively narrow range for most of the week, the yield on the bellwether 10-year Treasury note spiked 15 basis points (0.15%), to 2.75%, in the wake of the October payrolls release. Among other fixed-income sectors, emerging-market debt weakened slightly during the week, while high-yield bonds continued to show resilience.

Current market updates are available here.

Financial Services

Upside surprises in latest economic data: “noise” or clear signals?

The trajectory of the U.S. economy over the past few months has been marked by decelerating growth in income, consumer spending, and employment, among other indicators. In many cases, the government shutdown exacerbated weakening trends. During the past week, however, some key data releases seemed to undercut the recent narrative.

GDP growth. The U.S. economy grew 2.8% in the third quarter, its fastest pace in a year, according to the government’s advance estimate. This figure exceeded consensus expectations, as well as our forecast. Beyond the headline number, however, were some areas of concern, including:

- A moderately weak consumer sector
- Inventory build-up that accounted for a disproportionate share (+0.8%) of GDP growth, given lackluster demand

The increase in inventory spending without corresponding growth in demand is a negative omen for fourth-quarter GDP. This is because businesses will have little need to boost inventory spending in the fourth quarter, having already restocked their shelves.

Monthly payrolls. The Labor Department reported that the economy added 204,000 jobs in October, far exceeding consensus expectations. Moreover, job creation for August and September was revised upward by a combined 60,000. We eye this report with some caution. The monthly employment series is notoriously volatile, and the government shutdown likely caused distortions in the data. However, if this report is confirmed by another strong jobs number in November, we would not be surprised if the Fed decides to move up its tapering timeframe from March 2014 to late 2013, as many market participants are now anticipating.

Personal income. Personal income growth was strong in August and September. Healthy income growth tends to show up as higher consumption growth with a one- to two-month lag. If this trend continues, it might translate to an upside surprise for the holiday shopping season and a boost to fourth-quarter GDP.

Europe’s central bank delivers a surprise of its own

The European Central Bank (ECB), which had been expected to hold short-term interest rates steady, instead lowered the rate at which it lends to banks, from 0.50% to 0.25%. The ECB lowered rates because inflation in Europe has remained well below the central bank’s target level of 2%; inflation that is too low can undermine growth, a key concern for the eurozone economy as it slowly climbs out of a long recession. During the week, an improved Purchasing Manufacturers Index (a gauge of manufacturing activity), along with corporate earnings reports that beat expectations, provided a boost to European markets, while a downgrade of France’s credit rating weighed on returns.

Outlook

Based on the surprising data released during the past week, it's tempting to conclude that the U.S. economy, which has been slowly decelerating, has suddenly sprung back to life. The latest readings on employment and income represent the clearest signal we have seen for some time that the economy is moving in the right direction, and it is possible that the private sector is stronger than we have accounted for.

On balance, however, we remain somewhat cautious in light of the potential "noise" in the recent data, and because we expect such distortions may continue. We need to see another few months' worth of data to confirm the positive trends. Accordingly, our current forecast for fourth-quarter GDP growth remains at 2% for now.

In equity markets, the U.S. has entered a choppy period as October's gains are digested and extremes of both price and sentiment are corrected. In general, smaller and riskier stocks have been sold in favor of larger and safer sectors. The index of the largest 100 stocks in the S&P 500 is almost back to its late October high. More generally, stocks with the greatest gains year to date appear ripe for selling as investors move to lock in gains for the year. Overall, we remain optimistic that the S&P 500 has continued upside potential, supported (for now) by Fed policy and steady corporate earnings expectations for 2014.

It is too early to tell if the past week's data means that a December timeframe for tapering is back on the table. What remains clear is that equities will likely stand to benefit more than bonds in a rising rate and/or tapering environment. Regardless of the timing, we believe the Fed is intent on minimizing the scope of rate increases and preserving accommodative monetary policy until the economy achieves "escape" velocity—i.e., the ability to sustain growth without Fed support.

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