Weekly Market Update

U.S. equity markets reach new highs despite a listless economy

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ARTICLE HIGHLIGHTS

- Fed chair nominee Janet Yellen's testimony claims the spotlight.
- U.S. and global stocks continue their broad advance.
- Bond markets are calm, posting moderate gains.
- U.S. economic releases confirm a weak start to the fourth quarter.
- Markets are anxious for details about China's potential economic reforms.

November 15, 2013

U.S. equity markets quietly rose to new record highs during the past week. There was no clear catalyst for the upward move, although investors appeared to take heart from Federal Reserve chair nominee Janet Yellen's congressional testimony, in which she reinforced the Fed's commitment to maintaining its supportive monetary policies.

For the week through November 14, the S&P 500 Index was up 1.1%, closing in on the 1,800 threshold—a level we have been expecting the index to reach in 2013. Based on MSCI indexes, foreign developed stocks gained a lesser 0.4%, while emerging markets were slightly negative, returning -0.1% before bouncing back on November 15.

Yellen's testimony also gave a modest boost to fixed-income markets. Sector returns ranged between 0.1% and 0.5% for the week through November 14, while the yield on the bellwether 10 year Treasury note fell from 2.8% to 2.7%. Overall, however, it was a better week for equities than for fixed income, suggesting that the two markets might be interpreting the Fed's signals slightly differently. While both markets anticipate continued accommodation from the Fed, fixed-income markets seem less convinced that future Fed policy will be as supportive as equity markets expect (or hope) it will be.

Current market updates are available here.

Financial Services

The week's U.S. data releases are few and uninspiring

There were scant noteworthy U.S. economic releases during the week, and nothing to alter our forecasts or move the markets. What little information was released indicated a sluggish start to the fourth quarter, confirming our expectations. Mortgage applications were down, the trade gap widened, and productivity gains were weak. The week of November 18 should be more illuminating, as several key indicators—including October retail sales, inflation, and existing home sales—are slated for release.

European stocks notch six-week winning streak, but GDP growth slows

European stocks extended their climb, but returns were flatter than they had been in the previous few weeks. Equities appear fairly valued on a price-to-earnings (P/E) basis, and the market is waiting for a better earnings picture and economic reforms before moving higher. Meanwhile, GDP growth in the eurozone slowed sharply in the third quarter, to 0.4%, from a downwardly revised 1.1% in the second quarter.

China's proposed reforms may support emerging-markets growth

In China, the conclusion of the Communist Party's Plenum (a three-day congress on economic reforms) left markets notably unimpressed, at least initially. Billed as a platform for unveiling significant market-oriented reforms, the Plenum instead issued an opaque statement that failed to provide policy details or convince skeptics that the Chinese government is serious about reform. In response, Chinese equities declined nearly 2%.

Since the preliminary statement on November 13, however, some favorable policy details have been leaked, and markets have responded favorably. For now, a key takeaway is that there will be no massive upheaval in China's economy or markets in the short term, while in the long run, market-based policies will be implemented to sustain growth. As a result, China's growth trajectory could hold at current accelerated levels in 2014.

If China remains on track, emerging-markets growth could be better than current pessimists expect. This view is supported by the promising start emerging-market economies are seeing in the fourth quarter. In October, the HSBC Composite Emerging Markets PMI (Purchasing Managers Index), measuring both manufacturing and service-sector activity, rose for the third consecutive month, to 51.7. (Readings above 50 indicate expansion.)

Japan surprises, but we remain unconvinced

Japanese equities surprised us with their continued strength (+2.1% for the week through November 14), which has been driven by a weaker yen and better sentiment regarding China. Although we have been wrong about further declines in this market, we remain skeptical about the sustainability of Japanese growth given the very slow pace of economic reform and the reluctance of Japanese corporations to both invest and raise wages. Japan's GDP growth fell to 1.9% in the third quarter, just half of the 3.8% growth it reported for the second quarter.

Outlook

While we welcome the S&P 500's climb, we remain concerned about the extended nature of the market's rally, especially in light of elevated short-term sentiment, which has reached optimistic levels that usually precede a correction. That said, this is a seasonally strong period for the market, and longer-term measures of sentiment remain subdued. Further upside beyond the 1,800 level is conceivable.

Our 2014 outlook for U.S. equities remains positive as well. Historically, when the market has advanced more than 25% in a year that gain has been followed by a further rise of up to 10% the year after. Of course, there are no guarantees that this historical pattern will repeat itself next year. In addition, market volatility will likely increase as the Fed's tapering timeline unfolds.

We continue to believe that fixed-income markets are fundamentally strong: the risk of corporate defaults remains low, corporate releveraging (the accumulation of debt following a period of paying it down) is modest, and liquidity for nearly all issuers is healthy. The mortgage sector is also on solid footing, as the housing market should continue to benefit from home-price increases in 2014, albeit at a slower, single-digit pace.

In our view, the primary risks to fixed-income markets are technical, relating to exactly when, how, and how quickly the Fed moves to taper and then shift to a more normalized interest-rate environment. Working in the bond markets' favor is that the Fed understands that anything more than modest rate increases would threaten to derail the economic recovery. This should help temper the speed and severity of rate increases that occur when the Fed decides to act.

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