Weekly Market Update

A strong jobs report helps turn the market

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ARTICLE HIGHLIGHTS

- Strong jobs numbers stop stocks from sliding.
- Positive economic data helps push the 10-year Treasury yield higher.
- Europe and China need to address lending issues.
- We see short-term rates remaining low, but long-term rates rising.
- While an equity pullback is certainly likely, the long-term outlook for stocks remains good.

December 6, 2013

The S&P 500 was down for the week through December 5 but turned sharply higher during early Friday trading after the release of a solid November jobs report. Markets were especially interested in these results following October's strong employment numbers as consecutive strong monthly employment gains could put the Fed back on track toward an early tapering of asset purchases. Foreign-developed and emerging-market equities also were in negative territory for the week's first four days, based on respective MSCI indexes; many rebounded during Friday trading.

In fixed-income markets, the employment report and the week's other positive economic releases helped push Treasury yields from 2.81% on Monday to 2.93% just after the jobs data was released. Spreads, which measure the difference in yield between various fixed-income instruments and comparably-dated U.S. Treasuries, remained flat or tightened slightly, partly because of a decline in new-issue supply as year-end approaches combined with relatively constant investor demand.

Current market updates are available here.

A solid jobs report headlines a largely positive week

The Labor Department reported that the economy added 203,000 jobs in November, handily exceeding expectations. Additional employment figures were also encouraging. The number of hours worked rose, as did hourly wages, and

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the unemployment rate fell from 7.3% to 7.0%, its lowest level since November 2008. Monthly employment gains have now topped 190,000 during the fall.

During the week, a slew of data points showed upside surprises mixed with some disappointments. Overall, though, the underlying trend was positive.

On the upside:

- The U.S. economy expanded by a 3.6% annual pace in the third quarter, the fastest increase in a year and a half. A look below this impressive revised gain reveals some underlying weakness, including the largest spike in inventories since 1998 and a deceleration of consumer spending.
- Jobless claims dropped by 23,000 to 298,000, the lowest level since early September.
- The Institute for Supply Management manufacturing index hit 57.3 from 56.4 in October, reaching the highest level in more than two years. And the final Markit U.S. Manufacturing Purchasing Managers Index registered 54.7 in November, up from 51.8 in October. (Readings above 50 indicate expansion.)
- Automakers reported their best U.S. sales month in more than six years.
- Consumer sentiment rose to its highest level in five months, according to a University of Michigan and Thomson Reuters index.

On the negative side:

- The ISM survey of non-manufacturing purchasing managers—executives who buy supplies for their companies—fell in November.
- The U.S. housing market's recovery remains a bit lopsided. According to CoreLogic, home prices in 12 states remain at least 20% below local peak levels.

Europe and China face lending issues

In Europe, manufacturing indexes in France and Italy have turned lower. European capital investment as a percentage of GDP is running below historical averages. A critical element to better European growth will be bank lending. In early 2014, as the ECB will conduct its Asset Quality Review bank stress tests.

We are hopeful that this review process will conclude by mid-2014. After that point, we believe that the ECB may introduce programs that could stimulate lending and improve liquidity. If our expectation comes to pass, current European growth expectations may prove low, which in turn could lead to dramatically better profit and market growth.

China also faces credit issues. However, China's challenge is to tame its lending-fueled growth without derailing overall growth. For next year, our fear is that a drain on liquidity could serve as a headwind, although the long-term outlook is better if the new administration follows through on its pledge to enact market-based reforms.

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Outlook

While tapering may start this month or next, we anticipate a reduction in asset purchases no sooner than March. But before tapering, the central bank needs to see stable jobs growth and a congressional deal on spending and on raising the debt limit. Additionally, the Fed wants to avoid causing a spike in interest rates. To gauge interest-rate movements, we will watch Treasury spreads between the 2-year and 5-year compared to the 10-year.

When tapering does begin, communications regarding the commitment to keeping rates low for as long as possible will anchor the short end of the yield curve. In all likelihood, the Fed won't begin raising rates until late 2015 or early 2016. Fed funds futures, interest-rate contracts that allow investors to bet on rate hikes, are aligned with this view. With the short end anchored, the 10-year is expected to rise to 3.25%, creating a much steeper yield curve.

Just as investors aren't sure when tapering will begin, it's equally unclear how different asset classes will ultimately react to a decline in the liquidity levels currently provided by the Fed, although higher volatility is likely. Adding assets with shorter maturities to a portfolio can help reduce the negative effects of rate increases. So can adding spread products (higher-yielding, non-U.S. Treasuries, including corporate securities), which are less sensitive to interest rates and are attractively priced based on our expectations for low default rates.

U.S equities remain fairly priced but are edging toward expensive. We remain concerned that very bullish sentiment may be setting the stage for a correction at some point in the near future. In fact, we would not be surprised by a 5% pullback in the S&P 500. However, we believe that the U.S. can again move to new highs in 2014 and for now expect another positive return for equities, although that expectation may be tempered by higher rates. This is a critical factor we will monitor.