Weekly Market Update

Economy up, markets down: a familiar theme as tapering nears

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Article Highlights

- Equity markets decline as improving retail sales spark December taper fears.
- Most bond sectors are flat, but investment-grade and high-yield corporate bonds post gains.
- Reported budget deal in Washington eases near-term fiscal gridlock.
- We continue to anticipate new equity market highs in 2014, but with heightened volatility.
- Our fourth-quarter forecast for GDP growth remains unchanged at 2%.

December 13, 2013

After marking a new high on Monday, December 9, the S&P 500 Index reversed course and declined in the latter half of the week. The sources of weakness were many, including:

- fear that Federal Reserve tapering will begin as early as December 18
- technical exhaustion (signs that the market may have peaked in terms of demand for stock)
- rising 10-year Treasury rates
- negative earnings revisions

For the week to date through December 12 the S&P was down nearly 2%. Foreign developed- and emerging-market stocks fell by a similar amount, based on MSCI indexes.

Fixed-income returns were generally flat during much of the week, although certain “spread sectors” (higher-yielding, non-U.S. Treasury securities) showed relative strength, including investment-grade and high-yield corporate bonds, as well as emerging-market debt. The yield on the bellwether 10-year Treasury note crept higher during the week, closing at 2.89% on December 12.

Current market updates are available here.

Financial Services

Improving retail sales highlight the week's U.S. data releases

Data released during the past week offered evidence of improving conditions in the U.S. economy, once again prompting market concern that the Fed is poised to pull the taper trigger at the conclusion of its Federal Open Market Committee (FOMC) meeting on December 18. Among the releases were retail sales, which have improved markedly since September:

- Retail sales excluding autos rose 0.4% in November, ahead of expectations.
- Including autos, retail sales were up 0.7%, the most since June.
- These favorable readings, combined with improving inventories at the manufacturing and wholesale levels in October, suggest that inventory spending could grow faster than many expect.

Other data reminded us that economic performance remains somewhat uneven. Inflation was flat to negative in November, an indication of lukewarm demand in the economy. In addition, first-time unemployment claims spiked to 368,000, a level we should not be seeing at this stage of the recovery. On balance, the week's releases were in keeping with our forecast for fourth-quarter GDP growth, which remains unchanged at 2%.

Europe continues to face challenges

Europe is a source of increasing near-term concern:

- While we continue to expect economic expansion, GDP growth in the eurozone appears vulnerable to falling short of consensus expectations of 0.9%.
- The euro has risen against the dollar, which curtails European exports, as the European Central Bank (ECB) recently refrained from lowering interest rates, and inflation remains low.
- Liquidity in Europe's banking system is subpar, and the ECB's current asset quality review (stress tests) further suppresses lending, as such reviews can encourage bankers to shrink their balance sheets and tighten credit standards.
- Earnings estimates for European companies are being cut while short-term market sentiment is elevated—a poor combination for investors.

Chinese stocks move lower, but economic releases are encouraging

Chinese equity markets moved lower during the past week on concerns that policymakers will cut expected GDP growth rates from 7.5% to 7%. Meanwhile, real-time economic data out of China has been very good. Vehicle sales grew 16%, bank loans 14%, money supply (M2) 14%, retail sales 14%, and industrial production 10%.

Outlook

The reported budget deal in Washington, while narrow in scope, eases near-term gridlock and provides fiscal clarity for the next two years. This will likely boost confidence and stimulate both consumer spending and corporate investment, each of which has been subdued despite a favorable macro backdrop.

There is very little consensus as to when Fed tapering will begin, although a strong case can be made for either December or March. As of this writing, we think there's a 50/50 chance that either will occur. Regardless of the timing, we continue to believe that market apprehension about tapering is disproportionate to the actual impact it will have. Moreover, assuming the Fed provides clear forward guidance as expected, we think equity markets will respond positively.

We are not alarmed by what appears to be a normal mid-cycle correction for U.S. equities. As we have noted before, the S&P 500 is long overdue for a pullback of 5% or more. Whether now is the time for this to occur remains to be seen, as December is typically a seasonally strong period for stocks. We continue to anticipate new market highs for equities in 2014, but with heightened volatility.

Despite recent losses, European equities remain on track to deliver favorable returns for 2013 as a whole. Valuations remain cheap and risk premiums are wide, but we are concerned about further downward pressure on stock prices. The market has already corrected more than 5% and could extend that to 10%.

In fixed-income markets, some of the recent rally in spread sectors reflects a continued decline in the supply of new issues against fairly stable demand. However, there is also an underlying sense that, while bond markets may be more challenged than equities in the months ahead, it is still possible to find attractive value, particularly if investors are cautious about their duration exposure. (Duration is a measure of a bond's sensitivity to changing interest rates, with shorter-term securities generally less vulnerable to sharp price declines when rates rise.)

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Many investors will continue to benefit from allocating a portion of their portfolios to fixed income. As Fed liquidity is gradually withdrawn, however, we are likely to see a new set of fixed-income outperformers, including investment-grade corporate bonds, which have rebounded after lagging for much of the year and may be poised to continue their recent outperformance in what we expect will be a gradually (rather than rapidly) rising interest-rate environment. Overall, we will continue to focus on asset allocation across fixed-income sectors while also seeking to add value through individual security selection.

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