Weekly Market Update

Equity markets rally on Fed's decision to taper

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Article Highlights

- The Fed ends months of speculation with December tapering announcement.
- Neither the Fed's decision nor market reactions lead us to alter our outlook.
- Third-quarter GDP grew at an upwardly revised rate of 4.1%.
- We maintain a positive outlook for U.S. equity performance in 2014.
- Fixed-income returns should be modest, but potentially higher than in 2013.

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On December 18, the Federal Reserve put an end to months of speculation by announcing that it would begin to taper its quantitative easing (QE) asset purchases. The Fed, which has been buying $85 billion of U.S. Treasuries and mortgage-backed securities every month since September 2012, will reduce this monthly amount by $10 billion beginning in January 2014.

In its public statement, the Fed said the decision to taper was based on "improvements in economic activity and labor market conditions" that are "consistent with growing underlying strength in the broader economy." Further reductions in monthly asset purchases will follow if the economy's current growth trajectory continues.

Market reaction is broadly positive—for now

During the past year, markets tended to react negatively whenever improving economic data or Fed comments appeared to raise the odds that tapering would begin sooner rather than later. When "taper talk" finally turned into taper reality, however, stock markets celebrated, with the S&P 500 Index gaining 1.7% on December 18, its largest one-day gain in more than two months. Developed- and emerging-market equities also rallied on the news, based on MSCI indexes.

Meanwhile, U.S. Treasury markets were much more muted in their response than they had been earlier in the year, when fear of imminent tapering caused the 10-year yield to spike from 1.66% on May 1 to nearly 3% on September 5. In fact, the 10-year yield rose only moderately in the wake of the Fed's December 18 announcement, from 2.89% to 2.94%. This type of measured response, which we

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anticipated, suggests the market now understands that "tapering" is not the same thing as "tightening." The Fed's guidance made this distinction clear, indicating that tapering will wrap up by late 2014 while short-term interest rates will remain at their current near-zero levels until late 2015.

Nonetheless, we still need to monitor Treasury yields closely, the movement of which will depend on the perceived pace of economic expansion. A sharp rise in the 10-year yield above 3%, and/or higher yields on short-term securities, could prove an impediment to equity price gains.

Current market updates are available here.

U.S. economy continues to strengthen

The balance of U.S. economic releases leaned positive during the week, although some specific data points bear watching. Housing metrics in particular have seemingly been telling a tale of two markets over the past few months, with new home sales activity picking up, while existing home sales continue to slow. Overall, demand for residential housing remains, even with higher mortgage rates, and buyers still favor the new home market, which should continue to provide support for builders. We expect existing home sales to reaccelerate next spring.

Also notable was an upward revision to the government's estimate of third-quarter GDP growth, from 3.6% to 4.1% on an annualized basis—the fastest pace of expansion in two years. The increase was driven largely by higher consumer spending and business investment in software, along with improved international trade.

European equities rally on Fed taper, but challenges remain

European equities responded favorably to the Fed's tapering decision, as the euro retreated sharply from its near-term highs against the dollar. A weaker euro benefits European exports, so this is an important positive for the region's economy, though not a cure-all. Among the challenges still facing the eurozone:

- liquidity remains tight
- the European Central Bank's (ECB's) balance sheet has contracted
- money growth has slowed
- bank loans are shrinking
- industrial production has moved lower.

Given the ECB's current monetary stance, which we believe is relatively tighter than it should be, we could see the euro move higher again, particularly if the pace of U.S. growth is slower than anticipated. This would likely set the stage for some sort of ECB policy response later next year, which in turn could jumpstart the equity market.

Japan benefits from a weaker yen, while Chinese equities slip

The yen continued to weaken, a positive development for Japanese exporters and for the government's attempt to reintroduce inflation into the economy. The Nikkei 225 Index rose accordingly.

China's Purchasing Managers Index (PMI), a key measure of manufacturing activity, weakened, but remained above the 50 threshold separating expansion from contraction. This weakness, along with market anxiety over receding liquidity, drove Chinese stock prices lower, nearing levels that could cause us to revise our bullish expectations.

Outlook

Nothing in either the Fed's tapering announcement or in market reactions lead us to change our expectations for the path of interest rates or the U.S. economy over the coming year. On balance, the economy is finishing 2013 on a positive note. Lead indicators are strengthening, consumer and corporate sentiment are brightening, and the recent budget agreement has added fiscal spending back into the equation. Meanwhile, economies in other parts of the world are stabilizing or growing modestly.

For equities, this favorable backdrop is complicated by short-term trading sentiment that, while slightly less bullish than it has been of late, remains elevated and in a zone that typically anticipates corrections. For that reason, we would not be surprised to see a market decline in the near term, although we maintain a positive outlook for U.S. equity performance in 2014.

In fixed-income markets, we expect to see some increased volatility in the coming months, as economic releases will have the potential to move Treasury yields considerably in one direction or another. Nonetheless, we have not altered our previously stated view that the 10-year Treasury yield will hover around 3% at the onset of tapering and gradually rise to about 3.45% toward the end of 2014, with possible further upside. Overall, we believe 2014 will be a year of modest returns for a diversified fixed-income portfolio, as price declines reduce the benefit of interest (coupon) income, although total returns could surpass those of 2013.

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