Weekly Market Update

Weak December jobs report takes markets by surprise

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Article Highlights

- Treasuries rally as December's low job creation tempers fears of rapidly rising interest rates.
- Upward revisions to the employment report are likely, and longer-term trends are positive.
- U.S. equities stage a modest comeback following the New Year's opening weakness.
- The drop in the unemployment rate could complicate the Fed's return to tighter monetary policy.
- We have raised our forecast for fourth-quarter U.S. GDP growth to 2.7% from 2.0%.

January 10, 2014

The week was capped by a sharp downside surprise in the Labor Department's monthly payrolls report for December. Only 74,000 new U.S. jobs were created last month—a three-year low and a far cry from consensus expectations of about 200,000. U.S. Treasury markets, clearly poised for a much stronger number, rallied in response, with the yield on the bellwether 10-year note falling to 2.87% in mid-day trading on January 10, after closing above 3% earlier in the week.

Other fixed-income categories also showed some resilience during the past week, as many market participants have significant amounts of cash and are beginning to put it to work. Investor flows into both investment-grade and high-yield corporate bond funds remained supportive of these sectors. Meanwhile, outflows continued for emerging-market debt and municipal bond funds.

U.S. equities made a comeback following lackluster performance in the opening days of 2014. Equity markets entered the New Year faced with the prospect of an improving economy and better corporate earnings, offset by fears of higher interest rates and possibly accelerated Federal Reserve tightening (although December's feeble employment data likely tempered that concern, at least in the short term). For the week to date through January 9, the S&P 500 Index was up 0.65%. Based on MSCI indexes, foreign developed- and emerging-market stocks were flat to slightly negative for the same period.

Current market updates are available here.

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Putting the employment report in perspective

While bond markets were quick to react to the December jobs report, we caution against reading too much into the depressed payrolls number. Extreme cold weather undoubtedly distorted the data, potentially reducing the number of new jobs created by 50,000 to 100,000, according to some estimates.

We remain focused on the longer-term trend of strengthening employment growth that we saw during the second half of 2013. (In fact, November's payrolls were revised upward, to 241,000 from 203,000). December's report merely suggests that monthly job creation remains in the 175,000-200,000 range, on average, as opposed to an elevated level between 200,000 and 225,000, as some consensus forecasts have projected.

Moreover, other recent employment gauges have remained solidly positive, including:

- weekly first-time unemployment claims, which declined to 330,000 in the most recent week (only slightly higher than earlier fourth-quarter lows);
- private payrolls, which jumped by 238,000 in December—the biggest gain in a year—as measured by the Automatic Data Processing (ADP) survey;
- employment sub-indexes of various production-related measures;
- favorable hiring intention surveys; and
- improving layoff statistics.

Given the weight of these and other indicators of the health of the labor market, we believe the December jobs report will be revised upward in coming months.

Other U.S. indicators continue to improve

Beyond the employment picture, U.S. economic data releases have generally been good but not spectacular.

- The jury is still out on holiday retail sales, although spending surveys released so far have been moderately positive.
- Business spending also appears to have held up fairly well during the fourth quarter, with increased expenditures on inventories, capital goods, and hiring.
- U.S. exports continued to rise, while higher domestic energy capacity continued to drive imports down. The result was a substantial improvement in the U.S. trade deficit in November ($60 billion lower versus a year ago).

On the downside, surveys of trucking activity have weakened, auto production schedules are sharply lower, and state tax receipts have declined. Another factor that gives us pause with regard to the strength of the recovery is the recent drop in oil prices. While this acts as a tax cut for consumers and is stimulative, it could also reflect ongoing global weakness in demand, specifically from China.

Outlook

Overall, we have raised our fourth-quarter GDP forecast to 2.7% from 2.0%. This would increase the average 2013 GDP growth rate to 1.9%.

Although we take the December jobs report with a grain of salt, in the near term we recognize that the downside surprise does make it difficult to assess with precision the actual pace of job creation. Moreover, the drop in the national unemployment rate, to 6.7% from 7%, primarily reflects a sharp decrease in the participation rate (the percentage of workers either employed or actively looking for work), not a material improvement in the jobs picture.

The distinction is important, because the Fed eyes 6.5% unemployment as its stated threshold for resuming tighter monetary policy but may be reluctant to signal a hike in short-term rates if unemployment falls to 6.5% or lower for the wrong reasons, particularly when average hourly earnings remain disappointing. We will be monitoring employment data closely and watching for further quantitative guidance from the Fed.

Regarding equities, the S&P 500 remains vulnerable to a correction. There is widespread recognition that the market is extended and that sentiment is elevated, although we are not really at "white hot" extremes. Therefore, while we would not be surprised by a significant pullback at some point in the near future, it may occur from a higher level than where the market is now.

In fixed-income markets, if weaker payroll growth continues, it could translate into a slower pace of Fed tapering, which would support higher-risk assets and help reduce pressure on emerging-market debt. Default risk in the high-yield sector remains exceptionally low by historical standards, and the likelihood of shareholder-friendly activities such as leveraged buyouts should be contained in the investment-grade space. Corporate credit continues to offer appeal as a core allocation in fixed-income portfolios, while emerging-market and municipal bonds face a tough year ahead, albeit one that should be better than last year. Our outlook continues to call for modestly higher Treasury rates in 2014, but we believe fixed income already weathered the worst of the difficult environment in 2013.

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