Weekly Market Update

Markets are mixed as economic releases suggest building momentum

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Article Highlights

- U.S. equity markets are choppy but generally positive for the week.
- Treasury markets continue to rally in aftermath of December's poor jobs report.
- Municipal bonds post gains and see positive fund flows for the first time in months.
- The U.S. economy may have grown faster than expected in the fourth quarter.
- We have raised our forecast for first-quarter GDP growth to 2.9% from 2.7%.

January 17, 2014

U.S. equity markets were choppy during the past week. The S&P 500 Index fell 1.3% on January 13 but turned sharply higher in subsequent sessions, closing at a new record high by midweek before slipping into directionless late-week trading. As in the previous week, there was no clear impetus for the market's volatility, although the tension between an improving economy and fear of Federal Reserve tightening remained a potential culprit. Non-U.S. equities also had an uneven ride, with European shares boosting developed markets and China weighing on emerging markets.

In fixed-income markets, U.S. Treasuries rallied during the week as many investors favored safer assets amid equity volatility and lingering concerns about the previous week's poor December jobs report. The yield on the bellwether 10-year Treasury note continued its recent decline from the 3% threshold where it began the year, hovering around 2.82% in midday trading on January 17. Weekly fund flows were positive for high-yield and investment-grade corporate bonds, high-yield loans, and—for the first time in nearly nine months—municipal bonds. Muni bonds have rallied following last year's sharp selloff, thanks to relatively stable interest rates and improving fundamentals for many state issuers as tax receipts rise. Emerging-market debt funds continued to see outflows, albeit at a moderating pace.

Financial Services

Markets are mixed as economic releases suggest building momentum

Current market updates are available here.

U.S. growth may have been stronger than expected in the fourth quarter

On balance, data released during the past week showed the U.S. economic picture brightening, if not quite shining.

- Consumers spent at a faster clip in December, with **retail sales** climbing 0.2% (+0.7% excluding autos) for the month, ahead of consensus forecasts for a 0.1% decline.
- **Business inventories** rose 0.4% in November, an indication that businesses think consumers will increase spending in the coming months.
- Weekly first-time **jobless claims** fell to 326,000, the lowest level in six weeks. The four-week moving average of claims, a less volatile measure, dropped to 335,000.
- **Industrial production** (+0.3% in December) and an uptick in the capacity utilization rate to 79.2% suggest that factories are finally starting to run up against capacity constraints, which is why we have begun to see companies announce plans for capital expenditures.
- **Regional indexes** of manufacturing activity published by the New York and Philadelphia Federal Reserve Banks exceeded forecasts. Additionally, the **"Beige Book"**—an anecdotal assessment of economic conditions in all 12 Fed districts—showed activity generally increasing in December, with gains in commercial real estate and construction, retail sales, energy, and non-financial services.

Other economic measures were more subdued, including housing starts and building permits, although slight softness in these indicators for December was not unexpected. Meanwhile, inflation at the producer and consumer levels remained benign, with prices rising only 1.2% and 1.5%, respectively, on a year-over-year basis.

The takeaway from the most recent batch of data is that the economy may have picked up a bit more steam than we originally thought in the fourth quarter. The government's initial estimate of fourth-quarter GDP growth, scheduled for January 30 release, will be instructive. We raised our estimate for fourth-quarter GDP growth to 2.7% last week, but the bias is likely more to the upside.

Europe’s sovereign debt performance improves despite political risks

Sovereign bond yields in peripheral European markets such as Italy and Spain have continued to decline—a phenomenon that appears to be at odds with the continued political risks that the eurozone will face in the coming year. These risks include, among others, potentially destabilizing elections in Italy, Greece, and Cyprus, as well as a long-delayed German high court ruling on the constitutionality of the European Central Bank’s sovereign bond-buying program. While not posing a significant near-term threat, together these risks underscore that improvement in Europe may not occur in a straight line.

On a positive note, French president Francois Hollande declared that France needs new policies to fuel economic growth—a heartening prospect for an economy that is now one of the weakest in Europe. While we will need to see evidence that his intent is enabled, the admission of weakness was a key first step toward altering an unsustainable dynamic.

Emerging markets continue to strive for improvement

Emerging markets continue to seek solid footing after recent selloffs. Economic results have improved at the margins, as measured by recent indexes of activity in the BRIC nations (Brazil, Russia, India, and China). While equity valuations and expected returns in emerging markets look attractive, we are concerned about consistent weakness in emerging-market currencies.

Outlook

In the U.S., it appears that the fourth quarter’s economic momentum is continuing into 2014, particularly on the business side. Announced capital expenditure budgets have increased substantially in the past few weeks, while spending on plant and equipment is rising, and spending on inventories appears to be holding up. Moreover, we expect employment growth to pick up from December’s abnormally weak reading. Overall, we are raising our first-quarter GDP growth estimate from 2.7% to 2.9%.

The choppy equity market action of the past few weeks has eroded the overly optimistic investor sentiment that we have frequently cited as a source of concern. The gauges of short-term trading sentiment that we analyze have backed off their extreme highs, and hedge funds have lowered their net exposures to equities. These trends reinforce the notion that a significant market correction, while overdue, may well come from higher levels.

In fixed-income markets, we view the underlying strength in many state balance sheets as evidence that the economy continues to heal, and we expect future jobs releases to support this case. Against a backdrop of economic strengthening in 2014, it remains prudent to expect moderate interest-rate increases in the coming months, with varying impacts on fixed-income assets, depending on their interest-rate sensitivity.

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