Weekly Market Update

Markets retreat on discouraging news from China and Latin America

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ARTICLE HIGHLIGHTS

- Stocks fall sharply on Thursday and Friday amid emerging-market weakness.
- Treasuries rally as investors shun riskier assets.
- U.S. economic releases are scant and uninspiring.
- Growth in Europe remains a concern, although there are some bright spots.
- Japan and China still need to push the pedal on reform.

January 24, 2014

After moving sideways during the past week's first two trading days, stocks worldwide fell sharply on Thursday and Friday, with weak manufacturing data from China and worries about growth in Latin America. A batch of relatively soft U.S. economic data added to investors' concerns. Emerging-market stocks were particularly hard hit, falling 1.28% on January 23 based on the MSCI index, while the S&P 500 Index dropped 0.89%. Losses were even steeper on January 24, pushing year-to-date returns for these indexes further into negative territory.

With their aversion to emerging markets and other volatile assets increasing as the week ended, investors shifted into safe havens such as U.S. Treasuries. As Treasury prices rose, their yields fell. The bellwether 10-year note closed at 2.79% on January 23, a seven-week low, and reached 2.71% during early trading on the 24th. Based on the Barclays index, the broad U.S. investment-grade bond market posted modest gains for the week through January 23. High-yield corporate bonds finished essentially flat.

Current market updates are available here.

The economy continues to expand, but at a slower pace than in the fourth quarter

Data released during the week of January 13 showed that the U.S. economy may have picked up a bit more steam in the fourth quarter than we had originally thought. The most recent data, however, reveal an economy that is still moving on a positive track but with a little less vigor. Among the weaker releases:

- **First-time unemployment claims** edged up by 1,000 to a seasonally adjusted 326,000. The total of new applications, although higher, remained near a post-recession low.
- Although only a "flash" (preliminary) estimate, the **Markit Purchasing Managers Index (PMI),** a gauge of manufacturing activity, slipped to 53.7 in January from 55.0 in December. (Readings above 50 indicate expansion.) This reading, partly attributable to unusually cold weather, signaled the slowest improvement in manufacturing conditions since October but was above the average for 2013.
- The Conference Board's **leading economic index** ticked higher (+0.1%) in December, marking the sixth gain in a row, although the reading fell short of estimates.

Slow growth in Europe remains a concern

While European economic data, as always, seems worrisome, a number of shifts are taking place that may alter the composition of growth in Europe:

- In **France**, we are increasingly encouraged by certain reforms that may indicate that even greater positive change is to come.
- Similarly, political shifts in **Italy** may set the stage for a more stable government and true economic reform.

However, on the negative side:

- Companies in **Spain** are closely tied to Latin America, which is now facing severe economic challenges that may pose a headwind to exports and corporate results.
- After a period of economic expansion in the **U.K.,** the Bank of England is set to begin raising interest rates, which may prove to be a market headwind.
- **Germany** looks strong in the short term, but there is concern that the addition of a new partner to the coalition government could lead to legislation that would damage German companies' cost competitiveness.

Reforms remain key in Japan and China

In Japan, we are concerned that a consumption tax slated to begin in April will slow down the economy in the second quarter. While it is possible that such a slowdown could lead to even more monetary easing, a weaker yen, and higher Japanese stock prices, it will be difficult for the country to emerge from its economic torpor without meaningful policy and legal reforms designed to increase wages and productivity, which have yet to be introduced. Furthermore, a yen that weakens below 120 to the dollar will lead to unhappiness on the part of Japanese trading partners, as well as trigger price inflation for imports, particularly energy.

In addition to fears of a sharper-than-expected slowdown in China, highlighted by the decline of January's flash PMI into contraction territory (49.6), a significant near-term issue is how much a contraction in credit availability will affect growth. Also of concern is how the government will address the failure of a so-called "shadow" trust

bank. Whether China will bail out investors or let them assume normal investment risks will be a key measure of the government's desire to reform the nation's financial markets.

Outlook

On balance, we believe the U.S. economy is still expanding. Many of the reports this month have been upbeat, or at least mildly positive. However, the overall picture is not as bright as it was in the fourth quarter. Notably, some reports suggest that bad weather may not have been as big a factor as previously believed in explaining December's disappointing jobs number. But while overall conditions may be slightly weaker, we expect the Federal Reserve to continue tapering its monthly bond purchases, given the overall picture of economic expansion.

For equity markets, the more measured pace of growth could paradoxically provide good news. As we have noted previously, the faster the economy expands, the more investors fear eventual Fed tightening, which could drive interest rates higher. So while strong growth is undoubtedly favorable for corporate earnings, the prospect of Fed action, with the accompanying rise in rates, may actually dampen equity gains.

In spite of the sharp drop in Treasury yields, we expect interest rates to rise modestly in 2014 as the economy continues on its upward path. In the coming weeks, fixed-income investors will look for cues from the equity markets, the Fed's upcoming meetings, and upcoming economic releases.

During the past week, net flows into fixed-income funds remained positive for both high-yield and investment-grade corporate bonds. Investors should be aware, though, that the S&P 500 Index remains vulnerable to a significant correction. If that happens, high-yield bonds, as well as commercial mortgage-backed securities and emerging-market assets, could suffer along with equities.

Financial Services

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