Weekly Market Update

Global concerns send markets lower, capping a volatile January

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Article Highlights

- Equities end a volatile week—and month—in negative territory.
- Emerging markets claim the spotlight amid falling currencies and economic pressures.
- Treasury markets extend their rally as investors seek safe-haven assets.
- Fourth-quarter GDP growth is a modest upside surprise, but other U.S. data softens.
- As expected, the Fed says it will taper its monthly bond purchases by another $10 billion.
- We still see potential for U.S. equities to move higher before a correction.

January 31, 2014

Global economic concerns contributed to a particularly volatile week in equity markets. Developments in Europe and the emerging markets, Fed tapering, and mixed U.S. economic data fueled wide daily swings in the S&P 500 Index, with the dominant trajectory being downward. Foreign developed- and emerging-market equities also declined, based on MSCI indexes.

Equity weakness was fully transmitted to fixed-income markets, which have become increasingly risk-averse. U.S. Treasuries rallied as investors sought their relative safety. Demand for Treasuries drove their prices higher and yields lower. The bellwether 10-year yield, which began the week at nearly 2.8%, was trading as low as 2.65% on January 31. Meanwhile, spreads (the difference between Treasury yields and those of higher-yielding, non-Treasury securities) widened across all categories, including high-yield bonds—which until recently had been relatively immune to the spread widening that has hurt other sectors.

Current market updates are available here.

GDP growth improves, while other U.S. data is mixed

A few weeks ago, we raised our estimate for fourth-quarter GDP growth to 2.7% while noting that the bias was likely more to the upside. This proved to be the case, as the government's advance estimate, released on January 30, came in at 3.2%. Growth was boosted by the biggest jump in consumer spending in three years and a healthy gain in net exports. Meanwhile, the government shutdown in

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October drove a sharp decline in federal government spending. Without that drag, the economy would have grown at a nearly 4% rate.

While the GDP number was encouraging, many of the past week's reports were weaker. Among the less favorable readings:

- **New home sales** fell 7% in December, while **pending sales of existing homes** were down nearly 9%, the most since October 2011.
- At the same time, **home prices** ticked down 0.1% in November but were up 13.7% versus a year ago, based on the S&P/Case-Shiller 20-City home index.
- **Consumer sentiment** was mixed. The Thomson Reuters/University of Michigan Index slipped in January, while The Conference Board's Consumer Confidence Index topped forecasts.
- First-time **unemployment claims** rose to a six-week high. However, we view the increase not as a trend, but rather a function of seasonal and weather-related anomalies.

As expected, despite some recent signs of economic softening, the Federal Reserve announced on January 29 that it will maintain the pace at which it is tapering its bond-buying program, reducing its monthly asset purchases by another $10 billion, beginning in February.

Emerging-market difficulties dominate the headlines

Currency weakness and market gyrations, especially in Turkey and Argentina, attracted the most headlines and investor attention during the week. However, we note that weaker emerging-market growth paradoxically can benefit developed markets, because such a slowdown keeps a lid on commodities prices. This, in turn, acts like a tax cut for developed markets.

Moreover, while emerging-market equities have produced poor returns, much of their underperformance relative to the U.S. and other developed markets has been driven by weaker local currencies. Otherwise, year-to-date equity results in emerging markets are generally in line with those of developed markets. We have already seen countries like Turkey, India, and South Africa hike interest rates to defend their currencies, and we will likely see more.

While the world worries about China, local investors remain calm

Among emerging markets, China is viewed as a primary source of vulnerability, with many economists recently scaling back their GDP forecasts to less than 7% growth in 2014. Of particular note are fears of a bursting property bubble, a potential collapse of the shadow banking system, and unfavorable currency moves. Given the opacity of China's economy, these concerns may have merit, but so far they seem to have been shrugged off by Chinese investors, as reflected in better performance by domestic equity indexes.

Europe's ties to emerging markets stoke volatility

European markets also felt the impact of global equity volatility, moving further into negative territory for the year to date. While the U.S. may be relatively insulated from an emerging-market slowdown, by some estimates Europe has up to one-third of its revenues tied to these markets. Any further weakening in emerging markets could persuade the European Central Bank (ECB) to introduce new monetary stimulus, especially with the annual rate of inflation falling to a record low in January. One possible measure that the ECB has mentioned is the purchase of European bank debt, similar to the Fed's quantitative easing program. This could meaningfully jump-start lending and growth.

Outlook

The U.S. economy remains on track for continued improving growth in 2014. Notably, the fiscal drag from October's government shutdown will fade, and government spending should become a tailwind. Against this economic backdrop, we expect the Fed to stay the course in terms of tapering and interest-rate policy.

In equity markets, while a further downturn is possible, we think the S&P 500 can continue to move toward the 1,900 level before a major correction (decline of 10% or more) would be triggered. Short-term sentiment has fallen sharply from bullish extremes, and with only a small percentage of companies trading above their 50-day moving average, valuations do not appear stretched. Additionally, earnings have been good: more than 70% of S&P 500 companies that have reported fourth-quarter results so far have beaten consensus forecasts.

In the fixed-income arena, there is growing concern that stress in the emerging markets could affect developed-market price valuations, particularly for riskier assets. Further, with the Fed maintaining its current pace of tapering, spreads will likely be vulnerable to further widening. The prevailing weak market sentiment could improve if we see a string of strong U.S. data releases, particularly on the jobs front. Overall, we continue to expect modest fixed-income returns in in 2014, with increased volatility in the near term.

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