Market & Investment Insights

2013 Fourth Quarter Equity Market Review

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Article Highlights:

- U.S. stocks moved higher in the fourth quarter, capping the best year for the S&P 500 since 1997, despite a government shutdown and the announcement by the Fed that tapering would begin in January.
- European equities trailed the U.S., but reacted favorably to the Fed's decision in December and finished strong.
- Emerging market equities were choppy, highlighted by concerns that China's economy is cooling, while important market reforms remained elusive.
- In Japan, the yen continued to depreciate during the fourth quarter, helping to fuel export growth and propelling the Nikkei Index near last spring's market highs.
- U.S. equities are at or close to fair value but can still generate gains in 2014, albeit with more volatility.
- Emerging markets are also beginning to look inexpensive. These markets may offer good expected returns in 2014, although periods of sharp volatility are possible.

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Developed market equities continue strong march in Q4

Global equity markets performed strongly across the board in the fourth quarter, despite protracted political wrangling over fiscal policy in the U.S. and economic uneasiness in many regions of the world. For the quarter, the S&P 500 Index advanced 10.5%, and the Russell 2000 Index (small-cap stocks) rose 8.7%. Based on MSCI indexes, foreign developed-market equities climbed 5.7% in the fourth quarter, led by Germany (+13.3%) and strong returns in peripheral European markets such as Spain (+11.4%) and Italy (+10.7%). The MSCI Emerging Markets Index gained a slight 1.8% during the quarter.

The fourth quarter capped an exceptionally strong year for U.S. stocks. For the year as a whole, the S&P 500 Index advanced 32% (its best performance since 1997), and the Russell 2000 Index rose 38.8%. Based on MSCI indexes, foreign developed-market equities (EAFE) climbed 22.8% in 2013, led by Japan (+27.2%) and Europe (+25.2%), as shown in Figure 1. The MSCI Emerging Markets Index,

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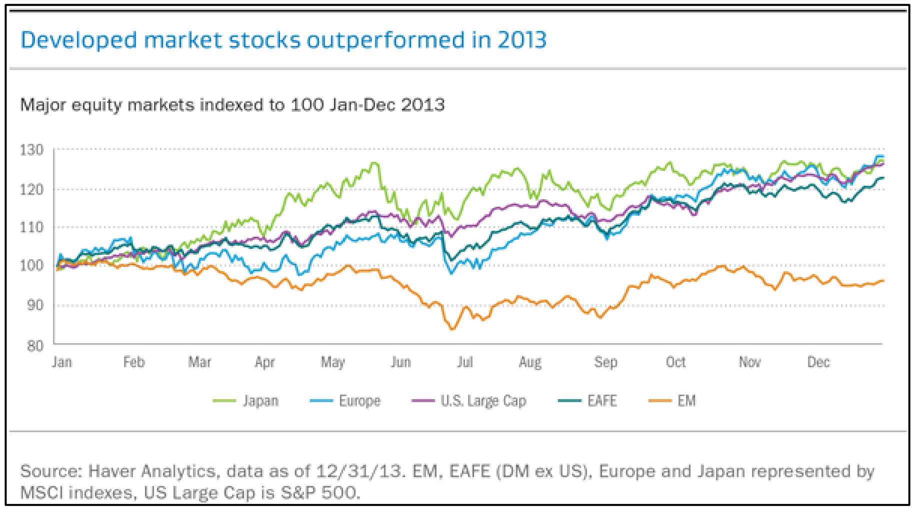
however, was negative for the full year (-2.6%), and the asset class stood out as a notable underperformer.

Figure 1: Developed market equities outperformed in 2013



Although the quarter ended on a positive note for equities, it had a rocky start: Political gridlock over the federal budget and the debt ceiling led to a U.S. government shutdown that lasted from Oct. 1-16. U.S. equity markets trended lower during the first several days of October but held up better than might be expected. Investors seemed to remember that previous government shutdowns proved less calamitous than originally feared.

Helping to stir optimism was the October 9 nomination of Janet Yellen, the vice chair of the Federal Reserve Board, to succeed Ben Bernanke as chair. The perception of Yellen as "dovish" in her views (i.e., inclined to favor Fed policies that promote lower interest rates to stimulate lending and economic growth) provided some clarity on the likely path of monetary policy going forward.

In the first half of December, the S&P 500 declined 1.3% as fears of imminent Fed tapering intensified in the face of strong economic data. Home sales improved, consumer confidence rebounded sharply and manufacturing activity remained strong. Consumers spent at a faster clip in December, and spending by businesses also held up in the final quarter. Retail sales increased 0.2% (+0.7% when automobile sales are not included).

At its December 18 meeting, the Fed ended the suspense by announcing a plan to slowly 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, said it would reduce this monthly amount by $10 billion beginning in January 2014. After months of dreading the prospect of tapering, stock markets actually cheered the Fed's move, with the S&P 500 Index gaining 1.7% on December 18, its largest one-day gain in more than two months.

Within the S&P 500, the industrials (+13.6%), technology (+13.2%) and financials (+11.0%) sectors led the way in the fourth quarter. Utilities (+3.1%), Consumer

Staples (+8.1%) and Energy (+8.5%) were relative underperformers. All sectors finished both the quarter and the year in positive territory.

European stocks also respond favorably to Fed tapering

The European Central Bank (ECB) began the quarter by issuing tough new ground rules for EU banks, causing a sharp drop in the region's financial stocks. But in November, European markets got a boost from improved manufacturing activity, as well as corporate earnings reports that beat expectations. Also that month, the ECB, which had been expected to hold short-term interest rates steady, instead lowered the rate from 0.50% to 0.25% to stimulate growth.

European equities also responded favorably to the Fed's tapering decision, and the euro retreated sharply from its near-term highs against the dollar, benefiting European exports.

Japanese equities continue their rise, but government reforms are delayed

With Japanese real interest rates firmly negative for the first time since the summer of 2008, the yen continued to depreciate during the fourth quarter, helping to fuel export growth. This pushed Japanese stocks up, with the Nikkei Index approaching last spring's market highs by the end of the quarter.

However, some of Prime Minister Shinzo Abe's critical structural reforms for the economy have, for now, been shelved or delayed. At the same time, Japanese corporations remained reluctant to invest and raise wages. All of this weighed on Japan's GDP growth, which fell to 1.9% in the third quarter—just half of the 3.8% growth reported for the second quarter.

China's economy appears to cool

In China, further signs mounted that growth in the world's second-largest economy is cooling. For the third year in a row, the country's GDP target was lowered, to 7.5%. What's more, a spike in the country's short-term interbank lending rate in December, plus weaker manufacturing activity, drove Chinese stock prices lower.

Moreover, market reforms that are needed to help China transition to a more domestically focused economy remained elusive. In November, the Chinese Communist Party's Plenum (a three-day congress on economic reforms) left markets notably unimpressed, at least initially. Billed as a platform for unveiling significant market-oriented changes, the Plenum failed to provide policy details or convince skeptics that the government is serious about reform. Chinese equities declined nearly 2% in the days following the Plenum's conclusion. On balance, the market now looks inexpensive, with the main Shanghai index (which reflects state-owned enterprises and banks) attempting to bottom. In contrast, the small-cap ChiNext index (a Nasdaq-like exchange consisting mainly of high-tech start-ups) repeatedly hit new highs in January.

The outlook for equities

In the U.S., we believe the fourth quarter's economic momentum will continue in the first quarter of 2014. Moreover, the U.S. economy should gradually move toward "escape velocity"—a sustained economic recovery that no longer requires the support of the Fed's extraordinary monetary stimulus but instead is propelled by higher consumer demand, robust employment gains, increasing private investment and continued strength in the housing market. Rising interest rates would be the greatest visible risk in this scenario. That said, initial economic data for January has been disappointing, with only some of the weakness attributable to bad weather. This could temper expectations for a significant near-term rise in interest rates.

Our base case for equities in 2014 is that U.S. stocks are at or close to fair value but can deliver another positive year, although the potential upside gain is likely far less than it was in 2013, and may come with greater volatility—as we have already seen in January. Our cautiously optimistic outlook could be compromised by the delicate balance between U.S. expected returns and rising interest rates. A combination of Fed tapering and a stronger-than-anticipated U.S. economy could force rates sharply higher, reducing the relative attractiveness of U.S. equities versus bonds. Foreign equities may offer better expected returns than U.S. markets this year but not necessarily enough to offset a potentially disappointing U.S. result if interest rates were to spike dramatically.

In Europe, we believe the economy will grow 0.7% in 2014, a positive swing of more than 1% from 2013's downturn. In Japan, we anticipate further economic strengthening as monetary and fiscal stimulus should continue to support higher asset prices, greater inflation, and stronger consumer demand.

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. Overall, China will represent a net positive for the global economy in 2014. More important than the GDP expansion itself is whether the new administration will liberalize the Chinese economy by allowing more market forces to drive performance.

Although equities in some other developing Asian countries are trading at price-to-earnings (P/E) ratios 20% below their average since 1987 (making them attractively valued), prices could face an uphill battle. Nearly $50 billion has flowed into emerging-market equities since 2012 as investors sought higher growth and yields. These flows reversed course in 2013 as interest rates started to climb in the U.S. Emerging markets in general are approaching valuation levels that appear inexpensive. These markets may offer good expected returns in 2014, although positive performance could be accompanied by periods of sharp volatility.