Weekly Market Update

Markets climb on reassuring Fed testimony and calmer global conditions

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Article Highlights

- Equity markets welcome Janet Yellen's pledge of "continuity" in Fed's approach.
- Among fixed-income sectors, high-yield and emerging-market bonds show the most strength.
- U.S. economic data releases are generally weak, with weather still a factor.
- Eurozone GDP growth lifts equity markets and keeps a lid on sovereign debt yields.
- Japanese equities remain challenged as currency and reform worries continue.

February 14, 2014

U.S. equities rallied during the past week, lifted by new Federal Reserve chair Janet Yellen's reassuring testimony before Congress, the raising of the federal debt ceiling, and diminished volatility in emerging-market equity, debt, and currency markets. Most international equity markets, led by Europe, also moved higher, based on MSCI indexes. Japanese equities continued to struggle.

In fixed-income markets, the bellwether 10-year Treasury yield, which moves in the opposite direction of its price, rose modestly on the week. Meanwhile, "spreads"—the difference between Treasury yields and those of higher-yielding, non-Treasury securities—narrowed in most sectors. When spreads narrow, or tighten, this generally indicates improved market conditions to the extent that investors are more comfortable taking on added risk without demanding a higher yield as compensation for that risk.

Especially notable were tighter spreads for U.S. high-yield bonds and signs of strength in emerging markets, including a number of new debt issues that came to market successfully. Calmer conditions in emerging markets offer hope that the worst of the turbulence in this sector may be fading, although outflows from emerging-market bond funds remain a possibility.

Current market updates are available here.

Financial Services

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Fed testimony and lifting of U.S. debt ceiling trump weak economic data

As they did the previous week, U.S. equities generally shrugged off tepid economic data. Instead, markets focused on Yellen's February 11 comments reaffirming the Fed's continued low-interest-rate policy and data-dependent approach to the pace of future tapering. This proved to be exactly what investors wanted to hear. Markets were also relieved when it became clear that there would be no repeat of a protracted political battle over raising the U.S. debt ceiling.

While these developments were favorable, economic releases continued to come in below expectations.

- **Retail sales fell** a sharp 0.4% in January, and sales for November and December were revised downward. This could dampen first-quarter GDP growth and lead to a lowering of the growth estimate for the fourth quarter of 2013.
- **First-time unemployment claims rose** by 8,000 to 339,000, versus expectations that they would fall slightly. The four-week moving average of claims also increased.

It is likely that these subpar readings are at least partly due to distortions caused by continuing poor weather. Moreover, consumer confidence appears to be holding steady: the University of Michigan-Thomson Reuters Consumer Sentiment Index was unchanged from January to February.

In addition, U.S. corporate earnings releases have been encouraging. On average, more than two-thirds of S&P 500 companies that have reported so far have beaten expectations. Importantly, operating margins have continued to improve due to falling commodity prices and subdued labor cost inflation.

Eurozone GDP growth helps add to week's gains

The bounce in U.S. equity markets carried over into Europe, where equities gained despite weaker earnings and a decline in fourth-quarter industrial production. Late in the week, favorable economic data for the eurozone provided an additional lift to European markets: GDP grew 1.1% on an annualized basis in the fourth quarter of 2013. Germany, the region's largest economy, led the way, but growth improved in key "peripheral" economies (e.g., Italy and Spain) as well. Yields on European sovereign debt, which rise during periods of economic stress, stayed low.

Europe's economic recovery, however, remains slow and fragile. In addition, the risk of deflation continues, prompting speculation that the European Central Bank (ECB) will eventually have to resort to some form of quantitative easing, perhaps by purchasing bank loans, to provide adequate stimulus. Some investors continue to hold out hope for such a move, but we deem it unlikely in the near term absent an unexpected crisis or shock to the system.

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Emerging markets continue to stabilize

Conditions in emerging markets improved: Equity prices rose, while volatility in debt and currency markets calmed. China released better economic data, highlighted by surprisingly strong net exports. However, tighter monetary policy continues to strain liquidity as China's central bank moves to rein in unregulated lending. Short-term interest rates remain on the rise, and increasingly it seems that Chinese growth may be vulnerable to further slowing. For the rest of the emerging-markets universe, equity valuations and expected returns look attractive, but we may see another downturn before investors finally overcome their aversion to these markets.

Japanese equities remain challenged

Japanese equities remained under pressure, with investors apparently concluding that the "third arrow" of reform under Prime Minister Shinzo Abe's economic program will not materialize. The other goals of "Abenomics" have also stalled recently— the yen is strengthening, not weakening, and economic activity is slowing rather than picking up. We expect further economic challenges with the implementation of a consumption tax increase in April.

Outlook

Initial optimism about first-quarter GDP strength has been tempered by weak U.S. economic readings. Once weather-related anomalies dissipate, we will begin to get a truer assessment of the economy's trajectory, and with it, a better sense of how much and how quickly interest rates may rise.

In U.S. equity markets, short-term trading sentiment has recently been quite pessimistic, correcting December's extreme optimism. However, long-term sentiment is becoming more optimistic, as measured by higher allocations to equities among Wall Street strategists and greater net equity exposures among hedge funds. If these contrarian indicators reach bullish levels, a significant market downturn could follow, so we are monitoring them closely.

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In fixed-income markets, we continue to believe that 2014 will be a stronger year than 2013. It is highly unlikely that the Fed will stop or slow the pace of tapering. Interest rates will rise further, but the risk of credit defaults remains low. Against this backdrop, we think bonds can generate modestly positive returns, primarily through coupon payments (i.e., interest income) and not price appreciation.

The information provided herein is as of February 14, 2014.

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