Weekly Market Update

Markets calm down as Ukraine crisis garners less investor focus

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Article Highlights

- Markets regain their footing after a volatile start to the week.
- Positive economic news helps equity markets advance.
- The European Central Bank decides against taking further action.
- Japanese stocks post gains, but reforms are still necessary.
- We see potential for U.S. equities to move higher before a correction.

March 7, 2014

After beginning the week with a sharp decline in response to an escalating crisis in Ukraine and fears of a possible Russian annexation of Crimea, financial markets recovered broadly, as tensions over the situation subsided and investor focus returned to assessing the economic health of the U.S. and nations abroad. As of March 6, the S&P 500 reached record highs in four of the previous six sessions, rising approximately 1% for the past week. European stocks realized modest gains after suffering a decline on Monday that was their largest in nine months, and emerging markets moved slightly higher despite the volatile situation in Ukraine, based on MSCI indexes through March 6.

In fixed-income markets, the week's largely positive economic news helped push up the yield (and depress the price) of the bellwether 10-year Treasury. Optimism about the U.S. economy also helped tighten spreads—the difference between Treasury yields and those of higher-yielding, non-Treasury securities—across most sectors, with particular strength in investment-grade and high-yield corporate debt, and commercial mortgage-backed securities. When spreads tighten, this generally indicates improved economic conditions to the extent that investors are more comfortable taking on added risk without demanding a higher yield as compensation for that risk.

Current market updates are available here.

Financial Services

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A solid jobs report headlines a largely positive week

Assessing the state of the U.S. economy continues to be difficult due to weather-related issues, although economic releases during the week generally pointed to improving U.S. growth after a seasonally challenged period:

- On the employment front, the U.S. economy added 175,000 jobs in February, exceeding expectations, and jobless claims fell to a three-month low. Both reports support the view that economic growth remains on track.
- The Institute for Supply Management (ISM) manufacturing index rose to 53.2 from an eight-month low of 51.3 in January. And the final Markit U.S. Manufacturing Index registered 57.1 in February, well above the 53.7 reading in January. (Readings above 50 indicate expansion.)
- An ISI company survey focused on housing showed improvement, as did net household wealth, which increased by $10 billion, or 14% over last year's levels.

The European Central Bank maintains the status quo at its March meeting

The European Central Bank (ECB) chose to keep monetary policy on hold, leaving its bank lending rate unchanged at 0.25%. This decision reflects ECB President Mario Draghi's sanguine views regarding Europe's prospects for a sustained economic recovery and also implies a lack of concern regarding inflation rates that remain well below the ECB's 2% target.

A lack of more aggressive action was a disappointment to some and could lead to a much stronger euro. Although the ECB may expect that stronger U.S. growth will limit the euro's advance, continued euro strength might hurt European growth and may force the ECB to implement measures to stimulate the economy.

Emerging markets exhibit relative calm despite the Ukrainian crisis

The markets' initial response to actions taken by Russia to exert control over Ukraine's Crimean peninsula reflected concerns over a souring of relations between Russia and the international community and over the imposition of sanctions that could result in a disruption of oil, coal, and gas supplies upon which Europe, in particular, is highly reliant. However, interdependencies between Russia and its trading partners are likely to limit the degree of this conflict's escalation.

Despite troubling headlines from Ukraine, emerging markets exhibited relative calm as the week wore on. Reduced valuations and outflows last month may have set the stage for a period of improved performance. Returns will hinge on the impact on growth across developing nations from recent interest rate increases, whether the Chinese economy will have a hard landing, and how quickly U.S. interest rates rise in coming months. In our view, threats will prove to be benign, and we see a likelihood of better performance in the future.

Japanese stocks advance, but reforms remain elusive

In Japan, markets lifted as the yen weakened after weeks of strengthening. We would expect the Bank of Japan to continue a policy designed to weaken the currency, which should in turn drive Japanese stocks higher.

There are indications that Prime Minister Abe is moving toward greater reforms, which in our opinion are critical for Japan to develop sustained growth. His agenda includes corporate tax cuts, possible flexibility for the government pension fund to purchase equities, and initiatives that would liberalize regulations for labor markets and real estate development. While these proposals are encouraging, they may not yet be enough to truly improve long-term growth rates.

Outlook

As long as steady job growth is apparent, we can expect the Fed to proceed with the tapering of quantitative easing in a methodical manner, even in the face of geopolitical concerns. We believe short-term interest rates will remain low for the next 12 months but afterwards will be subject to greater volatility as the economy strengthens.

With the S&P 500 remaining above the 1850 level despite being buffeted by Russia's implicit takeover of Crimea from Ukraine, a move to 1900 is likely before the market corrects. However the index's gain from its February low has been over 8% in an almost uninterrupted line—an advance that certainly merits a pause.

For fixed-income securities, fund flows continue to be supportive for investment-grade and high-yield corporate bonds, although emerging markets bonds continue to experience outflows. Given the strength in equities so far this year and the current level of interest rates, the tradeoff between risk and return for the two asset classes is more balanced than it has been in some time.