Weekly Market Update

Equity markets resume their climb, while bond markets slip

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Article Highlights

- U.S. equities rise amid stronger economic data and relative calm in Ukraine.
- European equity indexes also gain, but Japanese stocks continue to struggle.
- Fixed-income markets decline as investors digest the Fed's latest rate announcement.
- Europe's economy and markets make progress, but the euro remains too strong.
- Signs of economic improvement in China could bode well for emerging-market performance.

March 21, 2014

After falling more than 2% the previous week on heightened fears about the Ukrainian crisis and China's decelerating growth, U.S. equities rebounded during the past week. There was no shortage of reasons to worry, as Ukraine and China remained in the headlines and new Federal Reserve Chair Janet Yellen suggested that the Fed could raise short-term interest rates "around six months" after the current tapering process ends. (Tapering will most likely conclude in the fall of 2014). This time frame is earlier than the markets anticipated.

Despite these obstacles, the S&P 500 Index was up 1.7% for the week through March 20 and continued to work its way toward the 1,900 level—which we believe is the near-term threshold the index would likely have to reach before a correction is triggered. Stock market performance was mixed outside of the U.S. Based on MSCI indexes, European and emerging-market equities were in positive territory for the week through March 20, but Japan was down sharply for the second week in a row.

Fixed-income markets turned negative, particularly in the wake of Ms. Yellen's March 19 comments regarding the Fed's possible time frame for hiking short-term interest rates. U.S. Treasuries saw their prices drop and yields rise, with intermediate-term securities (3, 5 and 7 years) taking the largest hits. The bellwether 10-year Treasury yield, which ended the previous week at 2.7%, jumped to 2.8% on March 19 and hovered around that level for the rest of

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the week. High-yield corporate bonds, which tend to perform more in line with equities than with investment-grade fixed income, had slightly positive returns for the week through March 20.

Current market updates are available here.

U.S. releases continue to show signs of economic thaw

As we noted last week, the U.S. economy has begun to warm up following a chill in activity over the course of an unusually harsh winter. Improving economic signals have helped lift earnings expectations and may have contributed to the past week's outperformance of cyclical stocks (economically sensitive companies that tend to fare better during periods of stronger growth) over defensive stocks (whose performance is less driven by changes in the economic cycle).

Evidence that extreme weather was the predominant (but not the only) cause of the winter slowdown was found in a number of the past week's U.S. data releases:

- **Manufacturing.** Two regional gauges of manufacturing activity, the Empire State manufacturing index and the Philly Fed index, rebounded in March after disappointing readings in February.
- **First-time unemployment claims.** Initial jobless claims rose less than expected, while the four-week moving average of new claims fell to its lowest level since late November.
- **Leading economic indicators.** The Conference Board's Leading Economic Index, a forward-looking measure, gained 0.5% in February, following a meager 0.1% rise in January and a 0.1% drop in December.
- **Building permits.** Although housing starts slumped in January and February due in part to cold weather, building permits jumped 7.7% in February, hitting their highest level since last October.

Additional positive signs came in the form of accelerated growth in bank lending and a healthy rise in trucking activity based on a survey conducted by research firm ISI. This survey is highly correlated with GDP growth. On the down side, sales of existing homes dipped in January to their lowest level since July 2012, although the drop was in line with consensus forecasts.

European equities rise but concerns remain

Overall, European economic activity has improved somewhat, but earnings expectations are flat. The region's equity markets rose during the past week despite apprehension over Russia's actions in Ukraine and a euro that remains stronger than is justified by economic fundamentals. The euro came off its recent highs versus the dollar after Janet Yellen's press conference helped push up U.S. interest rates, but with monetary policy still tighter in Europe than in the U.S. we think the euro is likely to edge higher again. This would intensify pressure on the European Central Bank to cut interest rates.

In China, some hopeful signs amid general weakness

China has remained a focus of investor apprehension, as real estate prices, bad debt, and slowing export growth all increase the potential for an economic "hard landing." Countering this fear is the latest Chinese Purchasing Manager's Index (PMI) published by data provider MNI. This index ticked up to 53.4 in March from 50.4 in February. (Readings above 50 indicate expansion.) Moreover, credit conditions have eased and China's currency has continued to depreciate, which helps the Chinese export sector. On balance, these signals out of China are encouraging for emerging equity markets, which, while not materially strengthening, appear at last to have found their floor.

Japanese equities repeat their negative performance

Japan's equity market again came under pressure as the country's economic challenges remained in focus. Leading economic indicators have weakened in advance of an April 1 consumption tax hike, which is projected to cut GDP growth by 1%. Moreover, Japanese export numbers have yet to improve, despite a weaker yen. On the positive side, these difficulties put added pressure on Prime Minister Shinzo Abe's government to enact needed reforms, while the lack of inflation should prod the central bank to implement further monetary stimulus. These actions—combined with an improving corporate earnings picture and relative valuations that make Japan one of the least expensive equity markets in the world—may lead to better performance by the Nikkei 225 Index, although the index could fall further before that happens.

Outlook

While economic and geopolitical uncertainties have led to increased volatility over the past several weeks, no event has thus far proven serious enough to alter the U.S. equity market's upward trajectory. In fixed-income markets, we expect interest rates to continue to rise moderately unless equity markets correct sharply or an unexpected shock to the system drives investors into safer asset categories such as Treasuries and other high-quality investment-grade securities.

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