Market & Investment Insights

Volatile markets head lower as sell-off in growth and tech stocks continues

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- U.S. equity markets see wide daily swings, while bonds rally.
- Fed meeting minutes reinforce continued "dovish" commitment to low interest rates.
- Emerging-market equities and debt outperform as conditions improve.
- Greece returns to the bond market with a successful public auction.
- Despite volatility, we expect the S&P 500 to resume its climb—with some caveats.

April 11, 2014

Equities

U.S. equity markets had a turbulent week. The S&P 500 Index swung between large single-day gains and losses, with downward moves dominating. Foreign stocks—particularly in emerging markets—were generally less volatile than the major U.S. indexes. Since April 1, based on MSCI international benchmarks, emerging-market equities (+2.8%) have outperformed both their developed market counterparts (+0.3%) and the S&P 500 (-2.0%).

There was scant economic news to drive U.S. volatility, but recently markets have been trading more on fear than on fundamentals. The S&P's decline over the past several weeks was initially triggered by an overly literal interpretation of Federal Reserve Chair Janet Yellen's March 19 comment that short-term interest rates could be hiked "around six months" after Fed tapering ends. Yellen's remark provoked a spike in the 10-year Treasury yield and helped fuel a wave of rapid "de-risking" by hedge funds and other investors, who rotated out of high-momentum growth stocks and into value.

Fear of a sooner-than-expected rate increase was calmed at midweek, as minutes from the Fed's March meeting reinforced a continued "dovish" commitment to keeping rates low for an extended period. The market's respite was short-lived, however: Renewed anxiety over the Ukrainian crisis, disappointing Chinese

Financial Services

economic data, and poor earnings releases for certain growth tech companies prompted another round of selling out of growth and into value.

Fixed income

Bond markets rallied during the week, outperforming equities. The bellwether 10-year Treasury yield fell to 2.62% in midday trading on April 11, down from its 2.74% close the week before. “Spread products” (lower-rated, higher-yielding non-Treasury securities) were generally flat for the week. A number of factors supported Treasuries, including

- the Fed’s reassuring meeting minutes;
- no dramatic upside surprises in economic releases; and
- a modest “flight to safety” in the face of declining equity values.

Fund flows were positive across nearly all fixed-income categories, including emerging-market, high-yield, and investment-grade corporate bonds. In a major sign of how much the fixed-income environment has changed since the height of the euro crisis, Greece held its first government bond auction since 2010 and was met with strong investor demand.

A light week for U.S. data

There were few major U.S. economic releases during the week, but two of the more closely watched indicators were upbeat:

- **Weekly first-time jobless claims** declined by 32,000, to 300,000—a far better reading than anticipated and the lowest level in almost seven years. Claims are now about 14% lower than they were a year ago. This improving picture may augur well for upcoming employment reports and is typically associated with GDP growth of over 3% (versus forecasted growth of under 2% in the first quarter).

- **Consumer sentiment** rose in April to its highest level in nine months, based on the Reuters Thomson/University of Michigan index. Consumers are more optimistic about both current and future economic conditions, which could support consumer spending.

European markets turn more volatile on rekindled Ukraine worries

In Europe, equity markets trended weaker, partly in response to headlines from Ukraine, where Russia has apparently stepped up “activist” demands for independence. A number of potential negative outcomes may result from this conflict, but in our view, the odds still favor a de-escalation of tensions.

China’s export data is better than it appears

Although Chinese export data was disappointing, closer analysis shows that exports actually made steady gains after adjusting for overstated levels from a year ago. The Shanghai “A” Share and Hang Seng market indexes looked past the negative headline and moved higher for the week. The possibility of a “hard landing” for the Chinese economy remains a concern, particularly given the country’s credit bubble, but policymakers have been focused on cushioning any weakness. Reassuring talk of further targeted stimulus efforts and market reforms have helped drive a very inexpensive stock market higher. This market strength has contributed to the broader rally in emerging-market equities.

Outlook

In the U.S., backward-looking economic data has remained relatively soft, while forward-looking indicators appear more promising. The severe winter weather took a toll in the first quarter, and that will lead to lower average GDP growth for the year. We expect first-quarter growth to come in at roughly 1.4%, down from our previous 1.8% forecast. Second-quarter growth should return to 2.8%.

Despite current equity volatility, technical market factors look favorable, and we continue to expect the S&P 500 to move to and beyond the 1,900 level by summer. At that point, we may need to contend with another pullback, perhaps driven by yet another summer lull in activity. (For the past three years, economic activity has slowed markedly heading into July.) In addition, the path to 1,900 is not likely to be a straight line, as the past week's market decline demonstrates.

In fixed-income markets, spread sectors should continue to hold up well unless equity values decline further, into correction-level territory (-10% or more). One driver of strength in spread sectors is simply a shortage of supply relative to demand in several categories, including asset-backed securities and commercial mortgage-backed securities.

That said, at some point during the year fixed-income markets will be exposed to the impact of rising interest rates as job growth improves further and inflation expectations gradually edge higher from very low levels. Bond markets are also waiting to see whether the European Central Bank (ECB) will enact some form of quantitative easing or other monetary stimulus measures to ensure that deflation does not take hold in Europe. Effective action by the ECB would be bullish for fixed-income spreads both in Europe and globally.