Weekly Market Update

Equity and fixed-income markets tread water in a quiet week

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Article Highlights

- U.S. equities tilt modestly lower, while bonds register small gains.
- Economic releases are scant but generally upbeat.
- Technical factors and Ukraine worries are keeping Treasury yields artificially low.
- Europe is boosted by the prospect of imminent monetary stimulus.
- After dismal first-quarter U.S. GDP growth, a significant bounce is likely in Q2.

May 9, 2014

Equities

U.S. equities fell slightly during the past week. There were occasional echoes of the recent rotations out of growth and small-cap categories and into value and large-cap. Investors were particularly sensitive to corporate earnings disappointments at high-growth companies. Overall, however, market volatility and trading volume eased—indicating a normalization process that we expect to continue.

The S&P 500 Index, down 0.22% for the week through May 8, was mostly flat in midday trading on May 9. Non-U.S. markets generally fared better. Based on MSCI indexes, foreign developed-market equities rose 0.31% for the week through May 8, led by Europe (+0.78%), while emerging-market equities gained 0.56%.

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Fixed income

The bellwether 10-year U.S. Treasury yield remained in a narrow range around 2.6%, despite improving economic data that would typically be expected to spur yields higher. The relative strength in Treasuries is underpinned by ongoing geopolitical concerns, notably the crisis in Ukraine, as well as continued "dovish" commentary by Federal Reserve Chair Janet Yellen and a general demand for longer-maturity fixed- income assets.

Spread products (higher-yielding, lower-rated non-Treasury securities) also found support during the week, benefiting from decreased market volatility that encouraged investors to add to their positions in categories such as commercial mortgage-backed securities, high-yield bonds, and emerging-market debt.

Current market updates are available here.

U.S. economic indicators continue to firm

Although it was a relatively light week for U.S. data, there were some signs of continued strengthening in the economy.

- **The service sector expanded at its fastest pace in six months.** The index of non-manufacturing activity published by the Institute for Supply Management (ISM) rose to 55.2 in April, from 53.1 in March. (Readings above 50 indicate expansion.) April's reading was the highest since last October.
- **Weekly jobless claims fell.** First-time claims for unemployment insurance dropped by 26,000, to 319,000—the lowest level in a month. Some of the decline may be attributable to seasonal volatility, however.
- **The U.S. trade gap narrowed.** The trade deficit shrank by 3.6% in March, to -$40.4 billion, primarily on the strength of increased energy exports and higher demand for commercial aircraft. However, the improvement was smaller than the government estimated in its first-quarter GDP estimate, released on April 30. This suggests that GDP growth will be revised downward.

Europe gets a lift as the ECB signals monetary stimulus is likely next month

On May 8, the European Central Bank (ECB) indicated its willingness to take definitive steps to weaken the euro and boost inflation when the ECB meets in June. European equity markets rallied on the news. ECB action will likely take the form of further interest-rate cuts and/or a negative deposit rate. The latter option, which involves levying a charge on banks that park their excess deposits at the ECB, is intended to encourage banks to lend those funds to consumers and businesses instead.

Chinese economic data remains mixed

In China, economic releases continued to offer a mixed bag. The composite Purchasing Manager's Index (PMI) published by HSBC, covering both manufacturing and service-sector activity, was weaker than expected in April, but export/import numbers were much improved, supporting local equity markets. With China's economic performance closely tied to commodity markets, other favorable signs included a rebound in copper prices and a strengthening of the commodity-driven Australian dollar. These trends help buttress the case that the Chinese economy can avoid a "hard landing," or at least see a relatively benign outcome from declining real estate prices.

Japanese equities may have bottomed

The Japanese stock market appears to have bottomed, based on technical indicators. After mixed results through mid-week, the Nikkei index rallied impressively on Thursday and Friday. We expect better market results going forward but are mindful that strong equity performance depends in large part on the likelihood of a weakening yen. Japan's central bank is still waiting for more economic data before it initiates further monetary stimulus to drive the yen lower, and this wait-and-see stance is keeping the yen relatively strong.

Outlook

Given extremely weak U.S. GDP growth in the first quarter (+0.1% and subject to downward revision), a significant bounce in the next three months is likely. We now expect second-quarter GDP growth to come in at about 3%, and we may raise this number as new monthly data arrives. In our view, the U.S. economy is still on track to finish the year with a 3% growth rate, with stronger expansion next year.

Although we forecast economic growth to pick up, we have lowered our expectations for an increase in the 10-year Treasury yield, which we expect to settle between 3% and 3.25% by the end of 2014, versus earlier projections of close to 3.5%. This shift reflects our belief that short-term supply and demand factors, along with geopolitical concerns, are keeping bond yields artificially low. Nonetheless, we maintain our long-term view that yields will rise as the economy strengthens.

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In equity markets, we continue to believe that the recent rotations and performance disparities between value and growth stocks do not represent a fundamental shift in the market, but rather a return toward longer-term averages, triggered primarily by hedge funds selling off extended positions. We are encouraged by heightened negative sentiment in key contrarian measures that we follow: Hedge funds' net exposures to equities have fallen again, and Wall Street strategists have lowered their equity allocations to levels historically associated with 20% annualized returns for U.S stocks.

In the fixed-income arena, we remain cautious about a possible increase in volatility as the Fed's continued tapering brings a gradual end to quantitative easing. In such an environment, spread products could see a modest downturn in performance, providing potentially attractive points of entry for investors.

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