Weekly Market Update

Despite a volatile week, U.S. equities appear poised to move higher

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Article Highlights

- U.S. equities backpedal from record highs to finish the week essentially unchanged.
- The 10-year U.S. Treasury rally continues, despite a lack of fundamental drivers.
- First-quarter GDP growth surges in Japan, but disappoints in Europe.
- We expect U.S. economic growth to pick up from its current 3% pace.
- A number of signals point to a normalizing of U.S. equity markets, with lower volatility.

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Equities

U.S. equity gains continued to ebb and flow during the past week. After closing at record highs on Monday and Tuesday and breaching the 1900 level for the first time during Wednesday trading, the S&P 500 Index suffered a sharp drop on Thursday, May 15, and appeared headed for an essentially flat finish for the week as a whole.

Notably, small-cap stocks declined less than the broader market during the Thursday sell-off, and low-dividend-paying growth shares have begun to outperform. In contrast, utility stocks (which have higher dividend yields) came off their April highs. Together, these developments signal a potential “normalizing” of U.S. equity markets. Based on MSCI indexes, foreign developed-market equities were flat to modestly positive for the week, while emerging markets rose more than 2%.

Fixed income

Another rally in the U.S. Treasury market was highlighted by a surprisingly sharp drop in the bellwether 10-year yield, from 2.66% on Monday to 2.5% on Thursday—its lowest level since last June. (Yields move in the opposite direction of prices.) There was no obvious impetus for the continued decline in Treasury

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yields, although potential drivers include increased demand for safe-haven assets as tensions rise in Ukraine, the potential for deflation in Europe, and fears of a possible slowdown in the U.S. and/or Chinese economies.

In addition to Treasuries, other U.S. fixed-income categories also had positive returns for the week, supported by favorable fund flows. Investment-grade corporate bonds and mortgage-backed securities were among the top performers. In Europe, sovereign debt issued by "peripheral" nations (e.g., Italy and Spain) sold off from overbought positions as investors took profits.

Current market updates are available here.

Mixed U.S. data does not change our fundamental outlook

U.S. data releases in the past week were mixed. On balance, the economy appears to be improving, but not gaining much speed.

On the positive side:

- **Housing starts** surged 13.2% in April, to a seasonally adjusted annualized rate of 1.07 million—well above consensus expectations. **Building permits**, a sign of future demand for new homes, also climbed, rising at their fastest pace since mid-2008.
- **First-time unemployment claims** fell to 297,000 in the week ended May 10**—**the first time in seven years that claims have broken below 300,000.a
- **The Empire State Index,** a measure of manufacturing activity published by the Federal Reserve Bank of New York, jumped in May to its highest level in nearly four years.
- **Small-business confidence** climbed to a six-year high, as measured by the NFIB index.

Disappointing data releases included:

- **Retail sales** were weak in April, rising just 0.1%, although sales are still rising at an annualized rate of over 3% —a sign that aggregate consumption has more upside potential going forward.
- **Consumer sentiment** dropped unexpectedly, based on the preliminary May index published by the University of Michigan and Thomson-Reuters.

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Europe's GDP growth is lukewarm, but monetary stimulus should inspire markets

First-quarter GDP growth in Europe came in at a seasonally adjusted annual rate of 0.8%. This was in line with our forecast of 0.7%, but markets were expecting a much stronger reading. Of the large economies, Germany exhibited the strongest growth, followed by Spain, while France was flat and Italy contracted. Conditions have bottomed across the continent, and we expect to see continued improvement going forward**.** Moreover, the European Central Bank has telegraphed interest-rate cuts and other measures to jumpstart inflation and weaken the euro. This should bode well both for the economy and for European equity markets.

China's economy appears to be stabilizing, although risks remain

In China, lending and real estate statistics released during the week added to concerns of a collapsing real estate bubble and a possible credit crunch. Meanwhile, the government remains focused on reforms and on seeking to rebalance the economy through targeted infrastructure spending. Mindful of the real estate risks, China's central bank liberalized mortgage lending rules for first-time home buyers, a move that helped lift domestic equity markets in the past week. Overall, Chinese stocks remain inexpensive, trading at price-to-earnings (P/E) ratios far below their 2007 peak.

Japanese GDP growth surges

Japan's GDP grew 5.9% on a seasonally adjusted annual basis in the first quarter. This far exceeded our expectations. Growth was strongly influenced by the consumption tax hike that took effect on April 1, as consumers and businesses accelerated spending in advance of this hike. The benefit of that spending will disappear in the second quarter. In the meantime, it remains unclear whether anticipated economic and market reforms will be enough to achieve a sustainable level of growth in Japan. Nontheless, Japanese equities posted gains for the past week and look primed to move higher over the intermediate term.

Outlook

U.S. economic growth is currently tracking at 3%, and there is ample evidence to suggest this pace will accelerate. First, manufacturing activity is strengthening, pointing to future improvements in capital spending. Second, levels of consumer spending, while not stellar, are holding up despite meager wage increases. We have already begun to see improved job creation; higher wages and income will follow and support consumption. Lastly, the housing market, probably the weakest component of growth this year, is poised to rebound, as conditions favor increased demand.

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Against this backdrop, we believe U.S. equity markets are poised to move higher, with lower volatility than we have seen in recent months. In fixed-income markets, expectations of rising interest rates voiced early in the year have yet to materialize, leading a number of fixed-income sectors (and the broad U.S. bond market) to outperform the S&P 500 year to date. While we still expect rates to rise this year, the unexpected performance in 2014 so far supports the case for maintaining exposure to bonds as part of a well-diversified portfolio.

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