Weekly Market Update

Markets gain in anticipation of European monetary stimulus

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Article Highlights

- U.S. equities post new record highs in a quiet, holiday-shortened week.
- Technical factors continue to drive down the 10-year U.S. Treasury yield.
- All eyes are on the European Central Bank's next policy move.
- Negative first-quarter GDP growth in the U.S. sets the stage for a strong Q2 rebound.
- The S&P 500 is poised to continue its climb, accompanied by some short-term volatility.

May 30, 2014

Equities

U.S. equities rose during a quiet trading week shortened by the Memorial Day holiday. The S&P 500 Index reached new closing highs above our summer target level of 1,900. Returns were led by segments of the market—including small-cap, growth, and newer technology companies—that had sold off in April and early May.

Although U.S. economic releases were mixed, markets responded positively to expectations of stronger future growth and were supported by a continued decline in U.S. Treasury yields. Non-U.S. markets were generally flat to modestly positive.

Fixed income

Fixed-income markets also rallied. Demand for U.S. Treasuries pushed their prices higher and yields lower. The yield on the bellwether 10-year note, which had ended the previous week at 2.54%, dropped as low as 2.40% in May 29 trading before bouncing back to close the day at 2.45%.

Technical factors have been more instrumental than economic fundamentals in driving the recent Treasury rally. Among these are increased demand from European and other foreign buyers anticipating an imminent interest-rate cut and other potential monetary easing measures from the European Central Bank

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(ECB), as well as diminished U.S. Treasury supply due to a year-over-year decline in 10-year issuance.

Certain higher-risk fixed-income categories, such as investment-grade corporate bonds, outperformed Treasuries during the week, as the search for yield intensified. Even high-quality mortgages performed well, as new supply failed to keep up with institutional demand.

Current market updates are available here.

In a week of mixed U.S. data, markets take negative GDP revision in stride

U.S. economic data released during the week offered both disappointment and optimism.

- **First-quarter GDP growth** was revised downward, from 0.1% to -1.0%—the first negative reading since 2011. With the exception of personal consumption (which topped 3% for the second quarter in a row), other categories of spending declined. Spending on inventories saw an especially sharp downward revision. That said, we believe underlying momentum in the economy has since improved, especially on the employment front, which should contribute to much better second-quarter growth.
- On the housing front, **pending home sales** disappointed in April, rising just 0.4%. **Home price appreciation** continued to slow, based on the Case-Shiller 20-City Composite and FHFA indexes.
- At first glance, **orders for durable goods** appeared favorable: up 0.8% in April, with a healthy upward revision for March. However, all of April's gain came from a large military order for the Navy. Excluding orders for defense and commercial aircraft, durable goods orders actually fell 1.2% in April, revealing much softer spending across the economy. We are not overly concerned by this monthly data, which tends to be volatile, but it does suggest that economic growth may be more moderate than many presume.
- **First-time unemployment claims** dropped to 300,000 in the week ended May 24, while the four-week moving average declined to 311,500—the lowest level since August 2007.

Markets expect aggressive monetary stimulus in Europe as ECB's June meeting looms

Despite a modest Friday decline, European equity markets edged higher for the seventh consecutive week in anticipation of the ECB meeting scheduled for June 5. As of this writing, a number of potential measures could be announced, including further interest-rate cuts, a negative deposit rate (by which the ECB would charge member banks to park their excess reserves at the central bank), and a renewal of the long-term refinancing option that would provide long-term capital to European banks in exchange for targeted lending to small businesses. These measures would be designed to help weaken the euro, stave off deflation, and stimulate growth.

Because ECB action has been presumed for so long, the markets may not respond much when the policy announcement is finally made. In fact, with expected ECB action already priced in, the risk is that we could see a classic example of "buy the rumor, sell the news," particularly if the announced measures are not deemed aggressive enough. Overall, we expect the ECB to be incremental rather than drastic in its approach, preferring to leave its options open. While this could lead to near-term market disappointment, it offers flexibility to move more decisively later in the year if growth and inflation levels continue to disappoint.

Beyond Europe, other non-U.S. equity markets offer attractive opportunities

Equity performance in Japan, China, and the emerging markets has been generally positive.

- In **China,** equities have risen despite fears of a real estate collapse and possible defaults in the shadow banking sector. The Chinese government still has policy levers available to preserve growth. Given current valuations, local equity markets offer upside potential.
- **Emerging-market** equities overall have continued to rally and are now up 9% from their February low and almost 5% year to date. While we expect emerging markets to outperform their developed counterparts, such a trend would likely pause if U.S. Treasury rates were to reverse course and move higher.
- In spite of a stronger yen, the **Japanese** equity market advanced this week, perhaps reflecting anticipation of further reforms by the government. Technically, the Nikkei 225 Index appears poised to climb, and we expect it to breach previous highs.

Outlook

On average, the U.S. economy is still growing at around 2.25% and should accelerate toward 2.5%-2.6% by the end of this year. On a quarterly basis, we now forecast GDP growth of 3.6% in the second quarter, 3.2% in the third quarter, and 3.5% in the fourth.

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Equity market dynamics point to the S&P 500 moving above the 1,950 level before another correction occurs. We believe the index will move to and above 2,000 by the end of 2014, so any pullbacks along the way will be viewed as potential buying opportunities.

In fixed-income markets, it remains to be seen how the confluence of potentially stronger growth and job creation in the U.S. and the likelihood of more global stimulus (e.g., in Europe, China, and Japan) will influence interest rates going forward. Although fixed-income assets are expensive at current levels, they remain a valuable portfolio diversifier for many investors.

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