Weekly Market Update

U.S. jobs report and European monetary easing lift equity markets

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Article Highlights

- Solid U.S. employment report caps a week of encouraging economic data.
- Europe's central bank unveils a much-anticipated monetary stimulus package.
- The S&P 500 continues to hit new record highs; foreign stocks also rise.
- U.S. Treasuries post modest losses, while European and emerging-market bonds rally.
- If the euro remains strong, Europe may enact full quantitative easing (QE) later this year.

June 6, 2014

Equities

U.S. equities continued to climb during the past week, with the S&P 500 Index recording successive new highs, albeit on low trading volume. The market's recent gains have been led by improving performance from smaller-cap, growth, and other risk categories that had moved sharply lower from mid-March to mid-May.

Evidence of a strengthening U.S. economy contributed to the week's advance. In addition, the European Central Bank (ECB) pleased U.S. and global equity markets on June 5 with a highly anticipated interest-rate cut and other aggressive monetary policy actions designed to stimulate lending and economic growth. European equities rose for the eighth week in a row. Broad foreign developed- and emerging-market indexes were also up for the week.

Fixed income

Fixed-income markets were focused on the U.S. employment report for May (released on June 6) and the ECB's policy announcement. The increase in payrolls, while solid, was generally in line with many forecasts and did not move bond markets much. The ECB's monetary stimulus measures, however, were well received. Optimism that the central bank's actions will help eliminate the risk of deflation and promote growth across the eurozone fueled strong rallies in

Financial Services

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European sovereign debt markets, including Spain, Italy, Greece, Portugal, and Ireland—so-called “peripheral” nations whose economic and fiscal struggles were at the heart of the euro crisis in 2011-2012.

Emerging-markets debt also benefited from the rally in Europe, as greater global liquidity typically increases demand for the highest-yielding bonds and currencies. In contrast, U.S. Treasuries posted a modest loss for the week. The yield on the bellwether 10-year note, which had closed as low as 2.45% in late May, finished above 2.60% during the week and was trading near that level on June 6. (Yields rise when prices fall, contributing to negative returns). Based on Barclays U.S. indexes, returns for most investment-grade sectors were flat to slightly negative, while high-yield corporate bond performance was mildly positive.

Current market updates are available here.

U.S. employment report and other data align with our outlook

Most of the U.S. data released during the week points to further economic growth in the second quarter, closely tracking our forecasts.

- **Monthly payrolls.** The U.S economy added 217,000 nonfarm jobs in May, in line with our forecast of between 200,000 and 225,000. The unemployment rate held steady at 6.3%, while the number of hours worked and average earnings grew just over 2% on a year-over-year basis. Overall, this is a solid report, confirming stable growth of more than 200,000 jobs per month in 2014.

- **Weekly first-time jobless claims.** The number of people filing unemployment claims for the first time, while up slightly over the previous week, remained low, at 312,000. In addition, the four-week moving average of claims fell to 310,250, their lowest level since June 2007.

- **Manufacturing and service-sector growth.** Monthly indexes of manufacturing activity released by the Institute for Supply Management (ISM) and Markit rose to 55.4 and 56.4, respectively, in May. (Readings above 50 indicate expansion.) The ISM’s non-manufacturing gauge also climbed, to 56.3—the highest reading since last August.

- **Factory orders.** Orders for goods produced in U.S. factories climbed 0.7% in April and were revised upward for March, from 0.9% to 1.5%. This is a positive signal for the remainder of the second quarter.

- **Auto sales.** Car and light truck sales surged in May, to a seasonally adjusted annual rate of 16.77 million—the strongest rate of sales since July 2006. Although this number is impressive, we expect subsequent months to slow modestly.

On a somewhat disappointing note, construction spending rose a less-than-expected 0.2% in April. Year to date, construction spending is essentially flat, with the exception of spending on office space. We believe construction spending will pick up as the year progresses.

The ECB delivers, with further action possible later in the year

After months of speculation, on June 5 ECB President Mario Draghi delivered most, if not all, of what markets wanted in terms of monetary stimulus to weaken the euro and avert deflation. Put simply, the ECB will provide massive amounts of new liquidity to the system and will do so for a long time. Among its announced policies, the central bank:

- lowered its main lending rate by 10 basis points (0.10%), from 0.25% to 0.15%;
- introduced a negative deposit rate (-0.1%), in effect charging member banks who park their excess reserves at the central bank;
- unveiled a new Long-Term Refinancing Operation (LTRO), a program designed to stimulate the economy by incentivizing banks to lend to households and non-financial companies; and
- indicated that it will work on building a more robust asset-backed securities (ABS) market.

Because aggressive ECB action was considered a foregone conclusion, there was concern that markets might react negatively when the policies were finally rolled out—a classic case of "buy the rumor, sell the news." However, European equities and bonds rallied in the wake of Draghi's announcement, suggesting that the ECB's actions had not been fully priced in to those markets.

One surprise was that the euro, after initially weakening (to be expected in the face of monetary easing) finished higher on June 5. This suggests that currency markets had priced in the scope of easing the ECB delivered, and that further steps would be needed to drive the euro lower. If the euro continues to firm, the ECB may well be forced to take stronger action, including full quantitative easing (QE), later in the year.

Outlook

Even before the ECB's actions, we believed the risk of deflation in Europe was remote. The central bank's new monetary policies will ensure that continues to be the case. Nonetheless, it remains to be seen whether a substantial increase in credit will actually materialize, especially if demand in Europe fails to improve. The ECB has likely bought itself some time for the U.S. economy to pick up, thereby providing some of that missing demand. It has also bought some time to develop a deeper market in ABS, the most likely asset category of choice for QE in Europe.