Weekly Market Update

U.S. equities climb to new highs

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- The S&P 500 posts another record close.
- Despite an uptick in inflation, the Fed maintains its dovish stance.
- TIPS outperform nominal Treasuries as investors seek an inflation hedge.
- Robust U.S. production measures show there is little slack in the economy.
- Markets remain wary of the conflict in Iraq.

June 20, 2014

Equities

U.S. equity prices firmed during the week, responding to favorable economic news, positive corporate earnings revisions, and benign commentary from the Federal Reserve. The S&P 500 Index again reached new highs, moving closer to the 1,970 target that we have been anticipating. Despite rising oil prices and renewed tensions in Ukraine, European stocks also advanced—possibly in sympathy with the U.S. market and supported by the eurozone's improving economy. In Japan, the Nikkei 225 Average climbed to a nearly five-month high, continuing its recent recovery from a sharp drop related to a consumption tax hike that took effect on April 1. Emerging markets also gained for the week.

Fixed income

Fixed-income performance was mixed in a week highlighted by Federal Reserve Chair Janet Yellen's "dovish" comments on interest rates, generally strong economic releases, and evidence of a pickup in U.S. inflation, based on the Consumer Price Index (CPI). Longer-term Treasury returns were slightly negative, as yields edged higher for the week (price and yield move in opposite directions). Returns were positive in most higher-risk fixed-income categories, including commercial mortgage-backed securities, emerging-markets debt, and high-yield corporate bonds. Fund flows into investment-grade corporate bonds remained strong and now exceed 2013 inflows on a year-to-date basis.

Financial Services

U.S. equities climb to new highs

In general, bond markets seemed somewhat surprised by the Fed's willingness to tolerate increased inflation. Treasury Inflation-Protected Securities (TIPS) outperformed nominal Treasuries, indicating investors are seeking a hedge against potentially higher inflation in the future.

Current market updates are available here.

On balance, more positive news for the U.S. economy

U.S. economic data released during the week was broadly encouraging.

- **Manufacturing and industrial production.** Both the Empire State and Philly Fed regional manufacturing indexes surprised on the upside in June, while U.S. industrial production and capacity utilization (a measure of actual versus potential output) moved higher in May.
- **Leading economic indicators.** The Conference Board's index of leading economic indicators rose 0.5% in May, the fourth consecutive month of expansion. This suggests growth could pick up steam in the second half of the year.
- **Initial jobless claims.** Weekly first-time claims for unemployment fell by 6,000, to 312,000, in the week ended June 14, remaining near post-recession lows. The four-week moving average of claims also fell.

On the negative side, housing data remained muted, although this was not unexpected. The NAHB/Wells Fargo index of homebuilder confidence rose in June but remained below 50, indicating slight pessimism. Housing starts also disappointed, falling 6.5% in May. Building permits declined at a similar rate.

Europe improves, but the euro's strength remains a concern

Activity at European companies continues to improve, based on third-party surveys. Meanwhile, growth expectations for the region are moving higher, toward 2%. A potential concern is that the euro—which had fallen from nearly 1.40 to the dollar in early May to 1.35 in mid-June—could resume its climb in light of the Fed's continued dovish stance and real interest-rate differentials between the U.S. and Europe. Technical forces in the currency markets could conceivably push the euro to 1.42 to 1.44 to the dollar.

Chinese markets seek direction amid conflicting signals

China's mixed economic progress is reflected in the sideways performance of Chinese equity markets. While activity as measured by real time surveys continues to contract, other measures—including copper prices, electricity consumption, and the commodity-driven Australian dollar—suggest an economy that is bottoming and poised for a potential lift heading into the third quarter. The government continues to take steps to rebalance and reform the economy, a process that is painful in the short term but offers long-term positives.

Outlook

Modestly elevated CPI readings for May, coupled with Janet Yellen's comments that seemed to brush off the idea that inflation pressures are building more quickly in recent months, raised some eyebrows. There are really two points to emphasize here. First, the CPI is only one measure of inflation (and a "noisy" one at that). Instead of focusing on CPI alone, we should examine the trend across all measures. Second, we think the Fed will allow inflation to overshoot its 2% target. As long as inflation remains in the vicinity of this target and inflation expectations stay anchored, we are confident the Fed won't raise rates until late in 2015.

In U.S. equity markets, we believe a correction of up to 5%-10% is still possible once the S&P 500 breaches the 1,970 level. The odds of such a correction appear to have diminished, however, in light of very strong internal market dynamics. Rather than a correction, we could see the index mark time at these levels, perhaps with some rotations similar to those experienced in April and May. Regardless of short-term gyrations, we still see the S&P 500 exceeding 2,000 by year-end.

The situation in Iraq remains a significant concern for equity markets, given the potential for a sharp spike in oil prices, which could put the brakes on the world economy. Fixed-income markets are also apprehensive about Iraq. Further destabilization could drive a flight to safety that would benefit U.S Treasuries (reducing yields as buyers bid up prices), although the inflationary impact of higher oil prices could help offset this by exerting upward pressure on rates. Overall, we believe U.S. Treasury yields are poised to rise further, but not dramatically, as GDP growth stages a solid comeback.

Outside of the U.S., the outlook for emerging-markets debt is increasingly country-specific. Some nations—particularly the so called BRIC countries (Brazil, Russia, India and China)—face greater structural challenges than others. Meanwhile, Mexico and others have enacted economic and regulatory reforms to improve competitiveness.