Weekly Market Update

Markets trend lower amid unsettling global headlines

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Article Highlights

- U.S. equity markets retreat from recent record highs.
- Fixed-income markets tread water, with Treasuries slightly underperforming.
- Turmoil in Iraq fuels market uncertainty and drives oil prices higher.
- China's economic slowdown has moderated, providing a lift to emerging markets.
- Economic indicators point to U.S. growth of about 3.6% in the current quarter.

June 13, 2014

Equities

U.S. equities retreated from their recent record highs, trading down for most of the past week. As of June 12, the S&P 500 Index was down nearly 1% for the week. Disconcerting headlines about widespread violence in Iraq contributed to the pullback. Relatively muted U.S. economic data, along with market exhaustion after three consecutive weeks of gains exceeding 1.2%, also may have been factors. European and Japanese stocks also edged lower. Emerging markets, supported by improving economic signals out of China, continued to rally, hitting a new 52-week high.

Fixed income

Fixed-income returns were generally flat to slightly positive across most categories. For the week through June 12, high-yield and investment-grade bonds fared incrementally better than U.S. Treasuries. The yield on the 10-year Treasury note, which has trended modestly higher since the European Central Bank (ECB) unveiled major new monetary stimulus on June 5, ranged from 2.58% to 2.65% during the week and stood at 2.60% at midday on June 13. Fund flows continued to support most fixed-income asset classes, including emerging-markets and high-yield debt.

Current market updates are available here.

Financial Services

U.S. economic data continues to point toward acceleration

Although some indicators released during the week could be considered mildly disappointing, others were encouraging. On balance, the U.S. economy remains on track to pick up steam in the second quarter. Among the week's releases:

- **First-time unemployment claims** increased slightly, to 317,000, and the four-week moving average also climbed. Despite the uptick, claims remained near post-recession lows.
- **Wholesale sales** (+1.3%) and **wholesale inventories** (+1.1%) both posted solid gains in April. With sales generally keeping pace with inventories, businesses are likely to continue replenishing supplies to accommodate higher demand—a good sign for economic growth.
- **Retail sales** inched higher in May (+0.3%), but this was below most forecasts and was driven primarily by strong demand for autos. Excluding autos, sales were up only 0.1%. On a positive note, April retail sales were revised sharply higher, to 0.5% from 0.1%.
- **Consumer sentiment** dropped from 81.9 in May to a preliminary reading of 81.2 in June, its lowest level in three months, according to the University of Michigan-Thomson Reuters index.
- **Small-business optimism** rose for the third consecutive month in May to a higher-than-expected level of 96.6—the best reading since September 2007, based on the NFIB index.

European equity markets pause after recent surge

European equities marked time after the previous week's enthusiastic run. Buoyancy from the ECB's policy announcement faded, while the uncertainty in Iraq, higher oil prices, and news that Italian Prime Minister Matteo Renzi faces real opposition to his political reform efforts, all weighed on markets. We will get a picture of the initial impact of the ECB's new programs later this month, when eurozone inflation figures are released.

The slowdown in China's economy is moderating

Chinese stocks rallied further during the week amid evidence that the economy is stabilizing. Although China's GDP growth has decelerated from the high 7% range to the low 7% range, the pace of that deceleration appears to be moderating, and upside surprises in Chinese economic data have increased sharply in recent weeks. In addition, metals prices have firmed and the commodity-driven Australian dollar has strengthened—two indicators associated with the health of China's economy. Moreover, while China still faces significant challenges, the government has taken a number of incremental policy steps to address them.

Outlook

It's unlikely that the week's decline in U.S. equities is the start of the summer correction we anticipated would occur after the S&P 500 Index breached the 1,950

level. More plausible, in our view, is that the market moved lower on the news from Iraq and the unexpected primary election defeat of the U.S. House Majority Leader, which has the potential to create new political disruptions in Washington. In other words, we think the past week was a small speed bump, not a sharp U-turn.

Lending credence to this view are internal market factors that have remained strong during the S&P 500's recent rise through 1,950. The proportion of industry groups in uptrends and the price action of individual stocks point to a market that has further upside potential. For now, the next near-term target is 1,970, but it could be even higher—and reached sooner rather than later.

In fixed-income markets, it is clear that negative U.S. GDP growth in the first quarter was an aberration, and that continued stable expansion in the economy is not at risk. In light of this, we expect the 10-year Treasury yield to range between 2.5% and 2.75% in the coming weeks. That said, the turmoil in Iraq could have a potentially greater impact on bond spreads and Treasury yields than the recent crisis in Ukraine, as a sustained increase in oil prices could quickly drive consumer sentiment and spending lower.

Most fixed-income asset classes appear to be fully valued, and there is risk that yield spreads could widen (i.e., bond prices could fall) modestly from current levels. Severe spread widening, however, remains unlikely, as Europe, China, and the U.S. are on sustainable, albeit slow-to-moderate, growth paths. In our view, most of the fixed-income gains we expect to see in 2014 have already occurred.

On the macroeconomic front, both "hard" measures (e.g., trade statistics, inventory spending, retail sales, payroll data) and "soft" indicators (opinion and sentiment surveys, help wanted signs, anecdotal reports, and so on) suggest the U.S. economy will grow about 3.6% in the current quarter. We expect relative outperformance in consumer spending and hiring in the near term, and in areas such as corporate spending, construction, and housing later in the year.

Financial Services

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