Weekly Market Update

Equity markets slip and Treasuries rally in an unsettled week

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Article Highlights

- U.S. equity indexes retreat from record highs as conditions turn more volatile.
- Treasuries and other high-quality fixed-income assets outperform.
- European equities decline amid weakening economic signals.
- Japan unveils long-awaited structural reforms as part of its “Abenomics” program.
- Despite a negative first quarter, U.S. GDP remains on track for moderate expansion this year.

June 27, 2014

Equities

U.S. equities turned volatile during the week, responding to technically driven trading flows, concerns that valuations may have become stretched, apprehension about the Federal Reserve’s tightening cycle, and mixed signals on the U.S. economy. The S&P 500 Index appeared headed for a modest weekly loss as of mid-day on June 27, after hitting record highs the week before. European equities also declined. In Japan, the Nikkei 225 Average posted its first weekly loss since mid-May. Emerging-market equities were flat to modestly higher.

Fixed income

While equity markets lost some ground, fixed-income performance was mostly positive. The Barclays U.S. Aggregate Bond Index returned 0.47% for the week through June 26, with Treasuries and investment-grade corporate bonds among the leading sectors. Demand for intermediate- and long-term Treasuries pushed their prices higher, and yields lower. As of mid-day June 27, the 10-year yield was 2.53%, down 10 basis points (0.10%) for the week. Yields on higher-risk assets traded in a relatively narrow range but could widen if there is a correction in the equity markets or a jump in Treasury yields.

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Current market updates are available here.

Downward revision in first-quarter U.S. GDP growth is an anomaly

The U.S. economy is sending mixed messages, with recent data including both positive and negative surprises. The Citigroup Economic Surprise Index, measuring the extent to which economic releases diverge from consensus forecasts, has turned lower, but we remain confident that key data will firm in the second half of the year.

Among the week's disappointing releases:

- **First-quarter GDP growth** was revised lower, from -1.0% to -2.9%. The downward revision was due primarily to sharply reduced consumer spending on healthcare, a larger-than-expected decrease in net exports, and a weaker increase in business inventories. Despite this result, there is enough evidence to suggest the U.S. economy is picking up steam—but that pickup will continue to be slow and measured as we move forward.

- **Consumer spending** rose just 0.2% in May, versus consensus forecasts of 0.4%. The weaker-than-expected result follows a flat (0.0%) reading for April.

- **Orders for durable goods** (e.g., appliances, computers, and transportation equipment) fell 1% in May, driven by a decline in defense orders. Orders for "core" capital goods (i.e., non-defense orders excluding aircraft), rebounded 0.7% in May after a 1.1% drop in April.

Positive data releases included:

- **New home sales** jumped nearly 19% in May, to an annual rate of 504,000.

- **Manufacturing activity** accelerated in June, based on the 57.5 "flash" (preliminary) reading of the Markit Purchasing Managers Index (PMI). (Readings above 50 indicate expansion.) Meanwhile, **non-manufacturing activity** surged to 61.2, according to Markit.

- **Consumer confidence** continued to rise, measured by The Conference Board index, which climbed to 85.2 in June—its best reading since January 2008. Meanwhile, the University of Michigan-Thomson Reuters Consumer Sentiment index rose to a better-than-forecast 82.5.

Softer economic data shows Europe's recovery needs a boost

Europe's economic recovery remains fragile. Data released for France during the past week showed a sharp drop in PMI and flat first-quarter GDP growth. In Italy, retail sales disappointed, while in Germany, the closely watched Ifo index of business confidence fell to its lowest level this year. The Citigroup Economic Surprise Index for Europe has been in a steady downtrend since January.

China's economic and market landscape slowly improves, but further reforms are key

China's economy has likely bottomed and should reaccelerate with multiple rounds of mini-stimulus programs and a resurgent export sector. Against this backdrop, Chinese equity markets are also either bottoming or in uptrends. Among the risks for China are its housing market, which is cooling but not collapsing, and capital flows, which have again turned negative. Also of concern is the government's inconsistent commitment to reform, with market-based measures progressing but state-owned-enterprise reforms lagging or delayed.

Reform is the watchword in Japan

Japanese Prime Minister Shinzo Abe released the details of long-awaited structural reforms referred to as the "third arrow" of his economic plan. The first two arrows—massive monetary stimulus and increased fiscal spending—have so far been helpful in combatting deflation and boosting growth, but reforms are still needed to achieve lasting results. The measures unveiled by Abe on June 24 focus on strengthening corporate governance and addressing structural problems in labor markets and the agriculture sector.

Outlook

On balance, it appears that the U.S. economy remains on track. We expect second-quarter GDP growth to come in at 3.6%, supported by further employment gains, encouraging surveys of company activity, and strong industrial output. Housing will continue to improve, but at a much slower pace than last year, and its overall impact on the economy will remain muted in the second half of 2014. For now, the threat of a spike in oil prices looks remote, but higher gasoline prices have already hurt consumers.

Although equity market valuations are above their medians, we do not consider stocks to be overvalued. Moreover, hedge funds' net exposures to equities have fallen, and a survey of extremely high-net-worth investors indicated that they still hold 28% of their assets in cash. Such contrarian signals are typically associated with a rise in stock prices. While at current levels the S&P 500 Index is susceptible to a potential correction of up to 10%, we see scant evidence of this occurring. Any pullback would present an opportunity, as we remain focused on a move above 2,000 for the S&P 500 this year.

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The fundamentals for fixed income remain sound. There is little risk of default and, so far, only a modest threat from credit-negative events such as mergers and acquisitions or leveraged buyouts. Buyer demand continues to exceed supply across many fixed-income categories, especially older mortgage-backed and commercial-mortgage-backed securities issued in previous years.

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