Weekly Market Update

Equities retreat from record highs as week's gains are erased

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Article Highlights

- After four days of gains, the S&P 500 Index drops sharply in Friday trading.
- U.S. Treasury yields fluctuate but end the week modestly lower.
- Positive economic signals in Europe and China suggest global growth will accelerate.
- The U.S. economy will fall short of expectations for the second quarter but is still progressing.
- Housing remains a weak spot, and we do not foresee significant improvement this year.

July 25, 2014

Equities

After four days of gains culminating with a record high on July 24, the S&P 500 Index reversed course on July 25 and finished the week essentially flat. Prior to Friday's decline, the market had been supported by positive economic data and generally better-than-expected earnings releases, along with equity investors' willingness to shrug off the latest geopolitical headlines. However, even during the S&P 500's four-day advance, price action was somewhat "tired," with morning surges giving way to afternoon liquidations and minimal gains. Small-cap stocks are lagging the broader market and have yet to reclaim their July 1 highs. European stocks moved higher for the week despite a down Friday that eroded earlier gains.

Fixed income

U.S. Treasury yields fluctuated in a relatively narrow range for much of the week, responding variously to positive economic data releases, geopolitical tensions, and reduced U.S. and global growth forecasts from the International Monetary Fund. The yield on the bellwether 10-year Treasury yield closed at 2.52% on July 24 but fell to 2.47% in afternoon trading on July 25. Performance across most

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investment-grade fixed-income sectors was flat to slightly negative for the week through July 24.

Current market updates are available here.

U.S. data releases include strong employment signals, muted housing activity

It was a quiet week on the U.S. economic calendar, but the data released was generally favorable.

- **First-time unemployment claims** plunged by 19,000 to 284,000, a much better-than-expected reading. This marked the lowest level since February 2006 and the first time that claims have gone below 300,000 since May 2007. At current levels, claims are indicative of average monthly job gains in the range of 225,000 to 250,000. If this trend continues, wage and income growth should follow, along with an improvement in consumer spending.

- **Orders for durable goods** (such as aircraft, machinery, computer equipment and other big-ticket items) climbed 0.7% in June while orders for "core" capital goods (non-defense items excluding aircraft) rose 1.4%, rebounding from a 1.2% drop in May. The jump in core capital goods orders exceeded most forecasts and is a positive sign for U.S. business investment.

- **Existing home sales** grew 2.6%, to a seasonally adjusted annual rate of 5.04 million, in June. This represents the third consecutive month of sales increases and the fastest pace of sales since last October. In contrast, new home sales disappointed, falling 8.1% in June, while May sales were revised downward.

In Europe, economic improvement appears to be stirring

European economic data released during the past week has been largely positive. Purchasing Managers Indexes (PMIs) for the eurozone showed that private-sector activity grew more quickly that expected, according to Markit's "flash" (preliminary) estimates. Employment statistics were also favorable. We believe that GDP growth throughout the region will modestly accelerate through the remainder of this year. One note of caution came in the form of German business confidence, which fell for the third month in a row, as measured by the closely watched index published by Germany's Ifo Institute. Ifo attributes the decline in part to worries over geopolitical tensions in Ukraine.

China's economy is showing resilience

Chinese economic activity is also accelerating, evidenced in part by a stronger-than-expected rise in China's flash PMI for July, which came in at 52.0—an 18-month high—as measured by HSBC. (Readings above 50 indicate expansion.) In addition, China's currency, the yuan, has recently strengthened, indicating that policymakers inside China are signaling further growth. Because the yuan is heavily managed, the direction of the currency can still be used as a proxy for the direction of policy.

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Outlook

The U.S. economy will come in shy of expectations for the second quarter but is still making progress. This is especially true in the labor markets, where job growth finally appears to have taken hold, and in production, where output is improving. These factors should prove to be a good foundation for further acceleration during the second half of the year.

Overall, housing remains the weak spot in the economy. Activity has been positive but muted, which is why we are not overly optimistic about second-quarter GDP growth. Moreover, we don't foresee significant improvement in the housing sector for the remainder of 2014.

Despite the past week's retreat from record highs in U.S. equity markets, we believe that the S&P 500 Index could move through the 2,000 level. There are caveats, however: long-term sentiment has become more optimistic, and hedge fund net exposures to equities have risen. These contrarian signals warrant caution because they are often associated with a subsequent market downturn.

In fixed-income markets, yields on high-yield bonds have risen since the beginning of July, while yields on U.S. Treasuries have fallen, in part reflecting investors' aversion to risk in light of geopolitical tensions. The result has been a widening in high-yield spreads relative to Treasuries. We watch high-yield spreads closely, because widening can be an early warning indicator of a weaker economy. That said, barring a sizable correction in equities, we think it unlikely that spread widening will significantly affect other categories of riskier fixed-income assets in the third quarter, as Fed policy and the lingering effects of quantitative easing provide a supportive backdrop for these assets.