Weekly Market Update

Equities move higher as calm returns to markets

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Article Highlights

- The S&P 500 rallies following its recent drop into correction territory.
- European stocks also rebound and may offer higher potential returns than U.S. shares.
- Treasuries pull back from recent gains amid investors' renewed appetite for risk.
- Potentially favorable results from the ECB's "stress tests" could boost markets but are unlikely to spur economic growth.
- China reports its slowest GDP growth in five years.

October 24, 2014

Equities

U.S. equity markets rebounded during the past week. The S&P 500 Index surged 3.4% for the week through October 23 and was headed for its best week of 2014, with another gain through midday trading on October 24. Upbeat third-quarter U.S. corporate earnings and better-than-expected economic data out of Europe outweighed concerns over a slowdown in China. European and Japanese stocks also rallied. Amid a weakening yen and an easing in global volatility, Japan's Nikkei 225 Index jumped more than 5%, snapping a four-week losing streak.

Fixed Income

U.S. Treasuries, meanwhile, lost ground. The yield on the bellwether 10-year U.S. Treasury note, which moves in the opposite direction of its price, closed at 2.29% on October 23, marginally higher than its close on the previous Friday. High-yield corporate bonds outperformed other "spread products" (higher-yielding, non-U.S. Treasuries) and still offer attractive yields. In Europe, peripheral debt markets such as Spain and Greece rallied on improving global risk sentiment and expectations for generally positive results from the European Central Bank's (ECB's) Asset Quality Review, or "stress tests," scheduled for October 26 release.

Financial Services

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U.S. housing activity perks up and job creation remains on track

In a relatively quiet week on the U.S. economic calendar, data reports were mostly favorable.

- **Existing home sales** hit their fastest pace in a year (+2.4%), rising to a seasonally adjusted annual rate of 5.17 million in September. This better-than-expected report suggests that recent soft housing releases may have been transitory, and that the sector is progressing along the path we expected.
- **Home prices** also topped forecasts, increasing 0.5% in August.
- **New home sales** reached a six-year high in September, while purchases in August were revised downward.
- **First-time unemployment claims** moved up slightly (to 283,000) but are still indicative of average monthly job gains in excess of 225,000 for the rest of the year.
- The Conference Board's index of **leading U.S. economic indicators** accelerated in September, pointing to further economic expansion heading into 2015.

On a slightly less positive note, U.S. **manufacturing activity** hit a three-month low in September (56.2), based on the "flash" (preliminary) reading of the Markit Purchasing Managers Index (PMI). Still, the reading remained well above the 50 level separating contraction from expansion.

Without QE, the ECB's actions may have little effect on spurring growth or inflation

We believe European markets are more bearish on growth in the region than fundamentals warrant. Overall, "Flash" PMIs for September showed stabilization, auto sales jumped and unemployment fell in Spain. Aside from these improving indicators, the results of the ECB's asset quality review (a comprehensive balance-sheet assessment of 130 euro-area banks, including "stress tests" to gauge how well these banks would withstand a three-year shock to the economy), are of immediate interest. Results inspiring confidence in the health of the region's banking system could provide a catalyst for financial markets.

While there are additional potentially positive outcomes, including the prospect of banks being able to extend more credit, the eurozone's real struggle is not a lack of loan supply but weak loan demand. Moreover, the ECB's actions to date are unlikely to reverse Europe's declining inflation expectations. We still believe the ECB will eventually be forced to enact full-blown quantitative easing over the next year to jumpstart the region's economy.

The Chinese economy is in downshift mode

China's "flash" Manufacturing PMI reading improved slightly in September (to 50.4) and housing sales edged up, providing some relief to the country's struggling real estate market. Meanwhile, China's GDP in the third quarter grew at a reported 7.3%, its slowest pace in five years. We expect the pace of growth to continue declining as the Chinese economy retools to better accommodate its rising middle class. Over the past decade, China has been largely responsible for fundamental commodity price swings as well as global growth on the margin. In our view, that degree of influence will recede.

Outlook

Third-quarter corporate earnings results are especially important because they provide guidance on the Christmas season, thus setting expectations for the remainder of the year. With a few notable exceptions, earnings have been surprising to the upside. Add to this a small boost in U.S. housing activity and improving employment prospects, and we remain comfortable with our growth forecasts for the third and fourth quarter of 3.3% (or higher) and 3.5%, respectively.

As for fears that Europe's economic weakness will harm U.S. growth, it is worth noting that the U.S. export sector is small compared to that of many other countries, so the slowdown abroad has a less direct impact stateside. Much has also been written about the effects of a stronger dollar on U.S. economic growth, but a rising currency will not necessarily provide a headwind. A stronger dollar makes our imports cheaper and tends to lower consumer costs on items such as food, gasoline, and utilities. This helps to distribute growth better across the economy and boosts purchasing power.

In fixed-income markets, we continue to believe that investment-grade corporate bonds offer solid value and enough spread cushion to offset a gradual rise in interest rates. High-yield corporates likewise appear able to withstand sudden spread widening, although the high-yield asset class is subject to greater fluctuation in fund flows. We believe spread products are likely to rally modestly toward year end, while the 10-year Treasury yield should finish the year close to current levels.

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