Weekly Market Update

For equity markets, a quiet end to a positive month

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Article Highlights

- Global equities advance amid relative calm in the markets.
- European government bond yields touch record lows in advance of QE.
- We are not overly concerned about the downward revision to Q4 GDP growth, as consumer spending remained strong.
- Yellen testimony aims for flexibility but leads us to believe the Fed is closer to raising rates.
- We are maintaining our growth forecast for Europe as its economy continues to improve.

February 27, 2015

Equities

U.S. equities finished essentially flat for the week, giving up some earlier gains in late trading on February 27. Investors focused primarily on the latest comments from Federal Reserve Chair Janet Yellen during her bi-annual testimony before Congress and on a batch of mixed economic reports. For February as a whole, the S&P 500 Index was up nearly 6%, its best one-month return since October 2011.

Supported by the recent agreement to extend Greece's bailout and better-than-expected employment data from Germany, European stocks posted a modest gain for the week en route to reaching a fresh seven-year high and a return of roughly 6% for the month (in U.S. dollar terms). Japan's Nikkei 225 Index continued its year-to-date rally, a possible indication that reforms are beginning to have their desired effect.

Chinese equities were also up for the week and for the month. China's government announced that it will attempt to stimulate the economy by cutting fees, extending small business tax breaks, and pursuing a proactive fiscal policy. We expect weaker first-quarter GDP growth in China before activity begins to pick up in the second quarter.

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Fixed income

U.S. Treasury prices edged higher during the week, pushing their yields lower. The bellwether 10-year note traded in the 2.00% range after closing the previous week at 2.13%. Returns for “spread sectors“(higher-yielding, lower-rated, non-U.S. Treasuries) were broadly positive, led by high-yield and investment-grade corporate bonds. In Europe, government bond yields touched new lows amid strong demand and limited supply in advance of the European Central Bank’s quantitative easing (QE) program, scheduled to begin in March.

The U.S. economy remains in a holding pattern

Not unexpectedly, U.S. GDP growth for the fourth quarter was revised downward, from 2.6% to 2.2% in the government’s second estimate. We are not overly concerned, though, as most of the revision reflected weaker inventory spending, which is not as critical an indicator of underlying economic growth as consumer spending. Although consumers spent slightly less than originally estimated, consumption in the fourth quarter remained at its highest level since 2010.

Other data releases for the week provided evidence that the U.S. economy, while stable, has slowed since late last year:

- **First-time unemployment claims** jumped 31,000 to 313,000, and the less-volatile four-week moving average also rose, to 294,500.
- **Consumer sentiment** fell in February, according to the final reading of the Thomson Reuters-University of Michigan Index, as did The Conference Board’s index of **consumer confidence,** which declined from January’s multi-year high.
- **Existing home sales** dropped 4.9% in January, far more than expected. **New home sales**, while essentially unchanged from December, still topped forecasts. December new home sales were revised up to their highest level in almost seven years. **Pending home sales** rose 1.7% in January, and December’s reading was revised upward.
- **Home prices** rose 4.5% in December versus a year ago, in line with expectations and more than double the rate of inflation, according to the S&P/Case Shiller 20-City Composite Index. Overall, we expect housing data to ebb until the beginning of the spring selling season.
- **Durable goods** orders (aircraft, machinery, computer equipment and other big-ticket items) climbed 2.8% in January. Orders in December were revised downward, in line with the longer-term trend. Orders for “core” capital goods (a measure of business investment) also rose, but here, too, the trend remained negative.
- **Service-sector activity** rebounded to 57.0 in February, according to the Markit “flash” (preliminary) Purchasing Managers Index. (Readings above 50 signal expansion.)

Headline inflation as measured by the Consumer Price Index was negative in January, both on a month-over-month and year-over-year basis. However, excluding the impact of gasoline, core inflation increased for the month and remained at 1.6% year-over-year. This suggests that energy is driving the headline number. Since oil prices have stabilized, inflation measures should start to pick up again shortly.

Economic activity in Europe continues to improve

European activity is clearly improving, with the Euro Area Citi Economic Surprise Index, which measures economic releases relative to forecasts, turning sharply higher. (This means data readings were better than expected.) Moreover, the region's earnings growth estimates have been revised upward, and bank lending has risen. A pair of solid reports from Germany added to the upbeat mood: unemployment fell in February, and consumer confidence hit its highest level since 2001.

In spite of this brightening economic landscape, we see little evidence of significant improvements in activity in the near term, and we are maintaining our Eurozone GDP forecast of 1% (annualized) for 2015. We will reevaluate this once QE begins, allowing us to judge the effectiveness of the program. We are also mindful of the potential for further uncertainty in Greece and escalating tensions in Ukraine, factors that could stymie the region's economic growth.

Outlook

Although markets were searching for definitive clues regarding the pace and timing of the Federal Reserve's next interest-rate move, Chair Janet Yellen tried to strike a balance between paving the way for a June increase while trying to preserve the flexibility to hold off on raising rates if the economy faltered or if inflation, in the Fed's eyes, remained too low. We expect the Fed's language to change in its March policy statement, shifting away from assurances that it can "be patient" about raising interest rates as we head toward the first increase in the federal funds rate since 2006.

For U.S. equities, investor sentiment continues to edge into extremely bullish territory, and 80% of S&P 500 stocks are still trading at or above their 50-day moving averages—two signs of a possible correction. In fixed-income markets, corporate and securitized assets continue to benefit from positive fund flows.