Weekly Market Update

Robust February jobs report stokes fears of an earlier Fed rate hike

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Article Highlights

- U.S. stocks end a volatile week on a down note.
- February's surprisingly strong employment data sends U.S. equity and Treasury prices tumbling.
- European stocks are buoyed in advance of QE and by solid economic data.
- While Greece has dropped from the markets' radar, its debt problems are far from over.
- We think the Fed is now more likely to raise rates in June, but the pace and scope of rate increases should still be moderate.

March 6, 2015

Equities

With no significant market-moving economic news released during the week's first four days, investors seemed to be in waiting mode ahead of February's U.S. employment report, released on March 6. The jobs data, which exceeded forecasts, fueled investor fears that a Federal Reserve rate hike could come sooner rather than later. The S&P 500 Index fell more than 1.4% on Friday and was down 1.6% for the week.

Stocks in Europe finished the week in far better form, rising to a seven-year high. Shares responded to additional signs of the region's economic recovery and the European Central Bank's (ECB's) announcement that its massive quantitative easing (QE) program will begin on March 9 and continue through at least September 2016. The ECB will purchase €60 billion (U.S. $68 billion) per month of government bonds and other debt in order to reduce interest rates, increase inflation and stimulate economic growth. By week's end, the euro had fallen to a 12-year low against the dollar.

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Fixed income

While the number of U.S. jobs surged in February, the number of people seeking work declined, as measured by the labor participation rate. The bond market viewed this as a potentially inflationary combination, concluding that wages must eventually rise due to a limited labor supply. As a result, U.S. Treasury prices sank, pushing the yield on the bellwether 10-year note up by 16 basis points to a 2015 high of 2.24%. (Price and yield move in opposite directions.) Rising yields also broadly hurt non-Treasury sectors of the fixed-income market.

February payrolls demonstrate broad-based strength in U.S. jobs growth

The U.S. economy added 295,000 jobs in February, ccompared to an average of 266,000 per month over the prior 12 months. January payrolls were revised down modestly, to 239,000. Meanwhile, the unemployment rate declined to 5.5%, and the labor force participation rate dipped to 62.8%. Wage growth disappointed, with average hourly earnings rising by just 0.1% in February and 2.0% over the past 12 months.

Outside of the robust employment trend, February's economic releases to date are looking only marginally better than January's relatively lackluster data. We still expect business production to dovetail with strong consumer activity, leading to a stronger second quarter and second half of the year.

Among the past week's reports:

- **First-time unemployment claims** jumped to 320,000 and the less-volatile four-week moving average also rose, to 304,750.
- **Personal income** increased 0.3% in January, while **consumer spending** fell 0.3%. This decline wasn't surprising given the mix of soft economic data combined with the cold weather. We expect spending to rebound and income to continue to rise.
- The index of **manufacturing activity** published by the Institute for Supply Management (ISM) dropped to 52.9 in January, but remained above the 50 mark indicating expansion. A slowdown in inventory spending was a major factor behind the fall. A similar manufacturing index from Markit was revised up in February, to 55.1.
- **Service-sector activity** improved slightly in February, to 56.9, based on ISM's non-manufacturing index.

European indicators point to more upside, but we remain mindful of Greece

The Eurozone has continued to improve ahead of the QE launch. Retail sales rose for the fourth straight month in January and hit their highest rate in more than nine years. Additionally, manufacturing and service-sector activity in the Eurozone's four largest economies—Germany, France, Spain, and Italy—expanded for the first time in almost a year.

While Greece's debt challenges have receded from the headlines, we are still keeping a close watch on developments there. The Greek government must soon begin to enact austerity measures and deliver economic reforms in order to receive the funding necessary to keep the country afloat. The question remains whether the new government will be able to satisfy the demands of its international creditors while also keeping its anti-austerity election promises.

Outlook

Although non-employment economic data has softened, we think the February jobs report has increased the odds of a June rate hike, as Fed officials focus on an unemployment rate that is lower and falling faster than they expected. However, we still expect the pace and scope of rate increases to be moderate.

Although a 5% to 10% correction in the S&P 500 may be in store this year, we do not believe such a pullback is imminent. Despite reductions in corporate earnings estimates, economically sensitive sectors have been performing well, perhaps an indication that the market is looking past recent patches of soft economic data toward better future activity. Supporting our cautiously optimistic view are longer-term measures of investor sentiment: Hedge funds' net exposures to equities have fallen, and Wall Street strategists have been recommending lower equity allocations—two contrarian indicators often associated with a subsequent rise in stock prices.

The path toward future gains may not be smooth, however. U.S. equity valuations are stretched, and volatility will likely rise as markets digest both the start of QE in Europe and the prospect of Fed rate increases. Against this backdrop, we currently view Europe as a more attractive equity investment destination than the U.S., at least in local currency terms.

In fixed-income markets, the rise in U.S. Treasury yields should be mitigated by stronger demand from non-U.S. investors seeking more attractive yields than those available in Europe. While rates in Europe are already low, QE should push them even lower.

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