Weekly Market Update

Global equities stage late-week rally as oil prices rise

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- Equity markets worldwide continue to take their cues from oil prices.
- Fixed-income assets post varied results during the week, with high-yield bonds still bearing the brunt of risk aversion.
- U.S. data releases fail to inspire, pointing to a fourth-quarter slowdown.
- The oil price collapse may prove temporary, given falling production rates and a surge in crude oil imports from China.
- Although some forecasts have called for a U.S. recession, we believe the economy will not deviate from its positive, albeit slow, path of recovery.

January 22, 2016

Equities

Global equities endured a volatile week, highlighted by the usual medley of fears about plummeting oil prices and the decelerating global economy, specifically in light of China's weakness. China reported that its GDP had expanded at its slowest annual pace (+6.9%) in 25 years, fueling expectations for additional monetary stimulus from Beijing. Major Chinese indexes finished the week down sharply.

In Europe, the STOXX 600 Index snapped its three-week losing streak with a gain of 2.6% (in local currency terms). Markets took comfort from a mid-week rebound in oil prices off a 12-year low, and from strong hints by European Central Bank President Mario Draghi that further monetary stimulus measures were imminent.

U.S. stocks were also on track for their first weekly gain of the new year. The S&P 500 rose about 1.4% in the holiday-shortened week.

Current updates to the week's market results are available here.

Fixed income

After starting the week at 2.03%, the 10-year U.S. Treasury yield headed down through midweek, benefiting from a continued flight to safety, before retracing its steps, reaching 2.06% on January 22. (Yield and price move in opposite directions.) Returns for most U.S. fixed-income "spread sectors"

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(non-Treasury securities) ranged from mildly positive to slightly negative. High-yield corporate bonds again posted negative returns amid the prevailing risk-off environment.

U.S. economic indicators reinforce our expectations for a slower fourth quarter

The past week's data releases support our view that economic growth slowed as we approached year-end. (The government's advance estimate of fourth-quarter GDP growth will be released on January 29.) Among the week's reports:

- **First-time unemployment claims** rose by 10,000, to 293,000, and the less-volatile four-week moving average, considered a more accurate predictor of labor-market direction, increased by 6,500, to 285,000. We believe this data is going to take on added importance. The Federal Reserve has anticipated a deceleration in job creation this year, as job supply outstrips demand.

- **U.S. consumer prices** fell 0.1% in December, pulled down by falling gasoline prices. For all of 2015, inflation rose just 0.7%, the second-slowest rate in 50 years. Stripping out volatile food and energy costs, so-called "core" inflation ticked up by only 0.1%. Higher inflation is a key indicator of stronger economic growth, and a primary focus for the Fed.

- **The Philly Fed manufacturing index** declined for the fifth month in a row, further evidence of struggling U.S. manufacturers.

- **Home builder confidence** remained steady in January, according to the National Association of Home Builders. Overall, builders have gained confidence as the jobs growth has started to nudge wages higher.

- **Housing starts** dipped 2.5% in the month of December but climbed 11% year-over-year.

Outlook

In our view, the link between falling oil prices and their effect on global economies is a bit tenuous, but may reflect fear that potential defaults among bonds issued by energy-related corporations and by select sovereign nations will feed into weakness in developed markets. The prospect of such an occurrence has already led to substantially wider spreads on high-yield debt. Encouragingly, while spreads on non-energy-related debt have widened, they have not "blown out" (which would indicate a much steeper slowdown in economic activity). Overall, the oil price collapse may prove temporary, given falling production rates on the supply side and a surge in China's crude oil imports on the demand side.

We also question to what extent China's slowdown will affect the U.S. and European economies, while remaining mindful of the possibility that a "hard landing" of the Chinese economy could trigger a bank credit crisis. (We note, though, that the Chinese interbank rate remains stable, an indication of little or no stress in the financial sector.) Under a worst-case scenario, China's central

bank would be forced to liquidate its reserves, most of which are U.S. Treasuries. That would serve as a net drain on global liquidity at a time when the U.S. and European recoveries have slowed or remain somewhat fragile, and the Fed has embarked on a new tightening cycle.

For the U.S. economy, some forecasters have suggested that recessionary threats have surfaced. We disagree. Although sector growth hasn't accelerated, the real economy remains stable. We detect no bubbles or imbalances, and see no indication that the economy will deviate from its recovery trend. We now expect GDP growth to come in at about 1% for the fourth quarter of 2015 and 2% in 2016, levels that are below our previous forecasts.

In equity markets, fourth-quarter corporate earnings releases have, thus far, been relatively good. Of the 15% of companies that have reported, over 70% have beaten earnings-per-share forecasts, and 51% have topped sales forecasts. At the same time, S&P 500 earnings estimates have been marked down. In order for the market to hit new highs—which may take some time—the U.S. economy would have to generate better second-half growth.

Fixed-income investors are focused not only on oil, China, and global growth, but also on tight liquidity and uncertainty about potential problems in the less-mainstream financial community (such as hedge funds). U.S. banks, meanwhile, are well capitalized, unlike in 2008. Looking ahead, credit markets are unlikely to rebound strongly until oil prices stabilize and clarity emerges around the health of China's economy—a distinct challenge given Beijing's notorious lack of transparency.

Financial Services

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