Weekly Market Update

Equities begin February in the red amid dollar weakness and jobs uncertainty

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Article Highlights

- Volatile equity market performance is driven by a sharp drop in the dollar and a surge in commodity prices.
- January's jobs report sends U.S. and European stocks lower for the week.
- U.S. Treasuries rally, while investors continue to shun high-yield bonds.
- While the headline payrolls number is soft, wage growth accelerates and the unemployment rate falls.
- While further volatility is expected, we still believe U.S. equities can move higher through the year.
- China shows some signs of stabilizing but is not out of the woods yet.

February 5, 2016

Equities

The week's volatile equity market performance was largely defined by a sharp drop in the dollar, surging commodity prices, and January's jobs report. The dollar's retreat, triggered by further evidence of weaker U.S. growth, hints that China's economy is stabilizing, and the aftermath of Japan's recent surprise monetary easing measures, added to the mix.

The S&P 500 Index slipped 3.1% for the week, while Europe's STOXX 600 Index ended its three-week winning streak by falling 4.8% (in local terms). The Eurozone economy got off to a disappointing start to the year: Manufacturing and service-sector activity slowed in January, and inflation in the region rose just 0.4%, versus a year ago.

Stocks in Asia were mixed. Japan's Nikkei 225 Index dipped about 0.7%, while Chinese equities posted a modest gain. China's central bank injected funds into the financial system three times this week to address cash needs in anticipation of the country's upcoming Lunar holiday.

Financial Services

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

Fixed income

U.S. Treasuries traded within a relatively narrow range amid pockets of volatility. After beginning the week at 1.92%, the 10-year Treasury yield fell below 1.8% on February 3 on the heels of some weaker-than-expected data before closing at 1.83% on February 5.

Following the release of the January payrolls report, fixed-income markets focused on two distinctly different potential consequences: the possibility that January's robust rise in wages could prompt the Fed to accelerate its tightening timetable in 2016, and the likelihood that broad global deflation risks will cause the Fed to put further rate increases on hold. In our view, the Fed is likely to hold the line in March, with a maximum of one rate hike this year.

Based on Barclays indexes, non-Treasury markets produced mixed results. Returns for high-yield corporate bonds were sharply negative, while commercial mortgage-backed securities posted a modest gain.

January's jobs report points to a healthy labor market, but we need additional evidence

The U.S. economy added only 151,000 jobs in January, well below forecasts. While markets reacted poorly to this lower-than-expected headline number, we think the report as a whole was relatively strong, suggesting that the economy may be on the cusp of accelerating. Average monthly job gains are holding above the 200,000 mark, indicating that the underlying trend in jobs growth is not slowing. Moreover, November's payrolls were revised upward by 28,000, nearly offsetting December's 30,000 downward revision. Encouragingly, unemployment dipped to 4.9%, its lowest level in eight years, and wages jumped 0.5% in January, after remaining flat in December.

Other data reports were mixed. Among the week's releases:

- **First-time unemployment claims** rose by 8,000, to 285,000, and the less-volatile four-week moving average also increased, by 2,000, to 284,750.
- **Manufacturing activity** inched higher in January, to 48.2, but stayed in contraction territory for the fourth straight month, according to the index published by the Institute for Supply Management (ISM). (Readings under 50 indicate contraction.) A similar indicator from Markit also ticked up, to 52.4. Overall, the manufacturing sector continues to struggle against the headwinds of currency crosswinds and weak global demand.
- **Service-sector activity** grew at its slowest pace in almost two years, with ISM's nonmanufacturing index dipping to 53.5 in December.
- Even though **personal income** increased 0.3% in December**, consumer spending** was flat. Spending in November was revised higher, to 0.5%. For 2015 as a whole, consumer outlays were the strongest in a decade.

Outlook

Among global economies, China remains our greatest longer-term concern. Beijing's persistent problem of delivering clear signals to the market reinforces an impression that the government does not have a handle on its currency (the yuan), or the economy. A sharp decline in the yuan could trigger a destabilizing currency war in the Pacific Rim, with possible ramifications for the global economy.

Other challenges include overindebted companies and state-owned enterprises, as well as Beijing's lack of resolve in enacting market-oriented reforms. Moreover, real estate prices, while stable, have reached levels that if reversed could create problems for banks and consumers. There are signs of stabilization, however. In January, China's service sector notched its fastest pace of growth since last summer. Auto sales and other rudimentary measures are improving, and the weaker dollar has helped stanch capital outflows, another red flag for both China's and the world's economies.

In the U.S., the dollar's fall helps the equity market in many ways. Last year, dollar strength trimmed the share prices of S&P 500 stocks by up to $10 per share. Reversing the dollar's upward trend can help recoup that loss. Additionally, a weak dollar makes U.S. exports more competitive, increases the dollar value of overseas sales, and typically supports oil prices. Some believe that plunging oil prices presage the beginning of a bear market—a view that we do not share.

In fixed income, investors continue to cast a wary eye on the same issues that have prompted caution over the past month or so: the pace and scope of Fed tightening, China's slowdown, and what the direction of oil prices foreshadows about the health of the global economy. Although we believe fixed-income spreads have already priced in much of the negative sentiment, the uncertain environment has not encouraged investors to enter the market or aggressively add to their positions. Additionally, fund flows have generally been negative across most fixed-income asset classes, creating a modest headwind to performance.

Financial Services

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