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Equities continue to rally on improving economic data, rising oil prices

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Article Higlights

- March's U.S. jobs report helps U.S. and European stocks notch their third straight weekly gain.
- The market-friendly employment release confirms that the economy remains on track and should allow the Fed to keep rates steady in March.
- A "risk-on" environment dampens demand for Treasuries, while record inflows buoy high-yield bonds.
- Although a number of factors may hinder U.S. equities, we see potential for additional gains before the S&P 500 corrects.
- In fixed income, value exists in non-Treasury sectors, but volatility will likely persist, offering opportunities for active management.

Equities

Global equities worked higher during the past week, extending their recovery from February's lows. In the U.S., the S&P 500 Index returned 2.7% for the week, as economic data improved, inflation expectations rose, and commodity prices lifted, with oil jumping about 10%. A resumption of corporate buybacks also boosted the index.
In Europe, the STOXX 600 Index gained 3.1% for the week, as investors anxiously await the March 10 policy meeting of the European Central Bank, which is widely expected to deliver more stimulus to spur stubbornly low inflation on the continent.

Meanwhile, China's central bank cut the reserve ratio requirement for banks in a bid to bolster lending and growth. Recent economic data out of China has been mixed, and on March 3, Moody's downgraded its outlook on Chinese government debt to "negative" from "stable," citing uncertainty over Beijing's capacity to implement economic reforms, growing government debt, and falling reserves. Equity markets in China forged ahead nonetheless, advancing for the last four days of the week.

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

Fixed income

Demand for U.S. Treasuries slipped, pushing prices lower and yields higher in the week's prevailing "risk-on" environment. After dipping to 1.74% on February 29, the bellwether 10-year yield closed at 1.87% on March 4. (Yield and price are inversely related.) Based on Barclays indexes, non-Treasury "spread sector" performance was mixed. High-yield corporate bonds surged 2.42% for the week through March 3, buoyed by record inflows, rising oil prices, and reduced fears of a U.S. recession. After a rocky start to 2016, returns for this asset class are in positive territory

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(+0.80%) for the year to date. Emerging-market debt also rallied amid favorable supply/demand dynamics and expectations for a potentially slower pace of Fed rate hikes.

February's solid jobs report doesn't represent a fundamental change in the U.S. labor market

The U.S. economy added 242,000 jobs in February, well ahead of expectations. In addition, payrolls for December and January were revised up by a combined 30,000. The jobless rate remained at 4.9%, largely because more than 500,000 people joined the work force, and the labor-force participation rate moved up to 62.9%, its highest level since last May. Disappointingly, wage growth missed forecasts, falling 0.1%, after increasing in January.

Even though February's payrolls growth was a substantial improvement over January's (+172,000), in our view the U.S. labor market won't fundamentally change until wage growth accelerates. Broadly speaking, this report gave markets what they were looking for: confirmation that the economy remains on a steady growth trajectory but with wages struggling, which provides cover for the Fed to hold off on raising rates in March.

Among the week's other releases:

- **First-time unemployment claims** rose by 6,000, to 278,000, while the less-volatile four-week moving average edged down by 1,750, to 270,250.
- **Pending home sales** fell 2.5%, although they're still up 1.4% compared to last January.
- **Manufacturing activity** topped forecasts by increasing to 49.0 in February but remained in contraction territory for the fifth straight month, according to the index published by the Institute for Supply Management (ISM). (Readings under 50 indicate contraction.) Manufacturers expressed cautious optimism even as the headwinds of weak global demand and fewer orders from U.S. energy companies persist. In a hopeful sign, **factory orders** increased 1.6%, their biggest rise in seven months.
- **Service-sector activity** slightly exceeded expectations but inched lower nonetheless, with ISM's non-manufacturing index dipping to 53.4 in January.
- The **Citi Economic Surprise Index** has jumped from its early February lows. This index gauges the extent to which economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises.

Outlook

Whether stocks can maintain their rally remains to be seen. Corporate earnings estimates have disappointed, while an expected pickup in wages, combined with poor productivity, could pressure profit margins. On the positive side, an improving economy, rising commodity prices, and higher inflation—a key indicator of stronger economic growth—offer support to equity markets. Moreover, U.S. consumers, who have benefited from a healthy jobs market, may amp up spending amid falling gas prices.

As of now, a more bullish view may hold sway. Value, consumer cyclicals, and energy shares—sectors that tend to perform well when the economy is improving—have led the market's recent advance. Further, a rally is not what the consensus expects; sentiment has been extremely negative, a contrarian indicator that often signals a subsequent rally. That said, we would not be surprised to see a correction in the S&P 500 if the index moves above 2000, which would represent a rebound of more than 10% from its February low. However, we would still view that sort of a correction as a buying opportunity as we remain believers that the market may move back to and even through previous highs over the next 12 to 18 months.

In fixed-income markets, we believe many spread sectors continue to offer good value (including investment-grade and higher-quality high-yield bonds, and select structured products such as asset-backed and commercial mortgage-backed securities). Volatility is likely to persist, fueled by swiftly changing investor sentiment, bouts of illiquidity, and global events. We also expect volatility as the Fed sticks with its "data dependent" course, which forces both interest-rate policymakers and investors to react in real time. In addition to Fed watching, bond markets will also be highly sensitive to upcoming commentary from central banks in Europe and China. The impact of such uncertainty on market behavior may present opportunities for active management and fundamental credit selection.

Lastly, the March 7 release of China's currency reserves has the potential to move markets. A spike in capital flight from January's levels could further pressure the Chinese currency, the yuan. If outflows ease, however, currency markets could stabilize, stoking investors' risk appetite. Also noteworthy are signs of improving "China-centric" data. These include improving copper prices and a stronger Australian dollar, a commodity-intensive currency.

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