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Equities follow oil prices higher, while the impact of new European easing is mixed

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Article Highlights

- Following four days of meandering returns, U.S. stocks rally on a surge in oil prices and optimism for European growth following the ECB's announcement of a new round of monetary easing.
- Initial enthusiasm for the ECB's expanded program fades quickly on Thursday but rebounds on Friday, bolstering the market's strong advance.
- In our view, new stimulus efforts and other developments in China are more significant than the week's headlines about oil and Europe.
- Overall, we think the economic backdrop remains supportive of higher stock prices, but we would not be surprised by a correction.
- We currently see value across many fixed-income sectors, including high-yield and investment-grade corporate bonds, emerging-markets debt, and certain securitized assets.

Equities

The S&P 500 Index meandered for much of the past week as investors digested its impressive advance since hitting a two-year low in February. Volatile oil prices remained in the spotlight, tumbling on supply concerns earlier in the week and surging on Friday, March 11, when the International Energy Agency reported a drop in OPEC's crude oil output for February and suggested that "prices might have bottomed out." (Oil has staged a comeback from a low of $26 per barrel on February 11 to nearly $39 on March 11.)

This news drove the S&P 500 sharply higher and into positive territory as the week came to a close.

On March 10, the European Central Bank (ECB) announced another round of monetary stimulus that far exceeded expectations. The ECB cut its key lending rate to zero, lowered its already negative deposit rate, expanded its bond-buying program to include corporate debt, and unveiled a new series of low-cost, long-term loans for Eurozone banks. While the announcement initially sparked a rally in European stocks, its effect wore off quickly as ECB President Mario Draghi noted that any further rate cuts would be unlikely in the near term. Eurozone equities rebounded the next day, however, as investors eyed the potential benefits for bank shares.

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

Fixed income

Both investment-grade and high-yield corporate debt performed well during the week. High-yield bonds reacted positively to the improvement in oil prices, as up to one-fifth of the high-yield market consists of energy-related issuers. Demand for high yield was also evident in another week of positive fund flows. Investment-grade corporates benefited from the ECB's announcement that it was expanding its asset purchases to include Eurozone corporate bonds, as this could also have a positive effect on U.S. dollar corporates, many of which are issued by European companies.

Meanwhile, U.S. Treasuries fell from favor. The bellwether 10-year Treasury yield, which had been averaging around 1.87% for the month to date through March 10, was hovering close to 2% in afternoon trading on March 11. (Yield and price move in opposite directions.) This yield widening reflects continued strength in U.S. labor markets, including a drop in first-time weekly unemployment claims to a five-week low of 259,000, and a steady rise in inflation expectations. Healthy employment data may support the case for the Federal Reserve to raise interest rates as the year progresses, damping demand for safe-haven assets.

Recent developments in China warrant attention—and caution

It was a very light week for U.S. economic releases. And while markets focused on oil prices and Europe, we think developments in China were actually a more important story.

- First, consumption of China's foreign-currency reserves was much lower than expected, indicating that the government's attempts to stem the outflow of capital have been successful. This takes some of the pressure off the central bank to further devalue the Chinese currency—a significant risk with potentially global consequences, as we saw last fall.

- Second, the government announced a series of stimulus measures that are bullish for the economy in the near term. These include an increase of greater than $500 billion in fiscal spending on infrastructure, focused on nuclear plants and roads. In addition to creating jobs and boosting output, this spending should encourage materials consumption—an outcome that commodities markets already anticipate, based on the number of metals whose prices have surged.

- Third, the government is moving to increase real estate purchases in "tier 2" and "tier 3" cities by lowering down payment requirements. (Relative to tier 1 cities such as Beijing and Shanghai, these tend to be less well-known cities with attractive growth and foreign investment potential based on lower labor and operating costs, less competition, and rising consumer spending).

These efforts may well enhance short-term growth, but they raise longer-term issues compounded by a lack of structural economic reforms, particularly with regard to China's state-owned enterprises (SOEs):

- A boost in spending at a time when the country's fiscal deficit is rising—perhaps more than "official" data suggests—could lead to unsustainable debt loads.

- The renewed focus on infrastructure, which represents China's "old growth playbook," risks a further misallocation of resources that eventually may come back to compromise longer-run growth rates.

- Bolstering real estate purchases when real estate prices are rising again risks creating a bubble that, were it to pop, would damage already questionable bank balance sheets.

In essence, China has decided to drive growth now and not to dwell on the potential pain that may result down the road.

Outlook

Overall, the economic backdrop for equities remains supportive. The U.S. continues along a moderate but steady growth path, European GDP seems to be on trend to grow at a pace of 1%-2%, and China's new stimulative measures may help improve the economy there, at least in the short term. Stable to rising oil prices, accompanied by signs of further reductions in supply, should add to a generally positive environment.

In fixed-income markets, calmer waters will likely lead to substantial new issuance across sectors, as issuers who were shut out during the early part of the year enter the market to lock in what are still very attractive financing yields. Like the Fed, however, bond markets remain data dependent, and the same external risks (particularly from China) that rattled investors earlier this year could re-emerge, slowing the recent "risk-on" rally.

We currently see value across fixed-income sectors, including high-yield and investment-grade corporate bonds, emerging-markets debt, commercial mortgage backed securities, and asset-backed securities. U.S. Treasuries and residential mortgage-backed securities, however, look less compelling at this time.