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A dovish Fed and an improving U.S. economy push the S&P 500 into positive territory for the year

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Article Highlights

- The Fed's more cautious projection for rate hikes helps propel the S&P 500 to its highest close in 2016.
- Treasury and non-Treasury fixed-income securities alike also benefit from the Fed's outlook.
- U.S. data releases show signs of healing in manufacturing and ongoing strength in jobs and housing, tempered by disappointing retail sales.
- While we still believe the S&P 500 can reach and exceed previous highs during the year, the market has become over-extended, and a near-term pullback is possible.
- Higher-yielding fixed-income sectors may take a breather after their recent gains, although investment-grade corporate bonds still have room to run.

Equities

The S&P 500 Index continued to grind higher during the past week, supported by positive U.S. economic data that have begun to be reflected in corporate earnings releases. For the week, the S&P rose about 1.2%, pushing the index into slightly positive territory for the year to date.
U.S. equites received an additional lift from a dovish policy statement issued by the Federal Reserve after its March 15-16 meeting. While Fed officials kept short-term rates steady, as expected, they signaled that just two rate hikes were likely this year, down from December's more aggressive projection of four. This cautious tone drove down the dollar, boosting commodity prices and pushing oil above $40 per barrel on March 17 for the first time this year.

In Europe, the dollar's decline versus the euro weighed on the region's exporters, contributing to a 0.2% loss (in local terms), and an end to a four-week winning streak, for the STOXX 600 Index. Economic releases for the Eurozone were encouraging, however, with a better-than expected inflation reading in January, along with surging construction, car sales, and industrial output.

A sense of calm prevailed in China, adding to the week's positive environment for global equities. Chinese markets rallied as the currency (the yuan) stabilized further. The government's continued announcements of new stimulus and reform programs should sustain short-term positive momentum for China's economy, although they are not enough to provide the basis for stable, long-term growth.

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

Fixed income

Fixed-income assets performed well this week, bolstered by the Fed's revised outlook for fewer interest-rate increases. After beginning the week at 1.98%, the yield on the bellwether 10-year U.S. Treasury headed lower, with the decline accelerating midweek to around 1.87% as of mid-day trading on March 18. (Price and yield move in opposite directions.) The 2-year U.S. Treasury yield, which is highly sensitive to Fed policy moves, also headed lower, dropping 11 basis points (0.11%), to 0.87%, on March 17 alone. Meanwhile, the rally in non-Treasury "spread sectors" continued apace, buoyed by positive fund flows for nearly all asset classes. Notable outperformers included emerging-markets debt (particularly in local currency terms), as well as investment-grade and high-yield corporate bonds, which moved in sympathy with equities amid predominantly "risk-on" sentiment.

U.S. data releases are positive to mixed

Following the previous week's light menu, this week's batch of economic reports saw additional signs of strength in the jobs and housing markets, along with improvement in manufacturing activity. Retail sales disappointed.
Among the week's releases:

- **First-time unemployment claims** rose by 7,000, to 265,000, while the less-volatile four-week moving average edged up by 750, to 268,000. Claims have stayed below the key 300,000 level for 54 straight weeks, the longest such streak since 1973. In addition, job openings increased in January, according to the JOLTS report.

- **Homebuilder confidence** held steady in March, based on the NAHB/Wells Fargo index. **Building permits**, a forward-looking indicator, fell but remained 6.3% higher than a year ago. **Housing starts** climbed 5.2% in February after falling the previous two months.

- **Regional manufacturing activity** improved markedly in February after months of weakness, with both the Philly Fed and Empire State manufacturing indexes easily topping forecasts.

- **Retail sales** slipped 0.1% in February, and sales for January were revised downward to a 0.4% drop instead of the previously reported 0.2% gain.

- **U.S. consumer prices** dipped 0.2% in February, pulled down by lower gasoline prices. Over the past 12 months, prices have risen just 1%. Stripping out volatile food and energy costs, so-called "core" inflation jumped 0.3% in February and 2.3% on an annual basis, the biggest one-year gain since May 2012.

- The index of **leading indicators** published by The Conference Board rose in February for the first time in three months, suggesting that despite the risks to the U.S. economy, there is little chance of a near-term downturn.

- Despite the recent pickup in the stock market, **consumer confidence** fell to its lowest level since October, according to March's preliminary reading of the University of Michigan index. Increased concern about prospects for the U.S. economy and expectations for higher gas prices in the year ahead were to blame for the drop.

Outlook

Following its rapid rise since mid-February, we believe the U.S. equity market has become extended. Over 90% of the S&P 500's constituents are now trading above their 50-day moving average. Moreover, investor sentiment has become optimistic. These two technical indicators often presage a correction, supporting our belief that a near-term pullback is possible. Over the longer term, we still believe the S&P 500 can move to and through previous highs by year-end, underpinned by the stable economy and a weaker dollar, which could meaningfully contribute to earnings growth for U.S. multinational corporations.

In fixed-income markets, the significant rally in credit markets will likely lead to additional issuance in coming weeks. A modest retreat or slowdown in performance is also possible, even though select sectors—particularly U.S. investment-grade corporate bonds—may benefit from the European Central Bank's decision to begin purchasing Eurozone corporate bonds as part of its expanded bond-buying program. This could have a spillover effect into the U.S. investment-grade market, causing spreads to tighten further. In our view, the primary risks to the fixed-income market include China and geopolitical events.

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Foreign stock market returns are stated in U.S. dollars unless noted otherwise.

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