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A dovish Fed helps U.S. equities end a volatile quarter on an upswing

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Article Highlights

- The S&P 500 Index ends the first quarter and the week with gains, while European stocks languish.
- Fixed-income markets benefit from market calm, steady U.S. economic data, and dovish Fed guidance.
- March's jobs report meets our expectations, but further wage gains may not materialize.
- Manufacturing activity expands after four months of contraction and is poised to strengthen in Q2.
- Although the extended U.S. stock market makes a correction more likely, we still expect the S&P 500 to hit new highs by year-end.
- Opportunities exist among a variety of non-Treasury fixed-income sectors, but security selection is key.

Equities

The S&P 500 Index ended a turbulent, albeit modestly positive (+1.35%) first quarter on an upbeat note. The gain was supported by Federal Reserve Chair Janet Yellen's comments on March 30 that the Fed needs to "proceed cautiously" in raising interest rates against a backdrop of weakness in China and broadly slower global growth. Yellen's dovish remarks stood in contrast to the relatively hawkish tone recently adopted by other Fed policymakers and contributed to the U.S. dollar's ongoing slide. March payrolls and U.S. manufacturing seemed to provide a boost for the S&P 500, while another drop in oil prices weighed. For the week, the index gained about 2.0%.

Although the Fed's "go-slow approach" also gave stocks in Europe a lift at mid-week, the broad STOXX 600 Index was down 0.6% for the week as a whole and 7.7% for the quarter (in local currency terms), in part reflecting a stronger euro and the effects of the terrorist attacks. On a positive note, European data releases have been surprising to the upside over the past few weeks, potentially signaling a turnaround in equity prices.

China's currency, the yuan, has strengthened, helping to stabilize global financial markets and improve emerging-market equity performance. The MSCI Emerging Markets

Index returned 2.9% for the week through March 31 and 5.71% for the first quarter overall (in U.S. dollars).

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

Fixed income

Fixed-income markets continued to benefit from equity market resilience, a lack of exogenous shocks, and the steady pace of the U.S. economy, and, most importantly, the Fed's dovish guidance. The yield on the bellwether 10-year note dropped from 1.91% at the start of the week to 1.78 on April 1. The two-year note, which is highly sensitive to Fed policy moves, also fell during the week, to 0.76%. (Yield and price move in opposite directions.)

Returns for non-Treasury "spread sectors" were broadly positive, led by commercial mortgage-backed securities. Investment-grade and high-yield corporate bonds raised their year-to-date gains through March 31 to 3.35% and 3.97%, respectively, based on Barclays indexes.

The U.S. jobs market delivers and manufacturing rebounds—but consumers remain cautious

The U.S. economy added 215,000 jobs in March, in line with our expectations. With more people joining the work force, the unemployment rate inched up to 5.0% from 4.9%, and the labor-force participation rate reached 63% for the first time in two years. Wages rose 0.3% in March and 2.3% compared to a year ago. Although we are likely approaching full employment, the wage-rate increases that normally accompany full employment may not materialize.
Other reports suggest that consumers are still tentative, while manufacturing is gathering steam. Among the week's releases:

- **First-time unemployment claims** jumped by 11,000, to 276,000, and the less-volatile four-week moving average rose by 3,500, to 263,250.

- **Consumer spending** edged up 0.1% in February, while January's previously solid gain (+0.5%) was revised downward to 0.1%. **Personal income** posted its smallest increase (+0.2%) since September. **Consumer sentiment** was mixed, as The Conference Board's consumer confidence index rose in March, while the University of Michigan's consumer sentiment survey fell for the fourth month in a row.

- **Inflation,** as measured by the Fed's preferred inflation barometer (the PCE index), slipped 0.1% in February, largely because of lower energy costs, but rose 1% over the past 12 months. The core PCE index, which excludes food and energy costs, also ticked higher (+0.1%) in February and remaining unchanged (+1.7%) compared to a year ago.

- **Pending home sales** were up 3.5% in February from January's downwardly revised level. Over the past 12 months, pending sales have risen 0.7%, the 18th straight month in which they have been higher compared to the prior year.

- **Home prices** increased 0.7% in January and 5.7% versus a year ago, according to the S&P/Case-Shiller 20-City Composite Index.

- After contracting for four straight months, **manufacturing activity** expanded in March, with the index from the Institute for Supply Management (ISM) reaching 51.8. (Readings over 50 indicate expansion.) This broadly solid report suggests we may see a repeat of last year's activity, when a weak January and February was followed by a strong March and second quarter.

Outlook

We are receiving some mixed signals on the potential direction of U.S. stocks. On one hand, investors have become more optimistic, a contrarian indicator that often presages a market downturn. This supports our view that the S&P 500 Index is likely due for a correction after its rapid rise since mid-February. On the other hand, hedge funds have reduced their net equity exposure (to around 48%), historically a bullish sign. Moreover, continued dollar weakening should boost earnings for U.S. multinational corporations. Both of these factors point to better equity returns, in line with our expectation for the S&P 500 to notch new highs by year-end.

In fixed-income markets, we believe that high-yield bonds and leveraged loans are fairly valued, which means active management and careful security selection are key to identifying opportunities in these sectors. Investment-grade bonds also offer fair value, but certain sectors may be subject to heightened volatility—particularly European banks, as Great Britain's June 23 voter referendum on whether to exit the European Union looms.

Among emerging-markets debt, we still favor Brazilian and Latin America issues even after their recent significant rallies. In our view, their attractive yields may tighten as long as oil and energy prices remain at current levels. Following several weeks of significant inflows, which have largely remained on the sidelines, flows into fixed-income asset classes have slowed. Bond performance should partially be supported as fund managers put this influx of cash to work.

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