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Weak earnings, Japan's central bank keep equities in the red

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Article Highlights

- U.S. and European stocks fall for the week but are up for the month.
- As expected, the Fed holds rates steady, while the Bank of Japan surprisingly fails to unveil additional stimulus.
- An accommodative Fed, positive fund flows, and tight supply bolster non-Treasury fixed-income assets.
- GDP growth disappoints in Q1, but we expect an upward revision.
- U.S. labor markets remain the key to determining the economy's direction.
- This week's decline in the S&P 500 may mark the beginning of a long-overdue correction.

Equities

Global markets were on edge this past week, as investors digested a slew of mixed corporate earnings reports and economic data. Also in focus were decisions by the Federal Reserve and the Bank of Japan (BoJ) to avoid taking further monetary policy action.

In the U.S., the S&P 500 Index has now gone 2,608 days (through April 29) without a 20% correction, making it the second-longest bull market in history. Investors were not in a celebratory mood, though. Concerns over weak domestic growth and earnings took a toll on the index, which fell about 1.2% for the week—potentially signaling the start of a long-overdue corrective phase. For the month of April, the S&P 500 eked out a small gain.

While the Fed stood pat as expected, markets were primed for the BoJ to ease further at its April 28 meeting in a bid to bolster the country's sluggish economy. Instead, the central bank opted for inaction, sending the yen to an 18-month high versus the dollar. This weighed on the export-sensitive Nikkei 225 Index, which plunged over 5.0% in local currency terms for the week.

European stocks seemed to take their cue from Tokyo, with the broad STOXX 600 Index losing 2% on the week in local currency terms. Despite the down week, the index gained 1.2% for April as a whole, its second straight one-month advance. Encouragingly, the aggressive monetary stimulus unleashed by the European Central Bank (ECB) may be gaining traction, as Eurozone GDP grew 0.6% in the first quarter, twice as much as in the previous three months and better than forecast. Moreover, unemployment across the region hit a 4½-year low in March, and lending to Eurozone businesses and households hit a multiyear high. This positive news was tempered by April's 0.2% fall in consumer prices, underscoring the ECB's challenge to stoke inflation.

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

Fixed income

After rising for seven straight sessions to reach 1.94% on April 26, the yield on the bellwether 10-year U.S. Treasury dropped to 1.87% the next day after the Fed held interest rates steady and adopted a modestly dovish tone in its post-meeting press release. (Yield and price move in opposite directions.) The 10-year yield ended the past week at 1.83%.

Amid favorable fund flows and tight new supply, non-Treasury "spread sectors" posted broadly positive returns. High-yield corporate bonds continued their rally and are up 7.4% for the year to date through April 28. Investment-grade corporate debt (+5.2% year to date) also outperformed.

U.S. GDP underwhelms in the first quarter, but an upward revision is likely

The U.S. economy grew at a 0.5% annual rate in the first quarter, according to the government's advance estimate, its slowest pace in two years. Consumption was weak, as expected, and business investment disappointed. In contrast, an uptick in housing investment, and in state and local government spending, were bright spots. We would not read too much into this report, however. March's data releases have been slightly stronger, so GDP should be revised higher. Moreover, the U.S. government has been experiencing seasonal adjustment issues with first-quarter GDP data for years.
Among the week's other reports:

- **First-time unemployment claims** rose by 9,000, to 257,000, but remained near a four-decade low, while the less-volatile four-week moving average dipped by 4,750, to 256.000.

- Orders for **durable goods (**aircraft, machinery, computer equipment, and other big-ticket items) increased 0.8% in March, far less than expected, after a downwardly revised 3.1% decline in February.

- **New home sales** slipped 1.5% in March, while February's pace was revised significantly upward. After a downward revision to February data, **pending home sales** (+1.4%) reached a 10-month high.

- **Home prices** edged up 0.2% in February and 5.4% versus a year ago, according to the S&P/Case Shiller 20-City Composite Index.

- **Consumers' outlooks** dimmed in April, with both The Conference Board's consumer confidence index and the University of Michigan's consumer sentiment gauge ticking lower.

- Reflecting a cautious mood, **consumer spending** crept up a scant 0.1% in March. With **personal income** advancing 0.4%, the savings rate climbed to 5.4%, its highest level in more than two years.

- **Inflation**, as measured by the Fed's preferred inflation barometer (the PCE index), rose just 0.1% in March and 0.8% over the past 12 months. The "core" PCE index, which excludes food and energy costs, increased 0.1% in March and 1.6% compared to a year ago.

Outlook

In our view, continued improvement in U.S. labor markets holds the key to a pick-up in GDP. With an unemployment rate of 5%, the economy is approaching what historically has been characterized as full employment. At that level, job growth should slow as the labor pool becomes stretched, leading to an acceleration in wages and rising consumption. Unfortunately, substantial wage gains have not materialized, while consumption has decelerated significantly. The core issue is determining whether demand for jobs is increasing or decreasing.

If the former is true, wage growth is likely to follow. But if the latter is true, a near-term surge in wages, inflation, or consumption is unlikely. The sudden shift in the labor participation rate is also muddying the waters. After starting to decline during the recession, the rate began picking up noticeably last September, hitting a two-year high in March. This could translate into a larger labor pool, indicating that the economy has not yet reached full employment and stunting near-term wage growth. Against this backdrop, the Fed may opt to maintain its cautious approach.

In fixed-income markets, we believe most non-U.S. Treasury credit sectors are now fairly priced. Spreads may widen modestly in May amid new issuance, however. Meanwhile, although global risks are looking more balanced as Europe's economy shows some strength, in our view U.S. fixed income offers better value than European debt.

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