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Global markets cheer Fed and Bank of Japan decisions

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Article Highlights

- A divided Fed holds the line on interest rates, while the Bank of Japan attempts a new approach to boost growth and inflation.
- Despite a Friday fade, stocks in the U.S., Japan, and Europe all gain ground for the week.
- U.S. Treasuries and other fixed-income assets rally along with equities.
- With central banks commanding attention, markets largely ignore U.S. data releases.
- Although we expect the S&P 500 to hit new highs this year and next, higher longer-term Treasury yields could halt its advance.
- In the fourth quarter, bond markets will focus on key labor data and the November election, which may stir up volatility.

Equities

Central banks took center stage during the past week, with key policy meetings on September 21 grabbing headlines and driving markets.

In the U.S., the Federal Reserve left its benchmark federal funds rate unchanged, as expected. Three of the Fed's 10-member policymaking committee disagreed with the majority, voting instead for an immediate quarter-point (0.25%) increase. This marked the largest number of dissents since December 2014. While keeping rates at current levels, the Fed did lay the groundwork for a rate hike before year-end, citing continued labor-market strength and a pickup in economic activity.

Markets perceived the Fed's decision as dovish, driving the S&P 500 Index to within 0.5% of its all-time high of 2,190 set on August 15. Despite retreating on September 23, the index still gained about 1.2% for the week.

Although the Bank of Japan (BoJ) also held the line on interest rates, it shifted its policy framework. Rather than maintain a firm target of purchasing ¥80 trillion (about $785 billion) in Japanese government debt annually, the BoJ will buy at "more or less" that pace. It will, however, restructure the maturity distribution of those purchases in an effort to cap the yield on 10-year sovereign issues (-0.05% as of September 23) at 0%.

The new strategy is designed to increase the spread between yields on Japan's longer-dated debt and those on shorter-term Japanese bonds, which are currently even further below zero. Accomplishing this would help improve earnings for banks, who seek to exploit differences between the cost of short- and long-term credit. In a rare move for any central bank, the BoJ also vowed to overshoot its 2% inflation target in a bid to boost expectations for higher consumer prices, as the economy seeks to escape years of deflation.

In response to these monetary policy changes, financial stocks in Japan rose 6% on September 21, helping the Nikkei 225 Index gain 1.4% for the week (in yen terms).

Meanwhile, Europe's broad STOXX 600 Index edged back from a two-week high following the release of some disappointing business output data, but still rose 2.2% (in local currency terms) for the week.

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

Fixed income

U.S. Treasuries rallied. After beginning the week at 1.70%, the yield on the bellwether 10-year note fell to 1.62% on September 23. The further downward revisions to the Fed's longer-term interest-rate projections were seen as responsible for this drop. (Yield and price move in opposite directions.)

The prospects of interest rates staying lower for longer bolstered risk appetite and demand for non-Treasury "spread" sectors, whose returns ranged from modestly to strongly positive. Investment-grade and high-yield corporate bonds, along with emerging-market debt, performed especially well.

Markets pay little heed to mixed U.S. economic data

With central banks commanding attention, markets largely ignored the past week's economic releases. Among the reports:

- **First-time unemployment claims** dropped by 6,000 to a two-month low of 252,000, and the less-volatile four-week moving average also fell, by 2,250, to 258,500.
- After soaring in July, **housing starts** slipped 5.8% in August, while **existing home sales** unexpectedly decreased 0.9% in August. **Housing permits**, a forward-looking indicator, were flat.
- **Homebuilder confidence** soared in September, however, matching its highest level in more than a decade, according to the NAHB/Wells Fargo Index. Builders expect the housing market to make gradual gains throughout the remainder of the year and into 2017, fueled by rising household incomes.

- Following increases in June and July, The Conference Board's index of **leading economic indicators** dipped 0.2% in August. Despite this decline, the index still points to moderate economic growth in the months ahead.

Outlook

While we still believe the S&P 500 Index may reach 2,250 by year-end (and perhaps 2,400 over the next 6-12 months), equity markets might remain choppy, especially as we approach the Fed's December policy meetings. A sharp spike in longer-dated Treasury yields—for example, a rise in the 10-year yield to around 3%—could halt the S&P 500's advance, though we don't anticipate rates rising to that level until next year at the earliest.

As the third quarter winds down, our view is that now is not an appropriate time to boost net exposure to higher-risk fixed-income assets, given their nearly uninterrupted rally that began after the Brexit vote in late June. Looking to the fourth quarter, the upcoming presidential election could stir up volatility in bond markets. Other factors likely to demand investors' attention include key labor-market data such as jobs growth, wages, and the participation rate.

In terms of specific fixed-income asset classes, we believe emerging-market bonds could offer additional opportunities despite their strong performance so far this year, especially if the U.S. dollar continues to trade in a narrow range. Investment-grade corporate bonds and short-dated asset-backed securities also offer the potential for solid risk-adjusted returns.