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Fed rate-hike concerns weigh on U.S. equities

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Article Highlights

- The S&P 500 Index finishes essentially flat for the week, but European stocks decline.
- An unlikely (but possible) Fed move in September hurts Treasuries, while the search for yield bolsters non-Treasury fixed-income assets.
- Although the U.S. economy is picking up from its weak first half, for 2016 as a whole, we don't expect GDP to match the recovery's average annual growth rate.
- We believe the S&P 500 will reach new highs by year-end, but that advance is unlikely to be in a straight line.
- In fixed-income markets, investment-grade corporate bonds, asset-backed securities, and emerging-market debt offer the best risk/reward profiles.

Equities

Global equities struggled this week. While higher oil prices supported stocks, investors fretted over conflicting signals by the Federal Reserve regarding the timing of its next interest-rate increase.

In the U.S., after notching a new record high on August 15, the S&P 500 Index edged lower to finish essentially flat for the second consecutive week. For the year to date through August 19, the index is up 8.4%.

Overseas, Europe's broad STOXX 600 Index fell 1.7% in local currency terms. Several Eurozone economic data releases were positive, however: French unemployment hit a near four-year low during the second quarter, Eurozone inflation touched an eight-month high in July, and German economic sentiment improved in August. The MSCI Emerging Markets Index posted a modest gain for week through August 18, bringing its year-to-date return to a robust 17.4% (in U.S. dollar terms).

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

Fixed income

During the week, Fed officials indicated that a rate hike was still in play for September. Minutes from the Fed's July meeting, though, released on August 17, revealed a deep division among policymakers over when to restart tightening despite a general acknowledgment that near-term risks to the economy had subsided. Further insight into the central bank's thinking may come on August 26, when Fed Chair Janet Yellen is scheduled to speak at the Fed's annual conference at Jackson Hole, Wyoming. Against this muddled backdrop, Treasury yields rose. After beginning the week at 1.51%, the yield on the bellwether 10-year note closed at 1.58% on August 19. (Yield and price move in opposite directions.)

Meanwhile, the search for yield continued apace, as new supply for both high-yield and investment-grade corporate debt was met with robust demand. Year to date through August 18, these asset classes have returned 14% and 9.4%, respectively, based on Barclays indexes.

A generally positive week for U.S. economic data

The past week's data releases didn't move markets or suggest a shift in the U.S. economy's positive, yet moderate, growth trajectory. In our view, the economy is picking up from a weaker first half. Nonetheless, for 2016 as a whole, U.S. GDP will not match the recovery's average annual growth rate of 1.75%-2%.

Among the week's reports:

- **First-time unemployment claims** dipped by 4,000, to 262,000, a one-month low, and the less-volatile four-week moving average rose by 2,500, to 265,250.

- Following June's advance, The Conference Board's index of **leading economic indicators** climbed 0.4% in July, suggesting that moderate economic gains should persist through the end of 2016.

- **Home builder confidence** edged up in July from June's downwardly revised total, according to the NAHB/Wells Fargo Index. Overall, builders believe that historically low mortgage rates and a firming labor market will help keep housing on an upward path for the rest of the year.

- **Housing starts** topped expectations by rising 2.1% in July from June's upwardly revised figure, while **housing permits**, a forward-looking indicator, ticked down after rising for three consecutive months.

- **Consumer prices** were unchanged in July and up just 0.8% compared to a year ago. Stripping out volatile food and energy costs, so-called "core" consumer prices increased 0.1% in July and 2.2% over the past 12 months.
- **Regional manufacturing indexes** were mixed, as the Philly Fed rebounded slightly in August and the Empire State index slipped.

Outlook

In our view, a weaker dollar will continue to bolster U.S. corporate earnings, pushing the S&P 500 to new highs (around 2,250) by year-end. That said, the advance is unlikely to be in a straight line. Short-term investor sentiment is becoming more optimistic, and the proportion of S&P 500 stocks trading above their 50-day moving average is edging to the high end. These two indicators have historically presaged a market pullback.

As for the Fed, we expect one interest-rate increase—at most—in 2016, most likely in December. Before the Fed begins a consistent, sequential series of rate hikes, further labor market improvement will be necessary, with stronger wage gains leading to sturdier personal consumption. Additionally, inflation will need to rise to around 2%-2.5% and threaten to move higher.

In fixed-income markets, we believe investment-grade corporate bonds, asset-backed securities, and emerging-market (EM) debt currently offer the best risk/reward profiles. At this point, the risk of global deflation should keep a lid on domestic yields, one of the reasons we remain constructive on EM debt, which tends to benefit from lower U.S. rates.