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GLOBAL ASSET MANAGEMENT

U.S. equity markets resume their post-election rally to notch new record highs

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Article Highlights

- A strong showing by the S&P 500 is overshadowed by the ongoing surge in small-cap stocks. European shares enjoy their best week in two years.
- The ECB extends the length of its QE program but decides to trim the volume of its monthly purchases in April.
- High-yield bonds also benefit in the week's risk-on environment, easily outperforming other fixed-income sectors.
- U.S. Treasury yields continue to edge higher amid orderly trading.
- Several upbeat data releases highlight a solid week for the U.S. economy.

Equities

After taking a breather the previous week, global equity investors regained their risk appetite despite a near-certain hike in interest rates by the Federal Reserve at its December 13-14 meeting. Bolstered by a string of positive U.S. economic data releases, the S&P 500 Index strung together five consecutive winning days en route to a gain of 3.0% for the week.

Since November 9, the index has risen 4.5%, pushing it past our year-end target of 2,250. Given this extended rally, we would not be surprised to see a sharp correction in the S&P 500 at some point in the near future. Our target for next year remains 2,400, which may be revised upward if the S&P 500 rises above its current level of 2,259. Meanwhile, the small-cap Russell 2000 Index jumped more than 5.0% for the week, bringing its return since the election to over 16%.

Central bank activity was front and center in Europe, as investors focused on the December 8 meeting of the European Central Bank (ECB). While leaving its benchmark interest rates unchanged, the ECB extended the length of its quantitative easing (QE) program from March 2017 until December 2017 or beyond, "if necessary." And, in somewhat of a surprise given the Eurozone's generally sluggish recovery, the ECB announced it will scale back its monthly bond purchases, from €80 billion to €60 billion, starting in April. The fall in the euro-dollar rate from 1.075 to 1.055 following the meeting confirms that the market viewed the policy shift as dovish on net.

Equity markets cheered the decision to prolong stimulus, sending Europe's broad STOXX 600 Index to an 11-month high and its best week (+4.0% in local terms) in almost two years. The late-week advance extended gains from earlier in the week, as investors shrugged off the resounding "no" vote in Italy's constitutional referendum, which led to the resignation of Prime Minister Matteo Renzi.

Elsewhere, Japan's Nikkei 225 Index reached a 2016 high, while Chinese stocks trading on the Hong Kong exchange also rose for the week.

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

Fixed income

Fixed-income markets continued to trade in an orderly fashion in this rising-rate environment. After beginning the week at 2.40%, the yield on the bellwether 10-year note rose to 2.47% on December 9, more than half a percentage point above its close the day before the election. (Yield and price move in opposite directions.)

Returns for most non-Treasury "spread sectors" ranged from modestly negative to slightly positive for the week through December 8. High-yield corporate bonds were a notable outperformer. Buoyed by the largest inflows in almost four months, they gained 1.2%, lifting their year-to-date return to 16.3%.

A week of broadly positive U.S. economic data

This past week's data releases included further signs of consumer optimism, encouraging news from both the service and manufacturing sectors of the economy, and more evidence of labor-market strength.

Among the week's releases:

- One week after The Conference Board reported a rebound in consumer confidence for November, the University of Michigan Index showed **consumer sentiment** rising to its highest level since January 2015, according to November's preliminary reading.

- **Service-sector activity** climbed to 57.2 in November, a 12-month high, according to the index published by the Institute for Supply Management (ISM). (Readings above 50 signify expansion.)

- Indicating further healing in the manufacturing sector, **factory orders** rose 2.7% in October, their fourth consecutive one-month advance, following an upwardly revised 0.6% gain in September.

- **First-time unemployment claims** fell by 10,000, to 258,000, following the previous week's jump to a five-month high. Such wide swings are common during the holiday hiring season. The less-volatile four-week average edged up by 1,000, to 252,500.

- The **trade deficit** climbed 18% in October, to $42.6 billion, the steepest one-month rise since March 2015. Imports reached their highest level in 14 months, while exports declined.

Outlook

By deciding to reduce its monthly bond buying, has the ECB begun to “taper” its QE program? Many market participants think so. For his part, ECB President Mario Draghi stressed that the central bank was doing nothing of the kind. In his view, tapering requires reducing the pace of asset purchases to zero, which the ECB clearly is not prepared to do at this point.

Draghi was likely trying to avoid starting a “taper tantrum” in the markets, similar to the one that occurred in the U.S. in 2013, when then-Fed Chair Ben Bernanke’s suggestion that the Fed might wind down its own QE program sent bond yields soaring. Semantics aside, we believe that the ECB, while not directly signaling the end of its aggressive monetary stimulus efforts, is clearly moving in that direction. That should support the euro and longer-term German *bund* rates.