Weekly Market Update

April's strong employment growth prompts unexpected market responses

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Article Highlights

- Equities edge lower and Treasuries rally in wake of strongest monthly payroll gain in two years.
- First-quarter GDP growth comes in much lower than expected.
- The housing market continues to face headwinds.
- European manufacturing improves, but inflation remains well below the central bank's target.
- Despite the week's data surprises, we have not altered our forecast for U.S. growth in 2014.

May 2, 2014

Equities

Equity markets generally benefited from a calmer tone during the past week. The recent sharp rotation out of high-momentum growth stocks and into value shares subsided, easing the extreme disparity of returns for these two groups. The S&P 500 Index as a whole inched toward a new record high in the first four days of the week, responding to above-forecast manufacturing data and shrugging off a barely positive reading on first-quarter GDP growth. The index was down slightly on Friday, however, as a much-stronger-than-expected April jobs report failed to spark a sustained rally. Based on MSCI indexes, foreign developed-market equities rose nearly 2% for the week through May 1, while emerging-market equities were up a lesser 0.3%.

Fixed income

Returns were modestly positive for most fixed-income categories, as investors awaited the release of various economic reports for a greater sense of direction. U.S. economic data was mixed, but the Treasury market focused more on the weaker signals (GDP growth, home-price appreciation, and weekly unemployment claims) and less on positive surprises (monthly payrolls, manufacturing and industrial data). The yield on the bellwether 10-year Treasury note—which would normally be expected to rise in the wake of robust jobs data—actually fell in

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response to April's strong payrolls report. After starting the week at 2.70%, the 10-year yield fell to 2.59% in Friday afternoon trading.

Current market updates are available here.

Weak GDP growth and surging job creation dominate the headlines

It was an active week in terms of U.S. economic releases, with first-quarter GDP growth and the April employment report gaining the most attention. Despite some dramatic headlines, on balance there was nothing in the data to change our fundamental outlook.

- **GDP growth:** According to the government's preliminary estimate, GDP grew by only 0.1% in the first quarter—the smallest gain in three years. However, underneath the headline, it was clear that the cold winter had more of a dampening effect than we initially expected, especially in areas such as business spending and new home construction. Among the bright spots was a pick-up in consumer spending.

- **Monthly payrolls:** The U.S. economy added 288,000 jobs in April, exceeding expectations (including our own). In addition, there were substantial upward revisions to February and March payrolls. While equity markets initially cheered the report, there was a downside: The labor force participation rate sank to 62.8%, matching a 35-year low, as more than 800,000 people dropped out of the workforce. This negative factor was the primary driver in lowering the national unemployment rate to 6.3%, from 6.7% in March. Also on the employment front, first-time jobless claims rose for the second week in a row, to 344,000—the highest level since the end of February.

- **Housing:** Pending home sales and home price appreciation increased from March levels and from a year ago, but there are still signs the housing market has slowed. The severe winter weather certainly played a role in the first quarter, but we are also keeping a close watch on a number of other headwinds, including higher mortgage rates, decreased demand from institutional buyers, and supply constraints (such as land and materials) for builders.

  However, the housing sector should be supported by rising wages, stronger employment growth, and easing credit standards. Overall, we expect housing activity to be positive in 2014, but less so compared to 2013, with a 3% to 5% increase in home prices and a boost to GDP close to 0.5%.

- **Industrial activity.** A number of indicators showed improvement, including gauges of regional activity such as the Dallas Fed index and the Chicago Purchasing Managers Index (PMI). On a national level, the Markit Purchasing Manager's Index (PMI) and the manufacturing index published by the Institute for Supply Management (ISM) remained firmly in expansion territory.

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Economic news in Europe is mixed

While European PMIs hit three-year highs, corporate earnings have been revised downward, perhaps reflecting weaker demand from the emerging markets or the impact of a mild winter that temporarily boosted the region's economic activity. Meanwhile, eurozone inflation ticked up slightly to 0.7%—still well below the 2% target of the European Central Bank (ECB) but not low enough to prompt further ECB monetary stimulus.

Outlook

Despite the disappointing first-quarter GDP report, data for the month of March and a first glance at April's economic releases suggest that growth will reaccelerate to about 2.5% during the next three months. Furthermore, March's strong numbers for income and spending point to a potential upward revision of first-quarter GDP growth. Consequently, we are not altering our forecasts for the remainder of the year.

In equity markets, long-term sentiment has turned negative, and hedge funds' net exposure to stocks has fallen amid the market's recent volatility. Moreover, a closely watched indicator shows that Wall Street strategists have reduced allocations to equities. These technical signals have historically been associated with a subsequent rise in equity prices.

Fixed-income markets remain confident that the Federal Reserve will keep short-term interest rates at near-zero levels until inflation reaches the Fed's 2% target. In addition, we believe April's jobs report will not accelerate the Fed's timeframe, as wages remain low, keeping a lid on overall inflation.

The current environment is likely to be more bullish for equities than for debt. Greater consumer spending will likely benefit stock prices (through greater corporate earnings growth), while fixed-income investors will have to contend with the eventual rise in interest rates and the potential for modest declines in credit quality as mergers and acquisition activity picks up.