2014 First Quarter Equity Market Review

Slower U.S. Growth and Geopolitical Uncertainty Dominate Q1

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Article Highlights:

- U.S. equity markets recorded modest gains as economic growth hit a rough patch, leading to a downward revision of 2014 GDP growth forecasts.
- The European recovery remained slow and fragile, although equity markets were resilient in the face of the crisis in Ukraine.
- In Japan, delayed structural reforms coupled with worries over the impact of an April 1 consumption tax weighed on the Nikkei index.
- Despite troubling headlines from Ukraine, stocks in emerging markets exhibited relative calm as the quarter wore on.
- China is viewed as a primary source of vulnerability as its economy cools, with many economists recently scaling back their GDP forecasts to less than 7% growth in 2014.

After a strong end to 2013, global equity markets hit a rough patch in the first quarter. Unexpected sluggishness in the U.S. economy, attributable partly to a bad winter, along with the crisis in Ukraine and concern about China's growth prospects all took their toll. For the quarter, the S&P 500 Index advanced 1.81%, and the Russell 2000 Index (small-cap stocks) managed a 1.12% gain. Based on MSCI indexes, foreign developed-market equities increased marginally (+0.66%) in the first quarter, with several peripheral European markets posting strong returns, including Italy (+14.59%), Portugal (+9.72%), Spain (+4.78%), and Ireland (+14%). The MSCI Emerging Markets Index fell (-0.43%) during the quarter. (All returns are in U.S. dollars.)

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U.S. equities seesaw

Equity markets entered the New Year enlivened by the prospect of an improving U.S. economy and better corporate earnings. But early on there were hints the economy might not be as strong as many suspected. In early January, surveys of trucking activity weakened, auto production schedules were sharply lower, state tax receipts declined, and oil prices dropped, perhaps signaling weak global demand. The unexpected softness in these economic figures sent equity markets lower.

In February, however, the market began to rally, attributing economic weakness to the poor winter weather and focusing more on the political agreement to raise the U.S. debt ceiling and avoid another federal government shutdown. Also, Federal Reserve Chair Janet Yellen's February 11 comments reaffirming the Fed's continued low-interest-rate policy and data-dependent approach to the pace of future tapering proved to be exactly what investors wanted to hear. On February 27, the S&P 500 closed above 1850 for the first time.

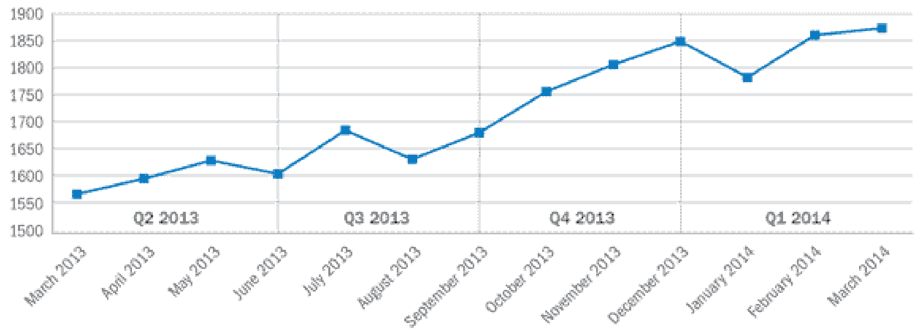
By March, however, the markets began to suspect that severe weather was probably not the only reason for economic underperformance. Markets were also taken aback by Yellen's suggestion that the Fed could raise short-term interest rates "around six months" after the current tapering process ends. (Tapering will most likely conclude in the fall of 2014.) This time frame was earlier than the markets anticipated. Added to these domestic uncertainties was the crisis in Ukraine, which began to take center stage, causing markets to oscillate as events unfolded.

Late in the quarter, there was a sharp rotation out of high-momentum growth stocks (particularly technology and biotech) and small-caps in favor of value stocks and companies with higher foreign sales. Value stocks gained 2.92% in the quarter, versus 1.07% for growth shares. This rotation suggested that U.S. equities were adjusting to the notion that China's economy may yet avoid a "hard landing," while Europe's economic picture is improving, and U.S. growth appears to be on track.

For the quarter as a whole, eight of the S&P 500's 10 sectors advanced, led by utilities (+9.77%), healthcare (+5.69%), and materials (+2.69%). Consumer discretionary (-2.91%), industrials (-0.02%), and telecommunication services (+0.11%) lagged. Based on Russell market-cap and style indexes, mid caps (+3.53%) outpaced both large caps (+2.05%) and small caps (+1.12%). Overall, U.S. stocks were positive for the quarter, although the strong performance experienced in 2013, shown in Exhibit 1, slowed dramatically.

Exhibit 1: U.S. equities rose slightly this quarter after strong growth last year…

S&P 500 Index, monthly, Q2 2013–Q1 2014



Source: Haver Analytics

Exhibit 2: … although the market was volatile during the quarter

S&P 500 Index, daily movement, January 1–March 31, 2014

Source: Haver Analytics

European equities weather Russian standoff

After falling into negative territory in January, European stock markets rebounded in February even though the European Central Bank (ECB) held short-term interest rates steady and did not provide the monetary easing many had hoped for. Respectable but still tepid economic data for the eurozone provided some lift to European markets: GDP grew 1.1% on an annualized basis in the fourth quarter of 2013. Germany, the region's largest economy, led the way, but growth improved in key peripheral economies (e.g., Italy and Spain) as well.

In the first half of March, European equities lost 3% as tensions between Russia and Ukraine escalated, leading up to the March 16 referendum on Crimea's secession and annexation. After the vote to secede, however, equities advanced for the next two weeks; markets in Europe apparently concluded that both Russia and the West had too much to lose to allow tensions to escalate much further.

In Japan, pressure mounts to enact reforms

After delivering strong returns in 2013, Japan's equity market remained under pressure during the quarter as the country's economic challenges stayed in focus. Leading economic indicators weakened in advance of an April 1 consumption tax hike, which is projected to cut GDP growth by 1%. Moreover, Japanese export numbers did not improve, despite a weaker yen. On the positive side, these difficulties put added pressure on Prime Minister Shinzo Abe's government to enact needed reforms, while the lack of inflation could prod the central bank to implement further monetary stimulus.

Mixed signals out of China

Concerns about China's growth were never far from investors' minds during the first quarter. By mid-March, a number of lackluster economic releases out of China, including lower-than-forecast industrial production and retail sales, along with government rhetoric that downplayed growth, reinforced concerns about a weakening Chinese economy. Escalating real estate prices, increasing levels of bad debt, and slowing export data all increased the potential for an economic hard landing.

Countering this fear, however, was the Chinese Purchasing Manager's Index (PMI), which ticked up to 53.4 in March from 50.4 in February. (Readings above 50 indicate expansion.) Moreover, credit conditions eased and China's currency continued to depreciate, which helped the Chinese export sector. Overall, the signals out of China during the first quarter were modestly encouraging for emerging equity markets, which appeared to find their floor.

Outlook: Better performance for equities

First-quarter growth was much lower than expected in the U.S., expanding at a paltry 0.1% annual rate, the slowest since the fourth quarter of 2012. While the headline number was stunningly low, the underlying data offered a number of signs that continue to point to an expanding economy. Data for March and April indicate that GDP growth may reaccelerate to its trend level of about 2.5% or slightly higher during the next three months. In addition, income and spending data for March suggest a likely upward revision of first-quarter GDP growth. On balance, the U.S. economy is still on track, and we remain confident that the S&P 500 Index can breach the 1900 level by summer, albeit with some bouts of volatility.

On the interest-rate front, we expect short-term rates to remain low well into 2015. However, as the economy strengthens, fear will mount concerning the first Fed interest-rate hike—historically a headwind, with U.S. equity markets tending to peak and fall six months ahead of the Fed's initial increase following an extended period of low rates. Assuming the Fed's first rate increase occurs in mid to late 2015, U.S. markets could be more vulnerable during or after the fourth quarter of 2014.

In Europe, the economic picture is improving, but the recovery remains slow and fragile. The eurozone's strong ties to emerging markets expose it to geopolitical risks; also, the risk of deflation is real enough that the ECB may eventually resort to some form of quantitative easing, perhaps by purchasing bank loans to provide adequate stimulus.

Among emerging markets, China is viewed as a primary source of vulnerability, with many economists recently scaling back their GDP forecasts to less than 7% growth in 2014. Of particular note are fears of a bursting property bubble and a potential collapse of the shadow banking system. Given the opacity of China's economy, these concerns may have merit, but so far they seem to have been shrugged off by Chinese investors, as reflected in better performance by domestic equity indexes in the first quarter. Overall, we believe the Chinese economy will grow at roughly the pace projected by the government (about 7.5%), but that the potential for market-moving events and increased volatility will grow as reforms are continued.

Emerging markets as a whole exhibited relative calm as the first quarter wore on, despite troubling headlines from Ukraine. Reduced valuations and outflows may have set the stage for a period of improved performance. Looking ahead, returns will hinge on the impact that recent interest-rate increases will have on growth across developing nations, whether the Chinese economy will experience a hard landing, and how quickly U.S. interest rates rise in coming months. In our view, the outcomes of these current unknowns should prove to be benign, likely leading to improved equity market performance for the balance of 2014.