Weekly Market Update

Equities rally on favorable earnings, economic data

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Article Highlights

- First-time unemployment claims and retail sales offer good news, but housing lags.
- The S&P 500 Index rebounds in holiday-shortened trading week.
- Fed Chair Janet Yellen's dovish comments help temper a rise in U.S. Treasury yields.
- China's GDP growth slows to 7.4%, generally in line with forecasts.
- Japanese equities are undeterred by the Bank of Japan's policy inaction.

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Equities

U.S. equities logged four consecutive positive sessions in a trading week shortened by the Good Friday holiday. The S&P 500 Index advanced 2.7%, quietly climbing more than 50 points from the previous week's low. Volatility waned as generally favorable earnings releases calmed the market's worst fears. Investors also cheered mildly positive economic data, along with Federal Reserve Chair Janet Yellen's further reassurances that interest rates will stay low for a long time to come. Based on MSCI indexes, foreign developed markets rose 1.0% for the week through April 17, while emerging markets returned -0.6%, giving up some of their recent gains.

Fixed income

Prices for U.S. Treasuries fell during the week, pushing yields higher. The bellwether 10-year yield closed at 2.73% on April 17, up 10 basis points (0.10%) from the end of the previous week. Demand for safe-haven assets lessened as investors took the latest news out of Ukraine in stride, while first-time unemployment claims and retail sales data were better than expected. Treasury yields would likely have risen more were it not for Yellen's dovish comments.

"Spread products" (lower-rated, higher-yielding non-Treasury securities) performed modestly better than Treasuries, although returns were flat to slightly

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negative in most categories. High-yield corporate bonds had positive returns, in sympathy with improved equity market performance. Emerging-market debt continued to benefit from renewed demand.

Positive U.S. data releases: less than meets the eye?

U.S. economic data released during the week was favorable on a few fronts, but the bounce-back from the unusually cold winter has not been dramatic.

- **Retail sales rise more than expected.** Retail sales jumped by 1.1% in March, beating consensus forecasts. (Excluding auto purchases, retail sales climbed 0.7%.) While this positive report indicates that consumers are starting to shop again after the colder weather, the rate of growth does not yet indicate a stronger pickup in overall economic activity, so we remain guarded in our optimism.

- **First-time jobless claims stay near pre-recession lows**. New claims for unemployment insurance ticked up by a much-lower-than forecasted 2,000 in the most recent week, to 304,000, while the four-week moving average of new claims dipped to 312,000—the lowest level since October 2007. It appears that claims may have reached a downside breakout level associated with sustainably healthier employment growth.

- **Mixed news on housing.** Extreme winter weather can no longer bear the lion's share of blame for subdued activity in the housing market, especially as the spring selling season gets underway. On balance, tepid growth in home sales and new construction suggests that further stagnation in the housing sector could continue for some time. Among the past week's releases:

    - **Housing starts** increased 2.8% in March, but this was a smaller rebound than expected. Compared with a year ago, starts were down 5.9%.

    - **Building permits**, a forward-looking indicator, fell 2.4% in March.

    - **Homebuilder confidence** edged up, but weakly, based on the NAHB/Wells-Fargo index. Somewhat mitigating this weakness was a more upbeat homebuilder survey conducted by ISI.

The European economy is improving, but tensions escalate in Ukraine

In Europe, Purchasing Manager Index (PMI) levels, which measure manufacturing activity, have come in above expectations for virtually all countries in the region. However, this may reflect a very mild European winter, and we would not be surprised to see some reversal of PMI strength in the second quarter. Meanwhile, the euro remains strong, despite efforts by the European Central Bank (ECB) to "talk it down" by publicly musing about the need for some form of quantitative easing (QE).

The Ukrainian conflict heated up again over the past week, with small-scale skirmishes in eastern Ukraine and promises of further U.S. sanctions, this time targeted at Russia's financial system and energy sector. For Europe, the main risk with regard to Ukraine is a spike in energy prices and limited access to supplies, mostly on the natural gas side.

Japanese stocks climb while the government marks time

Japanese equities moved higher during the week (+2.2% through April 17), despite a disappointing period of inaction by the Bank of Japan (BOJ). Rather than take further decisive steps to weaken the yen, the BOJ has suggested that current monetary measures are working, and that inflation is on track to meet the government's 2% target. We think the BOJ will remain on the sidelines until mid-year, at which point we expect the announcement of another large monetary stimulus package—likely triggering a new surge in Japanese stocks.

China's growth slows as expected

China's first-quarter GDP growth rate came in at 7.4% on a year-over-year basis—down from 7.7% in the fourth quarter of 2013 and largely in line with expectations. Although the lack of transparency in Chinese government data may make this figure suspect, it is consistent with evidence of a broad slowdown. We view the GDP release more as a signal of policy direction than a measure of economic activity. The administration has clearly signaled its intent to shift development away from infrastructure and industry to consumption, food safety, pollution, health, and institutional capacity.

Outlook

While U.S. equity markets have recently found firmer footing, long-term investor sentiment is negative, and hedge fund net exposures to equities have fallen amid the market gyrations of the past three weeks. These technical signals have historically been associated with a subsequent rise in equity prices. Accordingly, we remain confident that the S&P 500 can move up to and beyond 1900 by summer—at which point a correction of up to 10% would be increasingly likely. In fixed-income markets, we expect interest rates to rise further in coming weeks as economic releases may continue to surprise modestly to the upside.