Weekly Market Update

Equities surge on strong September jobs report

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Article Highlights

- A Friday rally once again helps the S&P 500 Index temper a weekly loss.
- European stocks also rebound but can't overcome a disappointing ECB policy statement.
- September's healthy jobs report shows the U.S. labor market is clearly in expansion mode.
- U.S. Treasuries give back some gains in the wake of the strong employment numbers.
- China has too much at stake to overreact to the current political unrest in Hong Kong.

October 3, 2014

Following a poor September, U.S. equities continued to trade lower in the first two days of October. The decline was driven by investors—particularly hedge funds—seeking to "de-risk" their portfolios due to rising concern about economic growth prospects, the imminent end of the Fed's quantitative easing (QE) program, and a disappointing press conference at which the European Central Bank (ECB) appeared to be dragging its heels on QE-style monetary stimulus. U.S. and European equities alike rebounded on October 3 in the wake of a better-than-expected U.S. monthly payrolls report.

China's Shanghai Composite Index continued to climb, while the Hang Seng Index fell further amid ongoing anti-government protests in Hong Kong. In our view, China has too much at stake politically, economically and diplomatically to resort to extreme measures in quelling the demonstrations. A more likely scenario is that the Chinese government will take a measured approach that allows cooler heads to prevail.

Fixed Income

For much of the past week, U.S. Treasuries benefited from a more risk-averse environment amid increased volatility and a spate of economic data releases. The yield on the bellwether 10-year Treasury security, which moves in the opposite direction of its price, fell 10 basis points (0.10%) for the week through October 2. In contrast, most categories of "spread products" (higher-yielding, lower-rated non-Treasury securities) saw their prices fall and yields rise, trading in sympathy

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with the week's downward equity moves. This dynamic reversed on October 3, however, as equities surged and the 10-year Treasury yield moved higher.

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September's employment report shows solid momentum

The past week's batch of economic data was again mixed: personal income and consumer spending improved, while gauges of manufacturing and service-sector activity slipped (but remained firmly in expansion territory). Housing indicators, vehicle sales, and factory orders were softer.

The week ended on a strongly positive note, however, as the Labor Department reported that the U.S. economy added a higher-than-expected 248,000 jobs in September. In addition, July and August payrolls were revised upward by a combined 69,000, while the national unemployment rate dipped below 6% for the first time since July 2008. It is clear that the labor market is in expansion mode.

For some investors, ECB quantitative easing can't happen soon enough

European equities tumbled more than 2% on October 2 in the wake of the ECB's much-anticipated policy statement and press conference. Amid continued slowing of the eurozone economy and another drop in inflation, many investors were anticipating a definitive signal that the central bank would embark on full-blown QE. ECB President Mario Draghi's statements disappointed those who have been clamoring for more aggressive stimulus.

The market's disappointment reflects growing fear that Europe may be headed for a Japanese-style period of deflation and deep recession. We do not share that expectation, as there is evidence to suggest a more benign outcome, including:

- better employment activity in Spain as reforms bear fruit;
- lower oil prices, which are simulative;
- a weaker euro, which bolsters European exports;
- ongoing reform efforts in Italy and France.

The risks to this more optimistic view are mainly political. Reforms might not be carried through, or reactionary governments could come to power, threatening the integrity of the European Union. Alternatively, secession-minded regions, such as Catalonia in Spain, could attempt to break away. While these possibilities do not represent our base case scenario, they do pose a potential long-term threat if growth does not materialize as we expect.

As for the ECB, we continue to believe that Draghi will eventually deliver on some form of QE, most likely next year, assuming inflation expectations and growth remain muted. In the meantime, we think European equities remain attractively valued and poised for a period in which their expected returns will exceed those of U.S. stocks.

Outlook

Available U.S. data for September suggests that economic activity slowed somewhat compared to August. We are not overly concerned about this, as the trend appears to be a modest downshift, not a downward turn. Furthermore, the general upward trend in consumer sentiment is starting to translate into spending, particularly as falling oil prices aid disposable incomes. Consensus estimates of third-quarter GDP growth have been lowered and now match our current forecast of 3.3% or higher.

Following recent sharp volatility, the S&P 500 may have rebased and could be ready to attempt a new high above the intra-day peak of 2,019 reached on September 19. The favorable jobs report released on October 3 triggered an encouraging move that we believe may continue. Also supportive of a renewed advance are contrarian signals such as short-term trading sentiment, which has turned negative, and hedge funds' net exposures to equities, which have fallen below 50%. If the market does climb to higher target levels, small-cap stocks may begin to recoup some of their lost ground versus the S&P 500, as weaker international economic trends and a stronger U.S. dollar tend to depress large-cap earnings relative to small caps.

In fixed-income markets, U.S. economic fundamentals continue to favor high yield, as we expect defaults to remain low for some time. To the extent that equities remain range-bound or improve somewhat, we think high yield offers fair value at current prices. Investment-grade corporate debt also appears fairly valued at current yields, given that this category has traditionally performed well in rising rate environments. Although interest rate rises will likely be more measured and slower to manifest than we had thought earlier in the year, emerging-markets debt remains vulnerable to rising rates and currently offers lesser value relative to U.S. high yield. Lastly, we believe geopolitical fears associated with Ebola, Ukraine, and the Middle East are fully priced into fixed-income markets, as are concerns about potential European deflation and economic weakness in China.

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