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Global equity markets end September on a mixed note

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Article Highlights

- A report of a potential settlement in the Deutsche Bank case provides a late-week boost for stocks.
- The S&P 500 finishes with a modest gain for the week, but Europe's STOXX 600 still loses ground.
- Strong business investment drives an upward revision to Q2 GDP.
- The U.S. economic picture does not compel tighter monetary policy, but that may not deter the Fed from raising rates in the fourth quarter.
- The extended rally in high-yield corporate debt warrants a focus on better-quality high-yield bonds rather than their lower-rated counterparts.

Equities

During the past week, markets took comfort from gains in energy stocks, which rose on the back of higher oil prices. The advance was sparked by news that OPEC ministers had agreed in principle on a plan to cut oil production, even as specific details of the arrangement won't be finalized until the cartel's next meeting in November. Investors also fretted over hawkish rhetoric from Fed officials and, in particular, the health of Deutsche Bank.

Germany's largest lender, a key cog in global financial markets, faces a fine of up to $14 billion to settle an investigation into residential mortgage-backed securities it traded before the 2008 financial crisis. The bank's shares sank to multi-decade lows during the week, spurring concerns of risks to Europe's financial system generally and the adequacy of Deutsche Bank's capital specifically. A report on September 30 that the fine might be settled for substantially less than initially proposed boosted both financial stocks in Europe and the broad STOXX 600 Index, which still lost 0.7% for the week (in local currency terms).

The S&P 500 Index tracked European markets higher on September 30 to end the week and the month with small gains.

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

Fixed income

U.S. Treasuries rallied for most of the week as the sense of unease around Deutsche Bank triggered a modest flight to safety. The yield on the bellwether 10-year note fell to 1.53% during morning trading on September 30 before reversing course following the news of the potential settlement to close the week at 1.60%. (Yield and price move in opposite directions.) Returns for non-Treasury “spread” sectors ranged from modestly to strongly positive, with flows continuing into both high-yield and investment-grade corporate bonds.

GDP is revised upward, while other data is mixed

According to the government’s third and final estimate, U.S. GDP expanded at an annual rate of 1.4% in the second quarter, higher than the previous estimate of 1.1%. A pickup in business investment largely drove the upward revision. Government spending was less than previously reported, as was consumer spending, which nonetheless remained strong. For the third and fourth quarters, we are forecasting GDP growth of 2.0% and 1.8%, respectively.

Among the week’s other data releases:

- **First-time unemployment claims** edged up by 3,000, to 254,000, while the less-volatile four-week moving average dropped by 2,250, to 256,000.
- **New home sales** declined 7.6% in August, their biggest fall in more than a year, one month after soaring to their fastest pace since October 2007. **Pending home sales** slumped 2.4% in August to their lowest level in seven months.
- **Housing prices** increased 0.6% in July and 5.0% versus a year ago, according to the S&P/Case-Shiller 20-City Composite Index.
- Orders for **durable goods** (aircraft, machinery, computer equipment, and other big-ticket items) were unchanged in August following July’s strong showing. However, business investment picked up, as orders for core capital goods notched their third consecutive one-month increase.
- **Consumers’ outlooks** improved in September, as The Conference Board’s confidence index jumped in September to its best level in nine years, and the University of Michigan’s consumer sentiment gauge also rose.
- Disappointingly, **consumer spending** was flat in August. Spending in July was revised upward. With **personal income** rising 0.2%, the savings rate jumped to 5.7%, a three-month high.
- **Inflation**, as measured by the Fed’s preferred inflation barometer (the PCE Index), rose just 0.1% in August and 1% over the past 12 months. The “core”

PCE Index, which excludes food and energy costs, increased 0.2% in August and 1.7% compared to a year ago.

Outlook

Currently, the U.S. economic picture does not compel tighter monetary policy, but that may not deter the Federal Reserve from raising rates in the fourth quarter. Should payroll growth continue at its 2016 pace of around 170,000 jobs per month, the Fed could become convinced that inflation will soon follow. For now, the Fed's "dot plot" showing the path of anticipated interest-rate hikes calls for one rate hike before year-end and up to two in 2017, which is our expectation as well.

Given the fall's reputation as a challenging period, the recent patch of fixed-income volatility has not surprised us, and we are prepared for further volatility as the November elections approach. As we position our portfolios, we believe bonds are fairly valued overall. In terms of specific asset classes, the extended rally in high-yield corporate debt and the potential for additional market turbulence warrant a focus on better-quality high-yield bonds rather than their lower-rated counterparts. In addition, investment-grade bonds remain fundamentally attractive.