Weekly Market Update

Markets respond to stellar November jobs report

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Article Highlights

- The strongest U.S. jobs report in nearly three years boosts equities, hurts Treasuries.
- A modest gain for the week helps the S&P 500 Index close at a record high.
- European equities are volatile as QE hopes fall, then rise, in response to ECB rhetoric.
- While the S&P 500 remains vulnerable to a correction, further gains are possible, in part due to falling oil prices.
- In 2015, bond prices may find support from a dovish ECB and only a modestly tightening Fed.

December 5, 2014

Equities

U.S. equities began the month of December by bracketing two days of losses around two days of gains, then finishing the week at a record high following the release of November's employment report.

In Europe, equities tumbled on December 4 after European Central Bank (ECB) President Mario Draghi failed to deliver a definitive announcement on implementing full-blown quantitative easing (QE). European stocks recovered the next day, however, closing at a nearly seven-year high, while the euro slumped to a two-year low of $1.23, amid speculation that QE could arrive as early as January 2015.

Japan is preparing for elections on December 14, as Prime Minister Shinzo Abe seeks a new mandate for major structural reforms as part of his "Abenomics" program. The Nikkei 225 Index notched five straight days of gains to reach its highest level since July 2007. The yen, meanwhile, fell to a seven-year low of ¥121 to the dollar.

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Financial Services

Fixed income

U.S. Treasuries gave back gains following the prior week's rally. The yield on the 10-year U.S. Treasury, which moves in the opposite direction of its price, rose during the week on upbeat economic releases, eventually breaching 2.30% on the heels of the robust payrolls number. Based on Barclays indexes, returns for "spread products" (higher-yielding, lower-rated non-Treasury securities) were broadly negative.

Strong job creation dominates in a week of solid U.S. economic data

The U.S. economy added a higher-than-expected 321,000 jobs in November. Seasonal hiring undoubtedly added to the gains, but this was not just a holiday phenomenon, as business employment also rose. Perhaps more importantly, September and October payrolls were revised upward by a combined 44,000. So far in 2014, job creation has averaged 239,000 per month—the fastest rate in 15 years. With more people entering the workforce last month, however, the unemployment rate was unchanged for the month at 5.8%.

Other economic data released during the week was largely positive, including:

- **Manufacturing.** The Markit Purchasing Managers Index (PMI) fell to 54.8 in November, the lowest reading in 10 months. A similar manufacturing index published by the Institute for Supply Management (ISM) dipped to 58.7 but still showed improvement in new orders and exports, evidence that the production side of the economy is picking up. Despite the drop, both indexes remain firmly in expansion territory.

- **Non-manufacturing activity.** Growth in the U.S. service sector surged, based on the ISM non-manufacturing index, which rose from 57.1 in October to 59.3 in November. (Readings above 50 indicate expansion.)

- **Construction spending.** Outlays for construction projects rose 1.1% in October, the biggest advance since May, and September's result was revised upward.

- **Vehicle sales.** U.S. car and light truck sales in November reached the second-highest level in eight years, a seasonally adjusted annual rate of 17.2 million.

As we head into the fourth quarter's final few weeks, the economy is expanding at about a 2.7%-2.8% annual growth rate, but we remain confident the pace will pick up, leading to 3% growth for the quarter.

Downbeat economic data put added pressure on the ECB

At his December 4 press conference, Draghi lowered the ECB's forecasts for Eurozone growth and inflation. These projections followed a release revealing that consumer prices were just 0.3% higher in November, on par with the five-year low recorded in September. Additionally, the region's PMI fell to 51.1 in November, a 16-month low. These reports put added pressure on Draghi to implement QE, and the

ECB's press release did say the central bank "intended" to expand its balance sheet to 2012 levels (an increase of approximately €1 trillion)—slightly stronger language than in last month's statement, when the ECB said it "expected" to reach that level.

Outlook

As we anticipated, U.S. equities have become a bit more volatile. The S&P 500 has reached our expected target zone for the year, so some consolidation is not surprising. A correction is possible, but we view a pullback as a buying opportunity. The case for further equity gains is supported in part by the economic stimulus provided by falling oil prices, which on December 5 hit a five-year low of $65.

European markets have become increasingly sensitive to any signals regarding the timing of QE. We have some doubts that QE will be as effective as the market hopes. Even so, a weaker euro—a boon to exporters—combined with lower oil prices should increase corporate earnings and boost GDP. Consequently, we see Europe as an attractive region for equity investing.

In fixed-income markets, investors easily absorbed record levels of corporate bond issuance in 2014. Looking into next year, a dovish ECB and the Fed's ability to raise interest rates modestly amid declining global inflation expectations have the potential to support bond prices. Positive fund flows should also help. In our view, many European fixed-income categories offer better relative value than their U.S. counterparts, as the many years of support from Federal Reserve quantitative easing have made domestic bonds expensive.

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