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Markets welcome positive news on corporate earnings and China

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Article Highlights

- Equity markets in the U.S., Europe, and Asia all advance for the week.
- Strong performance by non-Treasury fixed-income sectors reflects the ongoing hunt for yield.
- Evidence of slowly building inflation and sustained housing market strength highlight the week's U.S. data releases.
- Although the S&P 500 may hit new highs this year and next, rising long-term Treasury yields and declining earnings expectations could halt the advance.
- We expect a pickup in bond-market volatility prior to year-end, creating potential buying opportunities.

Equities

Global equities ended the week broadly higher, as markets digested some positive U.S. economic releases, encouraging data out of China, and mostly upbeat corporate earnings results. An uneventful policy decision by the European Central Bank (ECB) added to the generally benign market backdrop.

The U.S. earnings season has gotten off to a good start. Of the 80 companies in the S&P 500 Index reporting, 63 beat expectations by more than 7%. Importantly, some 50 firms topped sales forecasts. Backed by higher interest rates and stronger trading revenue, U.S. financials have done especially well. For the month-to-date though October 20, they are the top-performing S&P 500 sector by far (+1.78%), outpacing the overall index by nearly three percentage points. For the week, the S&P 500 gained about 0.4%, partially offsetting its decline in the prior week.

In Europe, the ECB, as expected, left its benchmark refinancing rate at 0% and its deposit rate at -0.4%, meaning that banks still must pay to leave excess cash at the central bank overnight. Markets received few specifics about the future of the ECB's current quantitative easing (QE) program, aside from confirmation that its asset purchases will remain at €80 billion per month until March 2017, the scheduled end-date.

ECB President Mario Draghi suggested he will provide broader details at the ECB's next meeting on December 8, when updated macroeconomic projections will be available. Nonetheless, market expectations for stimulus to extend past March sent the euro to a seven-month low versus the U.S. dollar, helping Europe's broad STOXX 600 Index return 1.3%.

In Asia, China's economy grew at an annual rate of 6.7% in the third quarter—the third consecutive quarter in which the Chinese government reported that GDP expanded at precisely that pace. Easy credit, a surging property market, and government stimulus contributed to the growth. Chinese equities rallied during the week, as did Japan's Nikkei 225 Index, which notched a six-month high on the back of a steady yen and upbeat earnings.

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

Fixed income

Fixed-income markets focused on the developing world, as Saudi Arabia issued its first-ever dollar- denominated debt. At $17.5 billion, it is the largest issue ever by an emerging economy, topping Argentina's $16.5 billion offering in April. Investor orders topped $67 billion, reflecting robust demand.

In the U.S., returns for non-Treasury "spread sectors" ranged from slightly to solidly positive for the week through October 20. A drop in inventories helped send oil prices to a 15-month high, supporting high-yield bonds. Their investment-grade counterparts also performed well, bolstered by positive fund flows. Year to date through October 20, these asset classes have returned 16.4% and 9.1%, respectively.

U.S. Treasuries joined in the rally, as the yield on the bellwether 10-year note dipped from 1.79% at the beginning of the week to 1.74% on October 21. (Yield and price move in opposite directions.)

U.S. data releases are mixed to positive

Some bright spots for the U.S. economy were evident in data released during the past week, including signs of slowly building inflation and sustained housing market strength. Among the reports:

- **First-time unemployment claims** jumped by 13,000, to 260,000, and the less-volatile four-week moving average edged up by 2,250, to 251,750. Despite the uptick, the pace of layoffs remains exceedingly low. Some of the increase was likely caused by the disruptive effects of Hurricane Matthew.

- **Regional manufacturing** activity slipped in October, according to the Empire State and Philly Fed manufacturing indexes. The details of the reports, though, were encouraging, as both regions experienced growth in new orders and shipments.

- **U.S. consumer prices** rose 0.3% in September and 1.5% compared to a year ago, the biggest gain over any 12-month period since October 2014, though still weak historically. Stripping out volatile food and energy costs, so-called "core inflation" increased 0.1% in September and 2.2% over the past year.

- After surging in September to its highest level in a decade, **homebuilder confidence** eased in October, based on the NAHB/Wells Fargo Index. Despite the drop, builders have high expectations for future sales. September's 6.3% jump in **building permits**, a forward-looking indicator, is consistent with that outlook. However, **housing starts** plunged 9% in September to their lowest level in 18 months.

- **Existing-home sales** rebounded solidly (+3.2%) in September, following declines in the previous two months.

- The Conference Board's index of **leading economic indicators** rose 0.2% in September, a reversal of the 0.2% decline in August. This suggests the economy should continue expanding at a moderate pace through early 2017.

Outlook

In U.S. equity markets, we still believe the S&P 500 index may reach 2,250 by year-end and perhaps 2,400 over the next 12 months. Supporting this view is a report that portfolio managers are hoarding cash at levels not seen since 2001. This is a contrarian indicator that in the past has often served as a springboard for a market advance.

A sharp spike in longer-dated Treasuries—for example, a rise in the 10-year yield to around 3%—could halt the S&P 500's advance, though we don't anticipate rates reaching that level for some time. Disappointing earnings growth, possibly resulting from a strengthening dollar or higher labor costs, among other potential causes, could also hamper future gains.

Volatility remains low in fixed-income markets. It may increase before year-end—particularly as we approach the Fed's December meeting—if investor sentiment shifts strongly or equity market turbulence accelerates. While today's relatively sedate environment provides a better backdrop for locking in profits on select higher-risk credits, periods of wide price swings offer superior opportunities for active managers to buy bonds at attractive prices.

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