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Volatility weighs on global equities

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Article Highlights

- The S&P 500 and Europe's STOXX 600 both lose ground for the week.
- Higher yields hurt Treasury and non-Treasury fixed-income assets alike.
- Consumer prices maintain their momentum as the U.S. economy shows further signs of strength.
- European stocks offer more upside potential than U.S. shares, supported by attractive valuations, a still-dovish ECB, and the Eurozone's improving economic outlook.
- Although a pickup in consumer price inflation or significant wage growth could lead to a faster pace of Fed rate hikes, our base case still calls for a modest increase in bond yields.

Equity

Uncertainty over U.S. policy ahead of Donald Trump's inauguration finally began to leak into financial markets during the past week, as investors grappled with oil price, stock-market, and U.S. dollar volatility. In a holiday-shortened week, the S&P 500 Index wavered, ending the week with a modest decline. Since rising to a then-record high of 2,272 on December 13, the S&P 500 has traded essentially flat.

In Europe, the broad STOXX 600 Index lost 0.9% (in local currency terms), snapping a three-week winning streak. The index got a brief late-week boost when European Central Bank (ECB) President Mario Draghi announced that the ECB's asset-purchase program could be extended beyond its current December 2017 deadline, or expanded if economic conditions decline.

Also noteworthy was U.K. Prime Minister Theresa May's January 17 speech in which she outlined plans for a "hard" Brexit from the European Union. Her comments offered some clarity for markets, spurring a 2.9% spike in the British pound versus the dollar, its biggest one-day gain since 2008. For the week, the U.K.'s FTSE 100 Index returned -1.9% (in local currency terms), declining for the first time in seven weeks.

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

Fixed income

The rise in volatility extended to U.S. Treasuries. The yield on the bellwether 10-year note, which began the week at 2.40%, slipped to 2.33%—a seven-week low—before ending the week at 2.47% on the back of mostly positive U.S. data reports. (Yield and price move in opposite directions.)

Returns for non-Treasury fixed-income "spread sectors" were broadly negative for the week through January 19. One exception: high-yield corporate bonds, which managed a small gain despite steep outflows. Year-to-date, high yield has returned 1.13%, in line with the S&P 500.

Inflation hits a multi-year high—and the Fed's target level

This week's mixed bag of U.S. data releases showed signs of continued economic strength. Among the week's reports:

- Continuing a trend that began last summer, the **Consumer Price Index** jumped 0.3% in December and 2.1% for 2016 as a whole. This marked the fastest annual pace in 2½ years. Stripping out food and energy prices, so-called "core" inflation rose 0.2% in December and 2.2% in 2016. Both measures are now above the Fed's 2% target level.

- **Homebuilder sentiment** slipped in January from December's 11-year high, according to the NAHB index. Even though builders expressed concerns over rising mortgage rates, they remained optimistic that a better business climate under the Trump administration will support the real estate sector.

- **Housing starts** rose by a more-than-expected 11.3% in December, reversing November's sharp decline. Building permits, a forward-looking indicator, dipped 0.2%.

- **First-time unemployment claims** fell by 15,000, to 234,000, near a multi-decade low. The less volatile four-week moving average also dropped, by 10,250, to 246,750.

- **Regional manufacturing gauges** were mixed in January. While the Philly Fed index hit its best level in more than two years, the Empire State Index eased from December's eight-month high. Industrial production, a measure of output from U.S. factories, power plants, and mines, rebounded in December, posting its strongest advance in two years,

Outlook

On the U.S. political front, we're unlikely to see many significant legislative accomplishments in the first quarter, even on tax reform. But we may have a much better idea of what the eventual legislation will look like. On corporate taxes, the wild card will be whether the final proposal moves the U.S. to a destination-based tax system with border adjustment, i.e., a change in tax policy that would benefit exports and hurt imports of both inputs and end products. Such a policy could create a well-defined set of winners and losers across and within segments of the U.S. equity market.

Meanwhile, we continue to favor European equities over U.S. shares. Valuations are more favorable, and corporate earnings estimates are on the rise. In addition, the Eurozone economy is benefiting from low inflation, accommodative monetary policy, and improving growth. Outside the currency bloc, the U.K. economy is thriving; a weaker pound has lifted exports and helped revive the manufacturing sector. However, the U.K. still faces a wide range of obstacles as it negotiates an exit from the European Union.

One major risk for fixed-income investors is the possibility of a further pickup in consumer prices as President Trump seeks to enact his pro-growth agenda. If inflation were to rise above the Federal Reserve's comfort level, officials may have to abandon their "go-slow" approach to raising interest rates. Such a move could tighten financial conditions and hamper economic growth. Moreover, high inflation rapidly eats away at bonds' fixed payments. Our base case, however, calls for modest increases in yields and continued orderly trading in bond markets.

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