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Weekly Market Update

Markets continue to advance despite weak economic data

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ARTICLE HIGHLIGHTS

- Economic data releases are weak, but equity and fixed-income markets post solid gains.
- Although the government shutdown has clearly taken a toll, the economy was already slowing.
- Central banks in Europe and China move to address regional growth issues.
- Based on current conditions, we do not expect Fed tapering to begin before late March 2014.
- We are lowering our estimate of third-quarter GDP growth from 2% to 1.8%.

October 25, 2013

U.S. equity markets continued to rise during the past week, as a good start to third-quarter earnings season helped offset disappointing economic data. An early-week snapshot showed that 76% of S&P 500 companies that have reported earnings thus far have beaten estimates, although recent downward revisions to estimates had lowered the bar for positive surprises.

Based on MSCI indexes, foreign developed markets also gained, led by strong performance in Europe, while emerging markets were negative, weighed down by China.

Fixed-income returns were strong across sectors, as prices rose and yields fell for both U.S. Treasuries and “spread products” (higher-yielding, non-Treasury securities). The week’s best performers were emerging-market debt and commercial mortgage-backed securities, both of which stand to benefit if Federal Reserve tapering is delayed further. Asset flows into investment-grade and high-yield corporate bond funds were positive during the week, but emerging-market debt funds continued to experience outflows despite recent outperformance.

Current market updates are available here.

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Financial Services

U.S. economy was slowing before government shutdown took its toll

The economy clearly suffered from the government shutdown, which cut federal spending and damaged business and consumer confidence. With the government's doors reopened, delayed economic data has started to flow. Unfortunately, these numbers underscore what can only be described as a weak third quarter. It's worth noting that the data being released now covers periods prior to October 1, indicating that economic sluggishness—driven by the summer's rise in interest rates as Fed tapering fears intensified—pre-dated the shutdown.

On the employment front:

- The September jobs reports landed with a thud, showing just 148,000 new payrolls in the month, while the combined total for July and August was revised upward by a meager 9,000 jobs. These levels are nowhere near what the Fed needs to see before it begins tapering, nor what the economy needs to achieve self-sustaining growth.
- At 350,000, first-time unemployment claims were higher than expected in the most recent week, although claims data is still being skewed by the government shutdown and by continuing computer problems in California. We expect this figure will slowly improve to the low 300,000s over the coming weeks.

In the housing market, a slowdown has been evident since "taper talk" in May and June first sent mortgage rates higher. Although rates have eased somewhat, which should lead to a slight pickup in activity, signs of weakness continue:

- Existing home sales fell 1.9% from August to September.
- The FHFA home price index increased just 0.3% in August, and its July gain was revised downward.

Capping off the week's less-than-encouraging headlines was the final October reading of the University of Michigan/Thomson Reuters Consumer Sentiment Index. This measure fell to its lowest level in almost a year.

In Europe, the focus is on the central bank

The European Central Bank (ECB) issued tough new Asset Quality Review ground rules for EU banks, causing a sharp drop in the region's financial stocks. The good news is that this reaction means the market found the ECB approach credible, unlike previous review criteria that were deemed too lenient and left the market skeptical about bank asset quality. Improved confidence in balance-sheet integrity is essential to reintroducing cheaper credit to boost lending and support growth.

Also crucial will be the ECB's approach to the strengthening euro, which is close to breaching a key level versus the dollar. As the euro appreciates on a tradeweighted basis, it undermines EU competiveness. We expect the ECB to take action to reverse this trend, either through "jawboning" (i.e., ongoing forceful rhetoric) or interest-rate cuts, which would support European equities in the near term.

China moves to cool an overheated property market, sending stock prices lower

Recent economic improvements in China, including better-than-expected preliminary readings on monthly manufacturing activity, have emboldened the central bank to hike short-term interest rates, draining liquidity from lending markets. The government's aim is to cool an overheated real estate market and limit the expansion of credit. In response to these moves, the Shanghai Stock Exchange "A Share" Market took a tumble during the past week.

Outlook

We are lowering our estimate of third-quarter GDP growth from 2% to 1.8%, while keeping our fourth-quarter forecast at 2% until we can better determine the economic impact of the government shutdown. Growth looks better in 2014 if we make the twin assumptions that Washington will reach a more permanent fiscal and debt resolution and that the Fed's tapering will be measured and somewhat delayed. At this point, we do not expect to see the Fed taper before late March 2014.

In equity markets, we believe the S&P 500 has the potential to reach or exceed 1800 this year. That said, we would not be surprised to see a near-term correction, given elevated levels of investor optimism. More than 90% of S&P 500 companies are currently trading above their 50-day moving average, indicating an overextended market. A bullish view is supported, however, by longer-term sentiment measures that remain skeptical of this market. Among Wall Street strategists, for example, allocations to equities remain at the low end of their range, based on Bank of America Merrill Lynch surveys, while hedge funds' net exposures to equities are still less than 50%.

Meanwhile, weak economic data combined with strong corporate earnings has created an ideal environment for fixed-income investing. Barring any exogenous shocks or unexpectedly robust economic releases, bonds appear poised for a continued rally into year-end.

Markets continue to advance despite weak economic data

The information provided herein is as of October 25, 2013.

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