AUGUST 26, 2013

WEEKLY INVESTMENT COMMENTARY

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Watch Housing: It's Critical (to the Recovery and Markets)

Stock and Bond Markets Remain Volatile

With uncertainty around economic growth and Federal Reserve policy, markets have lurched from one data release to another. The past week was no different, with mixed reports leading to continued volatility in both stock and bond markets. The Dow Jones Industrial Average declined for a third consecutive week, down 0.5% to 15,010. Meanwhile, the S&P 500 Index inched up 0.5% to 1,663 and the Nasdaq Composite advanced 1.5% to end the week at 3,657. Medium-term interest rates hit another multi-year high last week before pulling back on Friday. The yield on the 10-year US Treasury note climbed above 2.90%, its highest level since July of 2011, but ended the week roughly where it started at 2.82%.

Rising Rates Threaten Housing... and the Economy

As interest rates have climbed, mortgage rates have followed suit. The cost of a 30-year conventional mortgage is now at about 4.7%, up from 3.6% in early May, and the monthly mortgage payment on a median US house has increased roughly $200 during the same period. As rates (and mortgage costs) have risen, mortgage and home sales activity has started to falter. A recent Mortgage Banker Association survey shows loan activity down by more than 50% from a May peak, and on Friday, the market learned that new-home sales plunged 13.4% in July, the biggest drop in three years.

The bond market quickly took notice of the drop in new-home sales. Bond prices rallied and yields fell following the news, a tacit acknowledgement of how critical the housing market is to the broader recovery. Indeed, if steeply rising rates cause the housing market to roll over, the economy is likely to go with it.

Housing is important in that it drives jobs and new construction, but perhaps more significantly because higher home prices have been a big factor supporting consumer confidence and consumption. As the US economy is roughly 70% consumption-driven, that confidence is crucial. So even in the absence of higher disposable income, consumers have been more inclined to spend as their "paper wealth" has increased (underpinned by a higher home value), a phenomenon known as the "wealth effect."

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The Faster Rates Rise, the Larger the Threat

Our baseline view is that investors have mostly factored in an autumn reduction in Fed bond buying (so-called "tapering"), and that the majority of the near-term adjustment in interest rates has already taken place. The Fed knows the recovery is still tepid, and higher rates will slow it further. If higher yields start to impede the recovery, it would put pressure on the Fed to maintain or even increase accommodation.

But there is the risk of rates rising faster than expected. Retail investors are becoming increasingly frustrated with bonds. Last week marked the fourth straight week of fixed income outflows, with investors selling over $7 billion in bond funds. If investors grow even more aggressive in selling their bond funds, long-term rates could breach 3% for a prolonged period, endangering the housing market and the economic recovery.

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Expect More Volatility, Stick With Stocks

In the near-term, uncertainty around the timing of the Fed's tapering and the direction of economic data is likely to lead to broad-based financial market volatility. But assuming inflation stays muted and the rise in interest rates gradual, stocks appear better positioned to weather this backdrop. Of course, selectivity is key. There are segments of the equity market that are vulnerable. In the past we've spoken about utilities. Another example is consumer discretionary companies, particularly those tied to the housing market. It's worth highlighting that an index of home builders is down roughly 30% from its May highs.

Scheduling note: *The weekly commentary will not be published next week (September 2) due to the Labor Day holiday in the US. The next commentary will appear on Monday, September 9.*

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