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WEEKLY INVESTMENT COMMENTARY

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Staying the Course as the Fed Signals Its Direction

Seesaw Week Ends on the Upside

U.S. stocks experienced dramatic swings last week, but ended sharply higher. Leading the major indexes, the Nasdaq Composite Index gained 3.18% to close the week at 5,026, continuing its push toward its previous record. Meanwhile, the S&P 500 climbed 2.68% to 2,108, within 1% of a new high, and the Dow Jones Industrial Average rose 2.13% to 18,127. As for bonds, the yield on the 10-year Treasury fell from 2.12% to 1.93% as its price correspondingly rose.

Although growth is not materializing as expected, investors are taking solace in the fact that low inflation and the moderating economic growth may lead the Federal Reserve (Fed) to increase interest rates at a slower, gentler pace.

When Bad News Is Good News

Given the current backdrop, what is notable is how stocks are advancing. Though select segments of the economy are performing well, last week's rally was more a function of slow growth rather than a booming economy.

Investors started the year with this thesis: U.S. growth would drive company earnings higher, which in turn would push stocks higher. So far this year, events have not played to script. Instead, a rising dollar has forced analysts to lower their forecasts of companies' earnings, with Tiffany the latest example of an export-dependent company struggling with a rapidly appreciating currency.

At the same time, the abrupt rise in the dollar has coincided with a slowdown in U.S. manufacturing and business sentiment, although a brutally cold February and a West Coast port strike are also to blame. With the notable exception of the labor market, U.S. economic data are generally running below expectations, to the point where an index of economic surprises is now at its lowest level since 2009.

However, rather than sell stocks, investors are once again treating bad news as good. Stocks rallied last Monday following a weak industrial production report, and investors used Wednesday's Fed announcement as another excuse to bid up equities. Despite the removal of the word "patient" from its statement, which indicated the strong likelihood of higher interest rates this year, investors reacted positively to the Fed's comments. While the statement sets the stage for a normalization in interest rates later this year, the central bank's recognition of the recent economic softness was interpreted as a dovish stance.

Russ Koesterich, Managing Director, is BlackRock's Global Chief Investment Strategist, as well as Global Chief Investment Strategist for BlackRock's iShares business. Mr. Koesterich was previously Global Head of Investment Strategy for active equities and a senior portfolio manager in the U.S. Market Neutral Group. Prior to joining the firm in 2005, he was Chief North American Strategist for State Street Bank.

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Treasuries rallied on the announcement, with the yield on the 10-year Treasury dipping back below 2%, as equities swung from a loss to a 1% gain. The only loser last week was the dollar. As investors recalibrated their estimates for an initial rate hike, the dollar slipped from its recent high, falling roughly 2% on the week.

We believe the recent gains can continue and we would remain overweight stocks relative to bonds, which have underperformed both domestic and global equities year-to-date.

Sticking With Stocks

Against this backdrop, we are sticking with our main investment positioning. We believe the recent gains can continue and we would remain overweight stocks relative to bonds, which have underperformed both domestic and global equities year-to-date. We still favor technology: The tech-heavy Nasdaq Composite is back where it was at the peak of the 2000 bubble, but earnings growth, not multiple expansion, has been the main driver of the advance. At 30 times trailing earnings, the price-to-earnings ratio on the Nasdaq has not changed much over the past two years and is still a long way from the 175 times earnings that marked the top in 2000.

We also continue to believe investors who are overweight U.S. equities should bring down their exposure and consider international stocks. Even with the recent rally, the U.S. is still up 2.5% year-to-date versus 18% and 12% (in local currency terms), respectively, for Europe and Japan.

That said, we'd once again offer an important caveat: Expect volatility to continue to be high. While U.S. stocks have managed to advance so far this year, the volatility of daily returns is already 25% higher than it was last year. Expect a continued bumpy ride in the months ahead.

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