Stocks: Weak Eurozone Growth, Stronger Dollar, and Geopolitics

The European Central Bank (ECB), concerned about weak growth in the Eurozone, announced additional accommodative monetary policy measures. The Bank of Japan also continued on its path of easy monetary policy. On the other hand, the U.S. economy is growing at about 2%, and the unemployment rate trended closer to 6% in the third quarter. The market feared that the Fed would be forced to raise interest rates earlier than anticipated. The dollar rose over 8% against the euro and the yen and 5.5% against the British pound. Strength in the U.S. dollar, along with new terrorist threats in Iraq and Syria, caused investors to take risk off particularly in international markets.

The MSCI All-Country World Index fell 2.2% in the third quarter of 2014. The index of international developed markets stocks EAFE fell 5.7% and emerging market stocks were down 3.4%. The U.S. markets fared somewhat better, the Standard and Poor's 500-stock index of U.S. stocks was up 1.1%. In the U.S., large company stocks continued to outperform stocks of smaller companies, suggesting that the bull market is maturing. In the third quarter of 2014, the Russell 2000-stock index of small companies fell 7.4% and is down 4.4% for the year.

Healthcare and technology continued their dominant performance and were up 5.5% and 4.8% respectively in the third quarter. As oil prices fell by 13%, energy stocks followed and were down by 8.6%. Real estate stocks were hit hard in the third quarter as the markets worried that the Fed would raise rates sooner than expected. The Dow Jones REIT Total Return Index declined 2.5% for the quarter. In international markets, investors fled areas of geopolitical risk. Russia was down 17.9% and stocks in Ukraine fell by 20.7%. A declining euro and its reliance on Russian energy imports hit Germany hard. The German dax fell by 11.4% in the third quarter of 2014.
Bonds: Flight to Quality
The bond market ended the quarter with a relatively flat return. The Barclays U.S. Aggregate bond index returned 0.17% as the yield on the 10-year Treasury rose during the quarter, but ended close to where it began at 2.49%. The risk-off mood extended into fixed income as government securities were up 0.3% while high-yield bonds were down 1.9% due to significant outflows.

Factors that continue to help the bond market include: subdued inflation in the U.S., falling deficits resulting in a reduced supply of Treasurys, lower rates in the Eurozone due to recessionary conditions, and central bank purchases of U.S. Treasurys.

Commodities: Excess Supply, Stronger Dollar Cause Oil Prices to Tumble
U.S. daily oil production has increased by over three million barrels over the past three years. According to the EIA, imports now account for 26% of the country’s oil needs compared to 45% in 2011. Even as the U.S. has become an increasingly dominant oil producer, consumption in China and the Eurozone stalled in the second quarter. According to the International Energy Agency, oil demand growth in the second quarter was the lowest of the past three years. As a result of the supply glut, prices were down 13.4% in the third quarter. The strength in the U.S. dollar and an improving domestic economy hurt precious metals. Gold prices fell 8.4% in the third quarter while silver was down 18.8%. The Bloomberg UBS commodity index, which tracks 22 commodity prices, fell 11.8% in the third quarter of 2014.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset