Weekly Market Update

Markets stabilize as investors look beyond weak jobs report

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- U.S. equities shrug off the disappointing jobs report and focus on earnings.
- We see improving long-term employment growth despite January's weakness.
- Fixed-income performance is mixed, with Treasury yields rising only modestly.
- Emerging markets benefit from a calmer environment.
- We remain cautious about the Japanese equity market.

February 7, 2014

U.S. equities began to find firmer footing during the past week, improving from oversold levels. The week started on a down note, with the S&P 500 Index falling 2% in the wake of disappointing manufacturing data. Equities rallied later in the week, and on February 7 appeared to be shrugging off the release of January's lower-than-expected job growth. Foreign developed- and emerging-market stocks followed a similar course, based on MSCI indexes.

Fixed-income performance was mixed. The bellwether 10-year Treasury yield, which moves in the opposite direction of its price, rose modestly on the week. Meanwhile, "spreads"—the difference between Treasury yields and those of higher-yielding, non-Treasury securities—narrowed for investment-grade corporate bonds, commercial mortgage-backed securities, and emerging-market debt. Narrowing spreads generally indicate improved market conditions to the extent that investors are more comfortable taking on added risk without demanding a higher yield as compensation for that risk.

Current market updates are available here.

U.S. fundamentals remain intact

The U.S. economy added 113,000 jobs in January—below consensus estimates of 160,000-185,000. We had expected an increase of 125,000, so we were less "surprised" by the softer headline number. Moreover, we do not consider the recent relative weakness in job creation as a break in the longer-term trend of improving employment growth:

Financial Services

- The jobs report was heavily influenced by unusually cold weather. (By some measures, it was the coldest January in 20 years.)
- Payroll gains for December and November were revised upward by a combined 34,000, and monthly job growth for 2013 as a whole averaged 194,000.
- Construction and manufacturing jobs grew in January at rates exceeding their respective monthly averages in 2013.
- First-time unemployment claims fell by 20,000.

Other U.S. data released during the week was mixed:

- The Markit Purchasing Manager's Index (PMI), a measure of manufacturing activity, held steady at 53.7, while the manufacturing PMI published by the Institute for Supply Management (ISM) fell sharply, from 56.5 to 51.3. (Readings above 50 indicate growth.)
- The service sector of the economy picked up, with the ISM non-manufacturing index ticking up from 53.0 in December to 54.0 in January.
- In December, construction spending increased by just 0.1% and factory orders fell by 1.5%, while January auto sales slowed.

Emerging markets benefit from a calmer environment

Emerging-market equities improved during the past week. Relative calm was restored as currency volatility subsided and equity returns turned positive. After a four-day Lunar New Year's hiatus, the Shanghai Stock Exchange "A" Share index reopened on February 7 and gained 0.6%. Meanwhile, Chinese home prices cooled their advance in January, helping temper fears of an overheating real estate market. Recent stress in China's money markets and currency also eased.

Overall, emerging-market equities look inexpensive at current levels, while expected returns appear attractive. We are actively focused on various tactical opportunities in these markets, recognizing that many developing economies have long-term structural issues that may take years to correct.

European equities rally despite central bank inaction

European stock markets rebounded from oversold levels. Equities gained even though hoped-for monetary easing by the European Central Bank (ECB) did not materialize. The ECB held short-term rates steady while vaguely hinting that some sort of monetary stimulus could occur in March, depending on economic data. We continue to believe that European equities can move higher in 2014, but we are wary of potential drags on economic growth that could increase the likelihood of deflation. If this occurs, we believe the ECB will act decisively to implement direct or indirect quantitative easing—likely prompting a sharp rise in equity markets, particularly in southern Europe (e.g., Italy, Spain), where valuations are among the most depressed.

Yen concerns and lack of reforms warrant caution on Japan

In Japan, an aggressive monetary stimulus program launched at the beginning of last year helped weaken the yen and drive Japanese equities higher, especially export companies. However, the yen has recently firmed somewhat, in part as Japanese investors repatriated investments in volatile emerging-markets. If emerging markets continue to stabilize, however, the yen could resume weakening, providing a lift to Japanese equities. The lack of true economic reforms promised by the government, along with a higher consumption tax that takes effect in April, may also have a bearing on how Japanese stocks perform. Overall, we remain cautious on this market.

Outlook

For the U.S. economy, it is clear that December was a weaker month than October and November, and that some of December's weakness carried into January, in part due to extreme cold weather. Nonetheless, we continue to believe that improving economic fundamentals remain in place, supporting stronger employment growth going forward.

In equity markets, much has been written about the "January effect"—the extent to which weak or strong equity market performance in January has historically predicted the outcome for the full year. While statistics suggest 2014 will be a toss-up in this regard, we continue to expect positive equity returns for 2014 based on improving economic data and stronger corporate results. In addition to upside earnings surprises from S&P 500 companies, we are beginning to see better-than-expected revenues being reported for mid-cap companies for the first time in several quarters. This suggests that demand is improving to the point where businesses will need to start investing capital to accelerate growth—something they have been reluctant to do over the past two years.

Markets stabilize as investors look beyond weak jobs report

In fixed-income markets, we do not expect recent signs of moderating growth to slow the pace of Fed tapering. Long-term interest rates should trend higher as the year progresses, putting some pressure on bond market returns but not negating the role of fixed-income assets in a diversified portfolio. Overall, we see continued demand for fixed-income assets from retail investors, money managers, and corporate pension plans.

Financial Services

The information provided herein is as of February 7, 2014.

The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate. Certain products and services may not be available to all entities or persons.

TIAA-CREF Asset Management provides investment advice and portfolio management services to the TIAA-CREF group of companies through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association® (TIAA®). Teachers Advisors, Inc., is a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). Past performance is no guarantee of future results.

Please note that equity and fixed income investing involve risk.

© 2014 Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), 730 Third Avenue, New York, NY 10017

C15071