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Market & Investment Insights

Ukraine worries temper a record week for U.S. equities

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Article Highlights

- The S&P 500 Index closes above 2,000 for the first time but struggles to maintain that level.
- Escalating Russia-Ukraine tensions take their toll, particularly on European stocks.
- An expected rise in U.S. consumer spending fails to materialize, potentially muting 3Q growth.
- Weak inflation in Europe could lead to some form of ECB quantitative easing by year's end.
- U.S. equities still have room to rise, but contrarian indicators of sentiment warrant caution.
- The dominant theme in fixed-income markets is the ongoing decline in government bond yields.

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Equities

U.S. equities gained in a quiet trading week ahead of Labor Day weekend. On August 26, the S&P 500 Index closed above the 2,000 threshold for the first time but retreated two days later amid escalating geopolitical fears related to the Russia-Ukraine conflict.

Small-cap stocks continued their recovery and were poised to outpace both large caps and the broader S&P 500 for the month. Similarly, growth-oriented sectors, including Internet and biotech stocks, have rebounded from their spring selloff. Cyclical, or economically sensitive, stocks traded in a narrow range during the week as investors avoided categories perceived to be more vulnerable to the Federal Reserve's first interest-rate hike, now expected in June 2015.

Outside of the U.S., Japanese equities posted a loss for the week amid weak consumer spending and factory production data. European stocks, which had rallied impressively in the wake of European Central Bank (ECB) President Mario Draghi's "dovish" Jackson Hole speech on August 22, reversed course late in the week on Ukraine worries.

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Fixed income

European sovereign debt markets continued to rally, with German and other government bond yields reaching new record lows. (Yields and prices move in opposite directions.) Weak economic data and anticipation of more aggressive ECB action to avert deflation helped push yields downward.

Yields on longer-term Treasuries declined, in sympathy with European debt. Most "spread" products (higher-yielding, non-Treasury fixed-income securities) also generated positive results. Investor demand for yield boosted returns for investment-grade and high-yield corporate bonds, commercial mortgage-backed securities, and emerging-markets debt.

Current market updates are available here. For additional insights on developments in fixed-income markets from TIAA-CREF Portfolio Manager Joseph Higgins, view the Weekly Market Perspective Video.

U.S. growth continues apace, but consumer spending lags

The Bureau of Economic Analysis raised its estimate of second-quarter GDP growth, from 4.0% to 4.2%, driven largely by stronger business investment and capital expenditures. Higher consumer spending, however, failed to materialize in the second quarter and in July.

- **Consumer spending** dropped 0.1% in July, the first monthly decline since January.
- **New home sales** fell 2.4% in July, and year-over-year **home price appreciation** continued to slow in June. **Pending home sales,** however, climbed 3.3% in July, to their highest level in 11 months.
- Orders for **durable goods** (e.g., aircraft, machinery, computer equipment, and other big-ticket items) soared 22.6% in July, although this record gain was skewed by a surge in orders for Boeing aircraft. "Core" capital goods orders, which exclude defense and aircraft, dipped 0.5%, although the overall trend this year has been strongly positive.
- **First-time unemployment claims** again fell below 300,000, a sign of continued healing in labor markets and a level associated with real GDP growth north of 3%.
- The Conference Board's index of **consumer confidence** rose for the fourth consecutive month in August, to its highest level since October 2007. The Thomson Reuters-University of Michigan gauge of **consumer sentiment** also climbed.

In Europe, fears of deflation and hopes of quantitative easing

With eurozone inflation weaker in August, the prospect of ECB intervention has grown more likely. While pressure mounts on Mario Draghi to act sooner rather than later, we do not anticipate a dramatic policy announcement in September. By year's end, however, we would not be surprised to see some form of quantitative easing, most likely via ECB purchases of asset-backed securities.

Outlook

The absence of increased consumer spending in the revised second-quarter GDP estimate and at the beginning of the third quarter is surprising. It remains to be seen whether continued healthy jobs growth and rising consumer optimism will translate into stronger consumer demand. For now, our forecasts remain unchanged.

Assuming no broadening of the Ukraine conflict, we believe the S&P 500 still has room to rise. That said, further gains may be limited given how far the index has already advanced. Moreover, contrarian indicators of market sentiment warrant caution. Hedge funds, for example, have raised their net exposures to equities from low to neutral levels. Although not yet in the danger zone of enthusiasm that often presages a market downturn, this elevated sentiment makes us more wary of a correction.

In our view, an eventual correction of up to 10% is to be expected but might not occur until after the S&P 500 reaches higher intermediate target levels. One likely trigger for a correction would be the formal end of Fed tapering in October, usually the most volatile month of the year. We would consider such a correction a buying opportunity.

Foreign equity markets may have even more upside potential than the U.S. European equities, for example, appear poised to continue their rally, assuming that Russian sanctions do not overwhelm positive factors such as the potential for ECB quantitative easing, a depreciating euro, lower corporate borrowing costs, and a possible move toward economic reforms in France. In Japan, the Nikkei index has stalled but could resume its advance on the back of additional monetary stimulus from the Bank of Japan and a continuation of positive earnings revisions.

In fixed-income markets, the dominant theme remains the ongoing decline in government bond yields in the U.S. and in Europe. The differential in yields between German bonds and U.S. Treasuries has reached levels not seen in 30 or more years. The magnitude of this trend may be overdone, particularly since there is no guarantee the ECB will implement new stimulus in September. What is increasingly apparent is that the 10-year Treasury yield is unlikely to breach 3% by year-end, even with continued U.S. economic improvement. Additionally, the dollar should strengthen further against the euro, as the U.S. is likely to experience rising interest rates much sooner than Europe. A stronger dollar would help boost Europe's economy modestly while having little negative impact on U.S. growth.

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