WEEKLY MARKET UPDATE

Markets respond to signs of progress in D.C. debate

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Markets remain fixated on Washington in second week of partial government shutdown.
- After a pessimistic start to the week, U.S. equities surge on signs of a thaw in negotiations.
- The government shutdown results in a dearth of economic data.
- Janet Yellen, nominated to be the new Fed chief, is likely to take her time tapering.
- Despite Washington gridlock, we remain optimistic on the U.S. economy and equity markets.

OCTOBER 11, 2013

With the partial U.S. government shutdown entering a second week, financial markets were attuned to any and all hints about where the debate may be leading. U.S. equities were volatile, selling off early in the week amid a more pessimistic tone out of Washington, then surging more than 2% on October 10 when Congressional leaders proposed a "clean" temporary debt ceiling increase. Foreign developed- and emerging-market equities also rebounded on the optimistic reports, climbing about 1% each based on MSCI Indexes.

Fixed-income markets were calmer than equities. Many investment-grade sectors posted flat to only slightly negative returns for the week through October 10, while the yield on the bellwether 10-year Treasury note stayed within a relatively narrow range between 2.5% and 2.6%. High-yield corporate bonds and emerging-market debt performed well, in part because the stalemate in Washington could further delay the beginning of Federal Reserve tapering, which would benefit these areas of the market.

For more perspective from TIAA-CREF on the government shutdown, the debt ceiling debate, and other political issues that could affect markets and the economy, visit our Washington Watch page. Current market updates are available here.

Financial Services

Delayed data, and an appointment to succeed Ben Bernanke

The October 9 nomination of Janet Yellen, current vice chair of the Federal Reserve Board, to succeed Ben Bernanke as chair has provided some clarity on the path of monetary policy going forward (assuming her nomination is confirmed). Yellen is perceived as being “dovish” in her views on monetary policy, suggesting that she will likely favor taking very slow and measured steps toward tapering the Fed’s bond purchases. We now expect the earliest date for tapering to begin will be after the Fed’s March 19, 2014 meeting.

In the meantime, the government shutdown delayed the release of key economic data for the second week in a row, including readings on the trade deficit, retail sales, business inventories, and producer prices. The Labor Department did release first-time unemployment claims, which spiked to 374,000, but this number is unreliable, given continued processing problems in California and the effects of the government shutdown. Among non-governmental data releases, the most notable was the preliminary October reading for the Thomson Reuters/University of Michigan Consumer Sentiment Index, which declined on concerns about developments in Washington and stock market volatility.

Europe showing resilience, but risks remain

The eurozone, along with other global markets, has kept a close watch on the political drama unfolding in the U.S., while also responding to events at home.

- European economic activity continues to improve, and the resolution of political uncertainty in Italy has eliminated a major threat to EU stability.
- Real risks remain, however, particularly regarding fiscal and political challenges in Greece, Portugal, and Cyprus.
- While we remain optimistic about European equities near term, we are concerned that too many others share that view, which could lead to investors overbuying the market.

In Asia, economic reforms remain key

China and Japan face very different economic scenarios, but a common theme is the need for meaningful government reforms.

In China, markets expect the Communist Party Congress scheduled for November to deliver major economic reforms. If significant policy changes do not ensue, there are risks to both market performance and the broader economy.

In our view, Japan’s “Abenomics” program remains suspect. The Japanese equity market has been disappointed by the lack of real reforms in the government’s approach, and we think that this market has further to fall.

Outlook

Despite recent challenges, we think underlying economic conditions in the U.S. are better today than they were earlier this year or last year. As of this writing, it remains to be seen what kind of political compromise will be agreed upon in Washington, but a settlement that is palatable to all parties could help economic growth return to its previous trajectory of roughly 2.5%, accelerating upward toward 3% and 3.5% after about a year. This is because the factors that have been in place since the summer of 2012 are still present: Housing is slowly returning to its central role in the economy, pent-up consumer demand remains, and business profitability is strong. Moreover, a mildly synchronized upswing in global economic activity has emerged.

Overall, we remain hopeful that a debt ceiling catastrophe will be averted but note that if only short-run solutions (such as a six-week extension) are negotiated, then the risk is another round of governmental gridlock next month, staring down another deadline without making any real progress. In the meantime, we are encouraged by the fact that equity markets, while volatile, have not been subject to panic selling in the face of the recent uncertainty. If we do see a sharp market drop, we believe it will be a buying opportunity.