April 2015

TIAA-CREF Asset Management

Second Quarter 2015 Investment Outlook: Watching the Fed

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Executive summary

- Investor anticipation about when and how quickly the Fed raises interest rates will influence markets almost as much as the hikes themselves; expect ongoing volatility.
- While the coming increase in rates will likely spark temporary weakness in equities, the Fed's action is fundamentally positive as it reflects steady U.S. economic growth.
- Above-average valuations and low earnings growth potential in the U.S. mean international equity markets are more attractive, though U.S. investors need to be mindful of currency risk.
- The increase in U.S. Treasury interest rates will be driven not only by the Fed's hikes but by rising inflation expectations; foreign demand, however, will help moderate the rise in yields.
- The income from higher-yield, higher-risk parts of the bond market, such as emerging-market debt and high yield, will bolster total returns even as rates rise, but selectivity is key.

Asset class preferences

Equities ↑
Large Cap ↓
Mid Cap ↑
Small Cap ↑
Growth ↑
Value ↓
Developed Markets ↓
United States ↓
Europe ↑
Japan ↑
Emerging Markets ↑

Bonds ↓
Government Debt ↓
United States ↓
Eurozone ↑
Core[2] ↓
Periphery[3] ↑
Treasury Inflation-Protected Securities (TIPS) ↓
Munis ↑
Corporate (IG) ↑
High Yield ↑
Emerging Markets ↑

Data as of March 31, 2015. ↑ = overweight; ↓ = underweight. [1] Materials, Industrials, Consumer Discretionary, Financials, Information Technology. [2] Core = Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands, Slovakia. [3] Periphery = Cyprus, Ireland, Italy, Malta, Slovenia, Spain. Please note the forecasts above concern asset classes only, and do not reflect the experience of any product or service offered by TIAA-CREF. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, and political and economic developments. Past performance is not an indicator of future results.

TIAA CREF
Financial Services

Global asset returns

	Market Value ($tr)	Relative P/E (%)*	Dividend Yield (%)	Total Return (%) First Quarter 2015 Local	Total Return (%) First Quarter 2015 USD	Total Return (%) Last Twelve Months Local	Total Return (%) Last Twelve Months USD
Equities							
Global (ACWI)	$37.5	4.6%	2.4%	5.0%	2.4%	14.3%	6.0%
World ex-US	18.2	11.0	2.8	9.1	3.6	16.0	-0.6
Small/Mid Cap	12.5	13.8	1.9	6.8	4.2	13.2	5.1
Growth	19.4	9.3	1.6	6.9	4.5	18.4	10.0
Value	18.1	19.5	3.2	3.0	0.3	10.1	2.0
High Dividend	9.6	20.0	3.9	3.6	0.2	10.6	0.2
Developed Markets	33.6	7.8	2.3	5.0	2.5	14.6	6.6
United States	19.3	18.2	2.0	1.4	1.4	12.8	12.8
Europe	8.5	20.9	3.1	11.7	3.6	15.3	-4.4
Japan	2.9	-8.1	1.7	10.4	10.3	30.9	12.4
Asia ex-Japan	1.6	7.7	3.8	8.0	3.2	13.7	-0.2
Emerging Markets	3.9	-5.4	2.6	4.9	2.3	11.3	0.8
Asia	2.7	-13.7	2.3	5.7	5.3	14.6	11.1
Latin America	0.6	21.7	3.2	1.3	-9.5	2.4	-20.7
Europe, Middle East and Africa	0.7	8.8	3.2	5.7	2.0	8.8	-11.6

	Market Value ($tr)	Duration (Years)	Yield (%)	Total Return (%) First Quarter 2015 Local	Total Return (%) First Quarter 2015 USD	Total Return (%) Last Twelve Months Local	Total Return (%) Last Twelve Months USD
Bonds							
Multiverse	$45.9	6.6	1.8%	1.9%	-1.9%	7.1%	-3.8%
Intermediate (1–10 Years)	36.1	4.4	1.6	1.2	-2.5	4.4	-5.8
Long (10+ Years)	9.8	14.7	2.3	4.4	0.3	18.2	4.6
Government	23.1	7.4	1.0	1.9	-2.2	8.1	-5.5
United States	6.5	5.7	1.3	1.6	1.6	5.4	5.4
Eurozone	6.4	7.4	0.5	4.3	-7.4	13.7	-11.4
Core	3.8	7.8	0.2	3.9	-7.8	12.8	-12.1
Periphery	2.5	6.9	0.9	4.9	-6.9	15.0	-10.4
Japan	6.0	8.6	0.4	-0.5	-0.5	3.1	-11.4
Agency	2.9	5.1	1.7	1.7	-2.4	5.1	-5.6
Inflation-Linked	2.5	11.8	-0.5	2.6	2.4	9.4	9.0
Securitized	6.7	5.4	2.0	1.2	-0.8	5.7	0.7
Corporate (Investment Grade)	7.6	6.5	2.4	2.1	-1.2	7.1	-0.7
Municipal	1.4	4.8	2.0	1.0	1.0	6.6	6.6
High Yield	2.3	4.2	6.3	2.8	0.6	2.5	-2.2
Emerging Markets	3.4	5.7	5.1	1.8	-0.5	4.8	-1.4

	Exchange Rate	Change vs. USD (%) First Quarter 2015	Change vs. USD (%) Last Twelve Months
Currencies			
Euro	$1.07/€	-11.2%	-22.1%
Pound	$1.48/£	-4.8	-11.0
Yen	¥120/$	0.0	-14.1
Canadian Dollar	CAD1.27/$	-8.5	-12.9
Swiss Franc	CHF0.97/$	2.3	-9.1
Emerging Market Basket†	nm	-4.4	-13.3

Data as of March 31, 2015. ACWI = MSCI All Country World Index. IG = Investment grade. EM = Emerging markets. All returns are in local currency unless otherwise indicated. Equity categories are for the respective MSCI index. Bond categories are for the respective Barclays index, except for emerging markets, which are for Bank of America Merrill Lynch indexes. *Relative P/E compares current 12-month forward P/E (price/earnings) ratio versus median value since 1987 (except Latin America since 1992, EMEA since 1997, Small/Mid Cap and High Dividend since 1999, and Japan since 2000). † Weighted average of currencies in MSCI Emerging Markets and JP Morgan GBI-EM indexes. **It is not possible to invest in an index. Performance for indexes does not reflect investment fees or transactions costs.** Data as of December 31, 2014. Sources: MSCI, Barclays, Bank of America Merrill Lynch and TIAA-CREF Asset Management.

Introduction

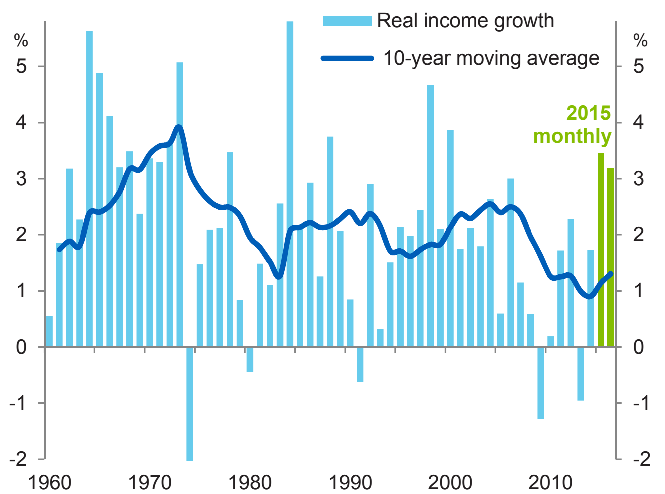
Debate about, conjecture on, and signals for hikes in the Federal Reserve's target interest rate will be a key driver of markets through the rest of 2015, almost as much as the actual hikes themselves. While discussion focuses on when the first increase will occur, the Fed has made it clear that the timing will depend on the strength of U.S. economic growth and inflation. As opinion about these two factors changes with each data release, market volatility will remain high.

Economy

Although U.S. economic growth is steady, the pace of the expansion remains below historical norms. We should see a modest acceleration this year, however, with the housing market and consumer demand as the key drivers. Housing prices are rising at nearly 10% year-on-year, boosting consumer confidence, and monthly housing starts have doubled since the nadir of 2009. Housing starts are nonetheless still 34% below 2000 levels, suggesting there is plenty of scope for more activity. The worry is that an increase in interest rates will cause construction to stall—the "taper tantrum" of 2013 saw a nearly 10% drop in housing starts over three months. But with mortgage interest rates rising from such low levels, we believe any setback will be temporary.

Importantly for future consumer demand, the household debt burden (the percentage of disposable personal income devoted to debt payments) has fallen to levels not seen since 1978. Between low interest rates, defaults and principal payments, consumers are now in a position to again take on credit, just as banks are slowly increasing their willingness to extend it. A better source of higher household spending would be income, however. With real wages stagnant, many wonder how consumer demand can rise. Focusing solely on wages, though, paints too pessimistic a picture. Measured by per capita disposable personal income (DPI), which takes into account all sources of funds (such as investment income and government benefits), incomes are actually rising—in inflation-adjusted terms—at rates not far below historical averages. In fact, the last two months show DPI surging by more than 3% (see Figure 1). Add cheaper gas and falling prices for imported goods thanks to a strong dollar, and consumer demand should accelerate throughout the year.

Figure 1: Real year-on-year growth of per-capita disposable personal income (DPI)



Data as of March 31, 2015. DPI is sum of wage and salary disbursements, supplements to wages and salaries, proprietors' income with inventory and capital consumption adjustments, rental income of persons with capital consumption adjustments, personal dividend income, personal interest income, and personal current transfer receipts, less contributions for government social insurance and personal current taxes. Sources: BEA, TIAA-CREF Asset Management.

Equities

While more attractive than bonds given rising interest rates, U.S. equities do not offer very appealing expected returns in the current environment. The multiple on the broad-market Russell 3000 Index is currently over 17x compared to a median of 14.3x since 1978. There are two reasons why a higher-than-average multiple may be justified: inflation is low, and low interest rates mean M&A activity increases the value of both the buyer and the seller; hence investors are willing to pay a premium in advance of a takeout or accretive deal. Nonetheless, the current 20%+ premium appears excessive, especially as earnings growth is likely to be modest. The companies in the index managed an 8% gain in earnings per share (EPS) in the fourth quarter of 2014 (excluding Apple, Gilead, and the Energy sector), but with margins near historical highs it will be a challenge to match this earnings growth rate in the future; the forecast for the current quarter is just 4%. There are other concerns, though rising interest rates are not necessarily the biggest risk to the market. While history tells us to anticipate a correction three to six months ahead of the first hike by the Fed, higher rates reflect economic growth, which is ultimately more important for corporate profits. The strong dollar is a burden for export-dependent companies, but the U.S. is a net importer, so in aggregate the economy gains more through cheaper imports than it loses through more expensive exports.

Across sectors, the only one that appears to offer much value is Technology, where multiples are slightly below historical averages, while most other sectors are above (see Figure 2). Combined with the Technology sector's potential to increase productivity (and hence earnings) more easily than other sectors, and rising investment in technology from non-tech companies hoping to achieve the same gain in EPS, the earnings outlook for companies in the Technology sector is comparatively good. The extreme multiple on the Energy sector, double its historical average, overstates the richness of the sector as the near-term earnings collapse is greater than the sector's long-term expected profitability. With our view that oil prices will recover to $60–$70 by the end of 2015, however, buying the commodity might prove to be more profitable than equities.

The multiple on the least attractive sector in the index, Utilities, is more than 30% above average, reflecting the high price investors are paying to pick up additional income from higher-dividend-yielding stocks. Multiples on companies offering above-average income are currently higher than they've been in at least 20 years, while low- or non-dividend-yielding company multiples are only slightly above average. As U.S. interest rates rise, the high-income stocks are unlikely to pay enough dividends to compensate for what we expect will be significant price underperformance.

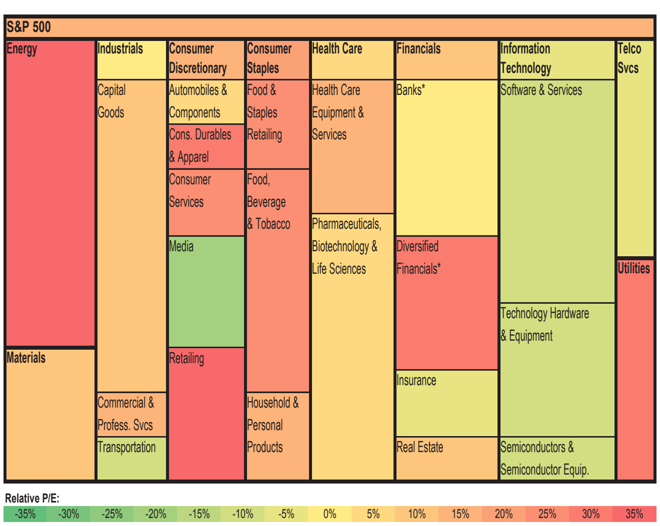
Fixed income

Inflation expectations are the tail that has been wagging the Treasury-yield dog since the summer of last year. While Treasury yields declined through all of 2014, the driver in the first half of the year was falling global growth expectations, which pushed down real yields. Growth forecasts bottomed out by the summer, however, but then oil prices began their descent from $100+/barrel and market inflation expectations followed suit. With the current stabilization of oil prices, inflation expectations – and Treasury yields – have recovered (see Figure 3). Significantly, inflation expectations based on survey data instead of inflation swaps do not show the same decline in the expected rate of price increases. Ten-year inflation swaps are currently 50 basis points (bps) below their average from the first half of 2014, suggesting a commensurate increase in Treasury yields as the year-on-year effect of the drop in oil prices fades.

What may prevent such a large increase in yields, at least in the short-term, is significant and rising demand for Treasuries from yield-desperate European investors. The unexpectedly large, open-ended quantitative easing (QE) program from the European Central Bank (ECB) has pushed yields into negative territory across much of Europe. In that context, a 2% yield on 10-year U.S. Treasuries looks very attractive, especially when the European investor's currency

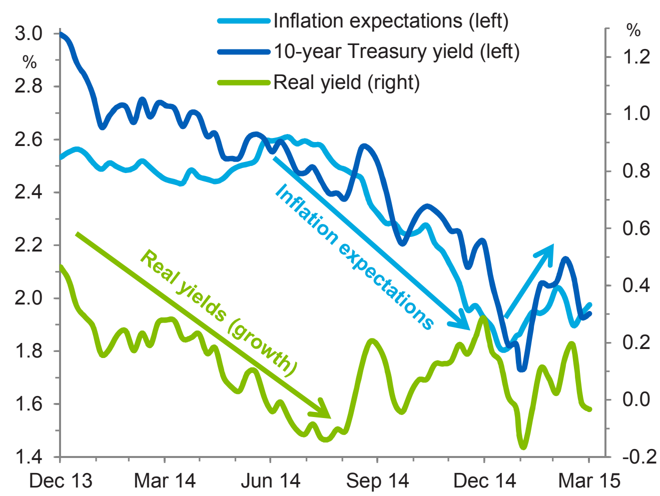
Figure 2: S&P 500 industry group relative valuations

Size of box reflects market capitalization



Data as of March 31, 2015. Note: Relative P/E based on NTM P/E vs. median since 1984. *Financials sector P/E excludes REITs. Diversified Financials reclassified into Banks Industry Group for historical comparison. Sources: Standard & Poor's, IBES, TIAA-CREF Asset Management.

Figure 3: Bond yields and inflation



Data as of March 31, 2015. Sources: Bloomberg, TIAA-CREF Asset Management.

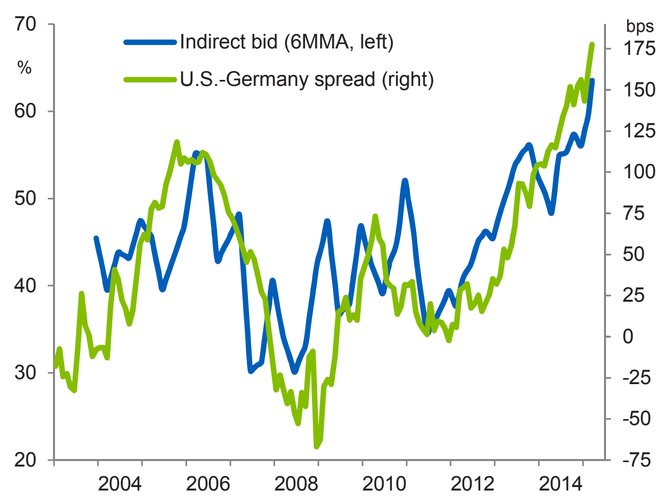
is expected to depreciate relative to the dollar. The latest Treasury auction showed unprecedented foreign demand, and this demand is likely to prevent Treasury yields from rising too quickly (see Figure 4).

Ten-year Treasury yields have ranged from 1.39% to 4% over the period that the Fed funds target rate has been set at 0%–0.25%, and a rising target rate will be a force pushing shorter-term market yields higher. The timing and pace of the hikes will depend significantly on wage inflation. Anecdotal evidence of wage hikes suggests that the labor market is sufficiently tight such that employers are being forced to offer more pay to obtain or retain the employees they need, even with the "underemployment" rate (which includes those who are not working as much as they would like) at 11%, compared to 9% in 2007. There is another reason to suspect wage inflation will begin rising, namely that the apparently low labor market participation rate gives a false sense of a large pool of untapped potential workers who will be drawn back into the labor market if wages start to climb, ultimately keeping those wage increases in check.

The percentage of the working age population that is able to work but isn't has indeed risen since the crisis began, from 34% in 2008 to 37% today. But of those who are not working, the percentage who would like to work has increased only modestly, from 6% to 7% of the total (see Figure 5). Though the drop in the percentage of working adults is negative for U.S. economic growth, the data do not indicate that there is a large pool of workers waiting and willing to work if only wages were higher.

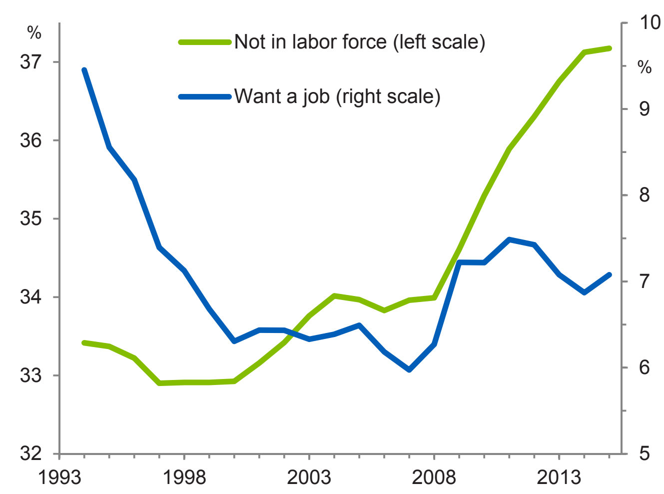
A tighter-than-perceived labor market means that wage inflation may show up sooner than expected, and hence the fed funds target rate may rise sooner than expected. We nonetheless foresee no more than a 25–50 bps increase between now and the end of 2015. With economic growth steady, inflation low (but rising), and only moderate interest-rate hikes ahead, credit instruments should perform better than Treasuries and Treasury inflation-protected securities (TIPS). Despite the shock to the high-yield sector stemming from the collapse in oil prices last year, current yields of over 6% on high-yield debt indexes appear attractive. We do not see spreads for the sector as a whole rising significantly, and this extra yield comes along with comparatively low duration (4.1 years on the Barclays index), unlike the investment-grade bond index, where achieving an above-inflation average yield of 3% requires a 7.4 year duration.

Figure 4: Foreign participation in 10-year Treasury bill auction and interest rate spreads



Data as of March 31, 2015. Sources: Bloomberg, TIAA-CREF Asset Management.

Figure 5: Labor market participation rates



Data as of March 31, 2015. Sources: BLS, TIAA-CREF Asset Management.

U.S. Commercial Real Estate Outlook: The return of volatility

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Institutional-quality U.S. commercial real estate (CRE) enjoyed another year of strong performance in 2014, with the NCREIF Property Index (NPI), a widely used benchmark, delivering a total return of 11.8% – its fifth consecutive calendar year of double-digit total returns. While the recent path of returns has been satisfying, past periods of strength have each ended with downturns associated with macroeconomic recessions. The last downturn, in 2009, was profound but short-lived. In contrast, the 2001 downturn was barely detectable, while the 1991 downturn was both severe and prolonged. The message for investors is: (1) celebrate the good times, (2) examine the likelihood of the good times continuing, and (3) identify the vulnerabilities that will determine the shape of the next downturn.

Looking ahead to the remainder of 2015, prospects for CRE are bright, based on improving economic growth, solid job creation, low interest rates, declining vacancy rates, rising rents, and modest new construction. Forecasters are affirming such positive prospects; the latest consensus survey by the Pension Real Estate Association (PREA) shows a 9.8% total return expectation for the year.[1] But in a real estate environment characterized by solid performance, strong capital flows, and expanding debt availability, conditions are also ripe for new supply. New construction is expected to be the key differentiator of market performance in the next phase of the CRE cycle.

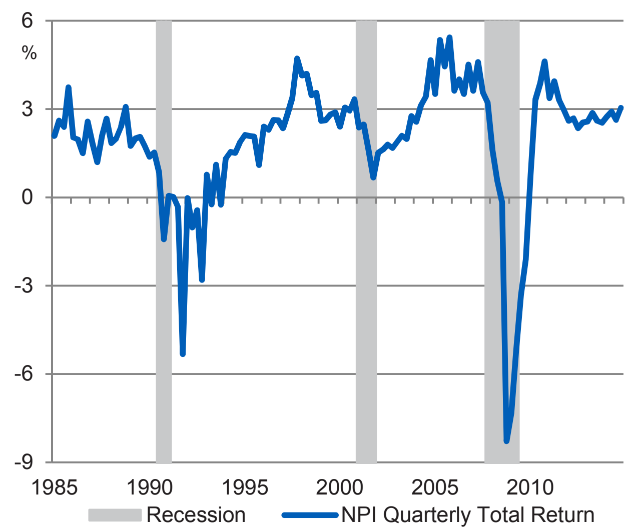
Among sectors, apartments are the furthest along in their cycle. This is evident in prices and rents that significantly exceed past peak values, as well as the substantial pace of construction now underway. Retail appears to be on the other end of the spectrum, with very little new construction and comparatively weaker fundamentals. It bears mentioning, however, that retail sector total returns have led the other three major sectors over the past 15 years, largely due to the investment performance of super-regional malls. Office and industrial property sectors are in earlier phases of recovery.

With all of these positives in place for 2015, it's important not to lose sight of the constraints on CRE performance that are also in play. Chief among these is the limited potential for further compression of cap rates – i.e., the ratio of net operating income (NOI) to property asset value – especially for higher-quality properties in more desirable locations. This suggests that CRE performance will be more dependent on NOI growth. While the anticipated economic outlook seems supportive of that outcome, there is no guarantee that the real world will cooperate. In particular, economic growth outside of the U.S. generally weakened in 2014, with slowdowns in the Eurozone and China of most concern. The U.S. has been able to withstand the drag, and we expect it will continue to do so, but relative global weakness could still leave the U.S. economy more vulnerable to shocks.

If the U.S. economy were to become more vulnerable, so too would U.S. CRE markets. The commercial real estate cycle has no expiration date and does not die of old age. It typically ends when external shocks crash into imbalances that have accumulated slowly over time. Over-building, over-lending, over-buying, and over-leasing are CRE imbalances that have characterized past downturns. When external shocks collide with CRE imbalances, property values and NOI growth suffer. We monitor for such imbalances, and our current analysis offers no reason to expect dire outcomes. Any potential shocks to the economy, should they occur, could lead to some bumps in the road for CRE performance but would not derail it.

In sum, we posit that "the return of volatility" will be the theme of both macroeconomic and CRE developments in 2015. Volatility itself is not a threat to the performance we expect to see in 2015. Rather, it is a catalyst that could cause disruptions in real economic growth or financial market liquidity that would likely not affect real estate immediately or directly, but could have implications later on. The return of volatility is therefore a signal for real estate investors to examine their taste for risk and prepare for eventualities.

Figure 6: U.S. economic & commercial real estate cycles



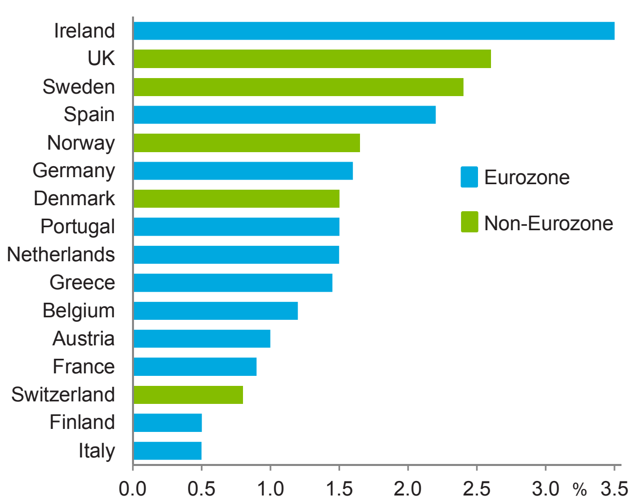
Sources: NBER; NCREIF, as of 4Q14; TIAA-CREF

Europe

The European continent is reprising "A Tale of Two Cities," with London and Paris (the two cities in the novel) apt proxies for the two differing economic models arising in Europe. London stands for the more dynamic, flexible, Anglo-Saxon economies (Ireland, parts of the Nordics) and for those economies that have implemented structural reform (Spain, Germany). Paris, meanwhile, is the avatar for resistance to reform and a poster child for the dogged belief that only yet more government borrowing and spending will bring back the glory days (Italy, France and Greece fall in this camp). Expected economic growth rates reflect this division, with the London countries at the top of the league tables and the Paris countries at the bottom (see Figure 7).

The risk for the head-in-the-sand Paris countries is a replay of Japan's lost decades, with wasted infrastructure spending, a high and rising debt burden, and inadequate growth to support an aging and shrinking population. This outcome is certainly not catastrophic (Japan remains the third-largest economy in the world), but neither is it appealing. The French government recently passed a reform package, but it was modest and had to be forced through parliament by extraordinary measures. The future of a more ambitious second package is in doubt given the low popularity ratings of the current government and recent election reversals for the ruling Socialist party. In Italy, the Renzi government is making slow progress, but the worry is that by the time any legislation is finally passed it will have been watered down significantly.

Figure 7: Forecasted GDP growth rates



Data as of March 31, 2015. Sources: Bloomberg, TIAA-CREF Asset Management.

We expect Greece will ultimately remain in the Eurozone given the dire consequences for the country if it were to exit. The stubbornness of the new Syriza government has been surprising, but the consistent demands from the "troika" (the International Monetary Fund, European Commission, and ECB) that Greece accept the previous government's commitments before further bailout funds will be disbursed means that Greece will have no choice but to acquiesce in the end, however long the process is dragged out. Even if Greece did leave, we think the impact on the rest of Europe would be minor and transitory (though the longer-term consequences for the European project as a whole would be greater). The other source of political risk is an exit of Britain from the European Union, but this depends on a Tory (Conservative) victory in May's election, which is far from certain. As with Greece, the costs of leaving the European Union are greater than the benefits Britain would gain, so even a Tory victory is likely to lead to little fundamental change.

Equities

The European equity market has had a stellar start to the year, outpacing the U.S. by over 10% in local currency terms (2.2% in U.S. dollar terms). The driver of these gains has been twofold: one, the long-delayed cyclical recovery from the 2008-09 recession seems finally to have arrived (the latest Eurozone Purchasing Managers' Index, or PMI, was the highest since 2011 and the U.K. economy should expand by over 2.5% this year); and two, the ECB has delivered with a larger-than-expected QE package, though arguably several years late. As in the U.S., Japan, and the U.K., QE seems to lead to equity market rallies as sentiment improves, the currency weakens, and investors anticipate stronger economic growth.

There are significant differences between the European equity market today, however, and those of the other countries when they launched their QE initiatives. Most importantly, on some measures European equities are expensive, while the other markets were inexpensive at the time. For example, at the end of 2008, the forward multiple for the U.S. equity market was around 10x earnings, well below historical norms. The forward multiple for the European market today is around 16x earnings, almost as much above average as the current multiple for the U.S. market (~20%). The crucial caveat is that earnings growth potential is low in the U.S. but much higher in Europe, thanks to margins that are well below previous highs (see Figure 8). The question is whether European companies will be able to generate enough earnings growth to bring down the market multiple even as prices rise. This is exactly what the U.S. market managed in 2004, when the multiple on the market appeared similarly high at 18.2x earnings. Over the next three-and-a-half years, however, the market gained 37% and the multiple fell to 15.3x expected earnings, thanks to a 73 bps gain in margins.

The European equity market has similar potential, though the trend in margins is currently flat rather than rising, as it was in the U.S. in 2004. We expect European equities to continue to outperform U.S. equities, although for more sustainable gains beyond QE-driven asset inflation margins will have to rise.

The upcoming U.K. election and the political uncertainty accompanying it have been a drag on U.K. equity market performance. The prospect of a coalition government made up of the liberal Labour Party and Scottish National Party (SNP), with higher taxes and spending to follow, have also fed through to a weaker currency (though not as weak as the euro). U.K. valuations are comparable to those for the Eurozone equity market index, but margins are lower. With more stimulative monetary policy in the Eurozone, U.K. equities are likely to continue underperforming, though given the heavy weighting of energy stocks in the index, a sharper-than-expected rise in oil prices would certainly benefit the market.

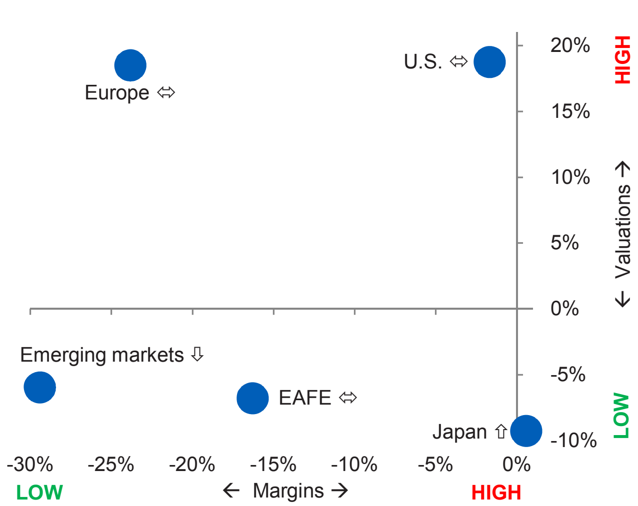
Fixed income

Quantitative easing has been a boon for European investors. The Barclays Euro Aggregate Index notched gains of about 4.3%% in the first quarter of 2015, compared to 1.6% for the U.S. Aggregate, and inflation is lower in Europe. The ECB has committed to its QE program through at least September 2016, so European bond prices are likely to remain well supported. Despite the gains already accrued, there is still scope for further appreciation. Index yields may be just 1% in Spain and Italy, but they are near zero in France and Germany, and negative for shorter maturities, so spreads could compress further (see Figure 9).

If the QE experience of the U.S. is any guide, high-yield debt should outperform corporate debt, corporate debt is likely to outperform government bonds, and inflation-protected securities should outperform government bonds. The lack of QE in the U.K. means that sterling bonds will probably be unable to keep pace with their Eurozone counterparts. Despite headline inflation recently touching zero, inflationary pressures are stronger in the U.K. than on the continent, and a Labour-SNP coalition would only add to this pressure. Robust forecasted economic growth and declining unemployment (5.5% in the U.K. vs. 11% for the Eurozone), mean the Bank of England is very likely to hike rates before the ECB does.

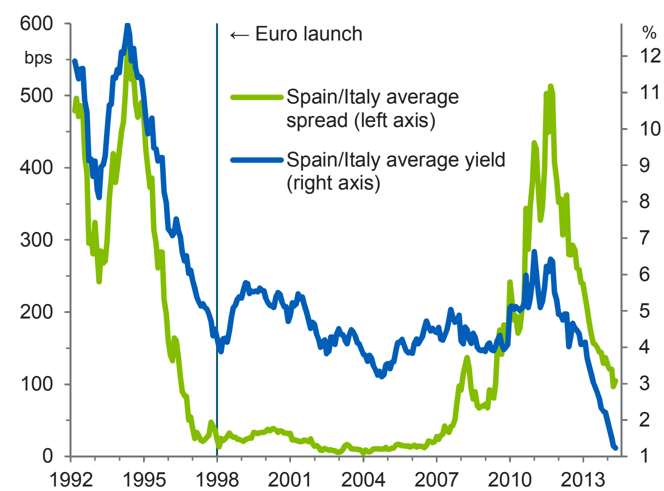
Figure 8: Market attractiveness: Valuations and margins

Arrows indicate trend in markets



Data as of March 31, 2015. Sources: Factset, IBES, TIAA-CREF Asset Management

Figure 9: Europe sovereign bond yields and spreads



Data as of March 31, 2015. Sources: Bloomberg, TIAA-CREF Asset Management.

Japan

Japan's economic performance has generally been disappointing over the last few months. The already lower-than-expected fourth-quarter 2014 GDP growth rate was revised downward, and February's composite PMI dropped below 50 (indicating contraction). There also appears to have been some loss of momentum on the reform front. The fall in oil prices has driven inflation back down, which does not help an economy trying to escape deflation. Quantitative easing by the Bank of Japan has forced the yen lower, which has helped corporate profits, but has also become a drag on consumer demand as the cost of imported goods rises.

All is not negative, however. As for any other oil-importing country, lower oil prices will support consumer demand, which has also been boosted by above-average increases in wages during the latest round of union negotiations. Lower oil is also particularly beneficial for Japan since the country moved from a current account surplus to deficit after the Fukushima nuclear disaster in 2011. The country switched off all its nuclear power plants and had to import large quantities of oil to make up the energy shortfall. Lower oil prices have helped recently, though part of the gain has been offset by the declining value of the yen.

Equities

The yen has traded around ¥120/$ since the end of last year, although this hasn't prevented Japanese equities from nearly matching the returns of European stocks in local currency terms. The question is whether the yen will resume weakening, and whether the equity market can continue to rise if it doesn't. As long as the Bank of Japan is printing yen, market forces should push the currency down, though the rate of any further depreciation is likely to be slower. There are other factors, however, that argue for continued market gains even in the absence of significant currency weakness. First is the potential for earnings growth despite margins that are already at historical highs. The potential for surpassing those highs exists because margins are just 5.3% in Japan, compared to peak margins of 10% historically in Europe and the U.S. That is, return on equity has always been chronically low in Japan, but it would rise above previous highs if the country's companies moved toward international levels of profitability. Any change is likely to be slow, however, and will only come under pressure. Fortunately, there is an ever-growing movement for improved corporate governance in Japan which over time should lead to better corporate performance.

The other positive factor for the equity market is the ongoing reallocation of pension funds from Japanese government bonds (JGBs) to equities, which helps explain the rally so far this year despite the stall in the yen's depreciation. The reallocation is set to continue, so strong demand should provide a further support to prices. There is clearly the risk that if the demand for equities is "artificial" as opposed to fundamental, it will result in simply higher prices and valuations. Multiples for the market have certainly risen, from 20% below average a year ago to just 8% today (though this is still far better than in the U.S. or Europe). The easy gains in the Japanese market are clearly in the past, and the third "arrow" of Prime Minister Shinzo Abe's "Abenomics" program seems to have landed somewhere in the brush. Nonetheless, a combination of relatively attractive valuations, a weaker yen, rising wages and consumer demand, and portfolio reallocations suggest there is still more room to run for the country's equity markets.

Fixed income

The yield on the Barclays Japan Government Bond Index stood at 0.4% on March 31, and JGBs returned -0.5% in the first quarter. Corporate bond yields offer slightly better prospects, but the Japanese bond market remains unappealing.

Emerging Markets

The economic outlook for emerging markets is even more varied than it normally is, between regions, between oil importers and exporters, and between countries with current account surpluses and deficits in an environment of rising U.S. interest rates. China, as always, stands alone.

The EMEA (Europe, Middle East, and Africa) countries have been hampered by persistent turmoil in Ukraine and in oil-exporting countries, but those closer to western Europe should gain from the region's recovery. Latin America has had its own albatross in Brazil, where the Petrobras corruption scandal is leading to political paralysis just when the country needs to implement fiscal measures to restore competitiveness. Asia depends on China, which if not doing as poorly as many believe, is still not generating very robust demand. In fact, some forecasts have India soon growing at a faster rate than China, though this is of little help to the region given the small size and closed nature of the Indian economy.

The biggest challenges are likely to be faced by those countries with budget and/or current account deficits, whose currencies have already seen significant depreciation this year. Central banks will be forced to either raise interest rates to support the currency, with the inevitable slowdown in economic growth, or let inflation rise. The adjustment has been lessened significantly for the oil importers, however, as lower fuel prices help shrink their trade and budget gaps, although countries such as South Africa, Turkey, and Brazil remain at risk.

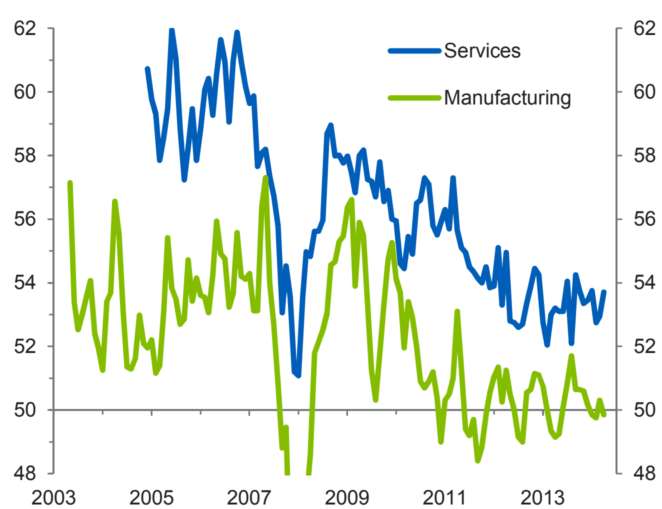
The reason that China is doing better than many believe is that the focus remains on the manufacturing sector, which is indeed struggling, while the services sector is performing relatively well (see Figure 10). The sub-50 readings for manufacturing PMIs reflect persistently weak global demand, while the steady 53–54 scores for services show that the domestic, consumer-oriented economy is faring better. This is all the more significant since we believe the investment opportunities in China in the future will be focused on domestic demand (both for goods and services) rather than on the old drivers of exports and commodities.

Equities

Emerging-market equities were able to outpace their U.S. counterparts in local currency terms in the first quarter of 2015, but the appreciation of the dollar turned the 3.6% outperformance into just a 0.9% advance for U.S.-based investors. The biggest contributor to emerging-market equity gains was China, helped significantly by the relative stability of that country's managed currency. EMEA's returns came from the recovery in Russia's market, but it is an open question whether or not that will be reversed. Latin America offset most of the profits generated by the other regions, primarily due to the depreciation of Brazil's currency, the *real*.

What clues do these returns provide to how portfolios should be allocated from here? Emerging-market Asian equities still appear attractive to us, in terms of both valuation and earnings potential. The apparently cheap valuations in China mask a different story at a sector level, however. The financial sector (which makes up around 40% of the MSCI China Index) appears very cheap on a forward-multiple basis, but we are hesitant to overweight the sector given the ongoing problems in the property market and excessive lending to municipalities. In contrast, the non-financial sectors appear slightly expensive, but the greater potential for earnings growth warrants the premium. One cautionary note is that a large share of the index's gains were driven by the technology sector. We believe the market will continue to expand thanks to the Chinese government's push for tech companies to expand into other parts of the economy such as financials, property, consumer, and auto sectors.

Figure 10: China: Manufacturing and services PMIs



Data as of March 31, 2015. Note: Manufacturing values are averages of official government series and HSBC series. Sources: National Bureau of Statistics of China, HSBC, TIAA-CREF Asset Management.

Latin America is likely to continue to be a drag on the broader index until there is more clarity on the situation in Brazil. Given that Brazil makes up over 50% of the index, it will be difficult for the other countries in the region to compensate, especially as the second-largest market, Mexico, suffers from falling oil prices and a weakened president. The *real* should not pose as large a threat as it did during the first quarter, when it lost 18% in value versus the dollar on top of the 18% it lost in 2014.

Russian equities appear cheap at just 5.2x earnings, compared to 11.6x for the emerging-markets index, but the median P/E for the Russian market is just 7x, reflecting its long-running limited appeal for foreign investors. Since the start of the current crisis in 2013 the multiple has fallen as low as 3.2x. We would prefer to see the multiple drop closer to 4x before advocating an overweight.

Now that Greece is a part of the emerging markets index, what would the country's exit from the Eurozone mean for emerging-market equities? Commensurate with Greece's small GDP relative to Europe, its weight in the MSCI Emerging Markets Index is just 0.3%. While an exit would prove temporarily disruptive, we would not anticipate it leading to meaningfully poor returns for emerging-market equities.

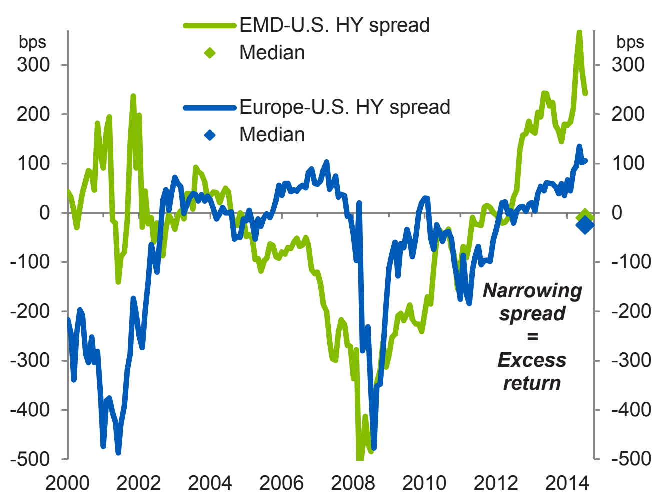
Fixed income

Investors in local currency emerging-market debt are unlikely to be satisfied with their returns in U.S. dollars, despite the 5% yield available on the index. As with emerging-market equities, the dollar's appreciation has subtracted from local currency gains, in this case returning -2.7% to U.S. investors instead of the 1.4% theoretically available to locals. We are still finding selective opportunities in local currency debt but are focusing on those countries with relatively stable currencies.

Returns for U.S.-dollar indexes have held up despite worries that depreciating currencies will lead to sharply higher defaults by issuers unable to generate enough hard currency to meet interest payments. Again, our focus is on those countries with steadier economies and currencies, though there are selective opportunities in oil-exporting countries if crude prices begin to recover more meaningfully.

Along with high-yield debt, emerging-market debt offers investors a yield above inflation, though obviously with additional risk. Of the two asset classes emerging-market debt appears the more attractive. Even though the percentage of the emerging-market debt universe rated investment-grade has risen over time, emerging-market debt currently offers an above-average spread over U.S. high-yield debt. Similarly, European high-yield debt yields appear generous relative to U.S. high-yield. Not only do emerging-market debt and European high-yield debt offer higher income in the meantime, as spreads normalize they should also outperform U.S. high yield (see Figure 11).

Figure 11: Relative attractiveness: Emerging-market vs. high-yield debt



Data as of March 31, 2015. Note: Difference in OAS: Global high-yield and emerging-market (USD) high-yield indexes; U.S. and Europe high-yield indexes. Sources: Barclays, TIAA-CREF Asset Management.

Conclusion

Investing in the current environment of full valuations for equities and rising bond yields requires more selectivity than has been needed over the last several years. Expected returns for U.S. equities have moderated significantly, while taking advantage of international equities comes with above-average currency risk. Fixed-income investors face the prospect in the short-term of rising rates, but even once yields have normalized, rates are going to be much lower than was the case in the 60 years prior to the onset of the global financial crisis. That is, rates are not only going to be lower for longer, to some degree they will be lower forever (or at least within any investible time frame). The potential inability of publicly traded securities to meet investor return expectations means that alternatives, such as real estate, may need to become an ever-larger share of investors' portfolios.

[1] Pension Real Estate Association Consensus Forecast Survey of the NCREIF Property Index, 1st Quarter 2015.