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TIAA GLOBAL ASSET MANAGEMENT

# Economic and Investment Outlook

## 2016 Second Quarter

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## Executive summary


- Our base case calls for the U.S. economy to grow by 1.8% in 2016. We anticipate one Fed rate hike in June, with another possible in December.
- Europe remains in slow, steady recovery mode. In Japan, the stagnant economy makes further monetary and fiscal stimulus likely. Chinese GDP growth should pick up slightly in Q2, but this doesn't change its longer-term trend of deceleration.
- While we still believe U.S. equities can reach new highs in 2016, the path will be far from smooth. In foreign equity markets, we continue to favor Europe over Japan. We maintain an overweight stance in emerging markets (EM) but have become more cautious in the near term.
- U.S. Treasuries are benefiting from demand for safe-haven assets amid global growth concerns. High-yield bonds and leveraged loans look fairly valued. In Europe, current low yields could come under pressure this summer due to political uncertainty. After a strong Q1 rally, EM debt may become more volatile as the Fed's June meeting nears.


### Asset class preferences

| Equities ↔ | Fixed Income ↔ |
|---|---|
| Large Cap ↓ | Government Debt ↓ |
| Mid Cap ↑ | United States ↓ |
| Small Cap ↑ | Europe ↔ |
| Growth ↓ | Japan ↔ |
| Value ↑ | TIPS ↑ |
| Developed Markets ↓ | Munis ↔ |
| United States ↓ | Corporate (Investment Grade) ↑ |
| Europe ↑ | High Yield ↑ |
| Japan ↔ | Emerging Markets (USD) ↓ |
| Emerging Markets ↑ | Emerging Markets (LC) ↑ |

↑ = overweight; ↓ = underweight. TIPS = Treasury Inflation-Protected Securities. LC = Local currency. Allocations based on an unhedged, U.S.-dollar-denominated portfolio. Please note the forecasts above concern asset classes only and do not reflect the experience of any product or service offered by TIAA. 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, as well as political and economic developments. Past performance is not an indicator of future results.

BUILT TO PERFORM.
CREATED TO SERVE.

# United States

## Economy

U.S. economic growth will be slower this year than it was in 2015 and 2014, with smaller-than-normal contributions to GDP from consumer and business spending, relative to past recoveries. Job creation has been healthy and should remain positive over the medium term, although it appears to be decelerating. Meanwhile, the stronger pace of wage growth and higher consumption levels that typically accompany full employment have thus far failed to materialize. Housing activity has been favorable but will not be a primary economic driver. For 2016 overall, our base case calls for the U.S. economy to grow by 1.8%, with slower growth in consumer spending roughly offset by a modest rebound in net exports. We currently expect the Fed to raise rates in June, with another increase possible in December, depending on the path of inflation and other economic data.

## Stocks

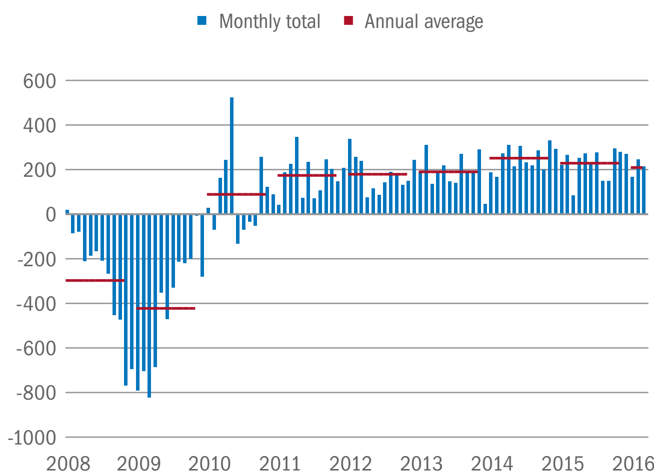
After a volatile start to the year that saw the S&P 500 Index tumble more than 10% through mid-February, only to rebound sharply to finish the first quarter with a 1.4% gain, U.S. stocks continue to grapple with conflicting forces. Investor sentiment became overly optimistic in early April, leading to an extended market ripe for another correction. On the other hand, leading economic indicators have been rising, and further dollar weakening should boost earnings for U.S. multinational corporations. We still believe the S&P 500 can reach new all-time highs in 2016, but the upward climb will not occur in a straight line.

## Bonds

U.S. Treasuries realized solid returns (+3.2%) during the first quarter, with the yield on the bellwether 10-year security falling from 2.27% to 1.78%. (Yield and price are inversely related.) Among non-Treasury “spread” sectors, positive fund flows supported investment-grade and high-yield corporate bonds. The significant first-quarter rally in credit markets will likely lead to additional issuance in the second quarter. In our view, however, the bulk of the rally is behind us. High-yield bonds and leveraged loans look fairly valued, which means active management and careful security selection are key to identifying opportunities in these sectors.

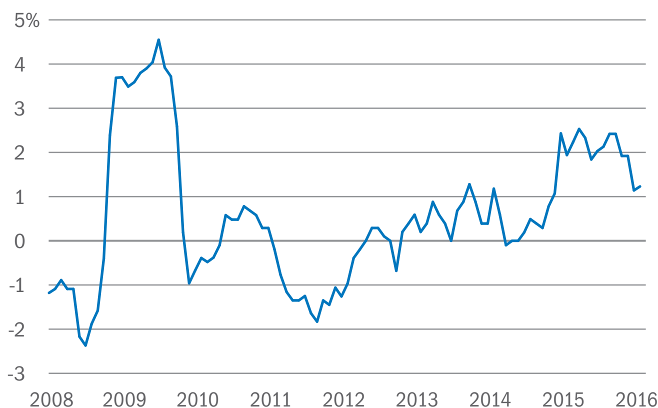
### Figure 1. Despite nearing full employment, wage growth has yet to accelerate

**Monthly job creation is likely to slow...**
Net change in nonfarm payrolls (in thousands per month)




Last data point March 2016. Sources: Bureau of Labor Statistics, TIAA.

**...while real wage growth has stalled**
Real hourly average earnings, seasonally adjusted, % change from year ago




Last data point February 2016. Sources: Bureau of Labor Statistics, Haver Analytics.

# Europe

## Economy

Europe remains in a steady, albeit modest, recovery mode, driven largely by stronger domestic demand. We expect 2016 Eurozone GDP growth to come in close to last year's level, in the 1.5% range. The latest round of easing by the European Central Bank (ECB) was large and extremely supportive, although monetary policy as a tool for stimulus has become somewhat less effective with time. Political uncertainty could pick up, particularly ahead of the June 23 voter referendum on Britain's possible exit ("Brexit") from the European Union. While related headlines will create volatility, at this point we expect the U.K. to remain in the EU fold.

## Stocks

The outlook for European equities is bolstered by evidence of the domestically driven recovery, economic reforms, a recapitalized banking sector, lower unemployment, rising consumer confidence, and the gradually fading impact of fiscal austerity. Against this backdrop, we believe European earnings estimates are poised to recover after almost five years of downward revisions in economically sensitive sectors such as Industrials and Consumer Discretionary. On balance, we continue to favor Europe over the U.S. and Asia as an equity market destination.

## Bonds

Supply dynamics and the ECB's expanded asset purchases should help keep government bond yields at low levels in the second quarter. However, given the significant flattening of yield curves that already occurred in the first quarter, we expect to see some reversal during the summer months. Peripheral markets like Greece (in potentially contentious debt relief talks with creditors) and Spain (facing the prospect of another round of elections) could see heightened volatility.

# Japan

## Economy

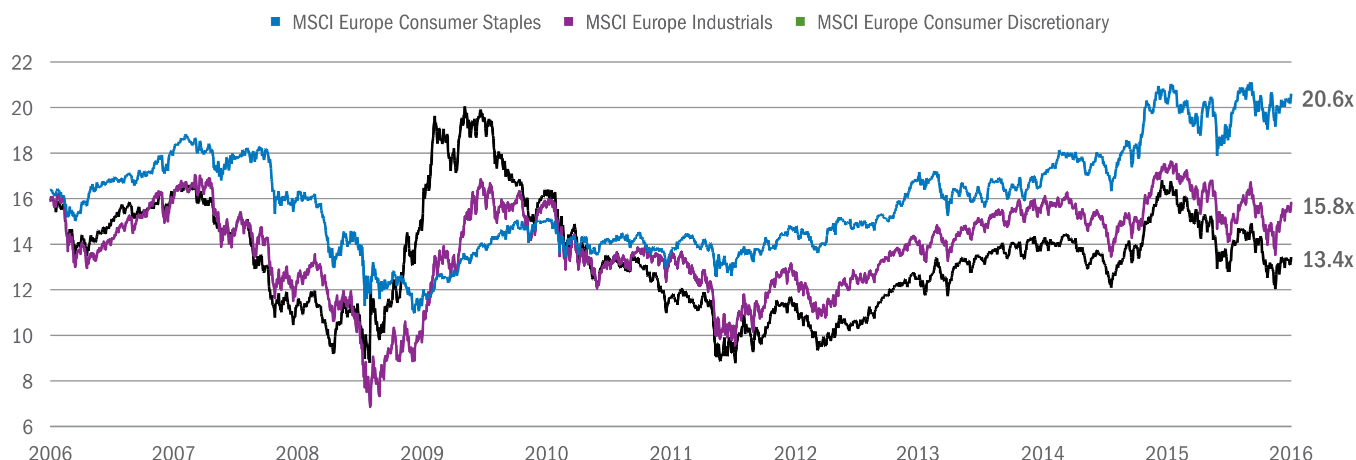
A key issue is whether Prime Minister Shinzo Abe will delay next April's highly unpopular sales tax increase. Also in focus is the direction of the yen, which has been appreciating versus the U.S. dollar despite the negative interest-rate program launched by the Bank of Japan (BoJ) in January. Given the country's economic stagnation (GDP growth of essentially 0%) and flagging inflation, we expect the BoJ to unveil further monetary stimulus in the near term.

## Stocks

Among foreign developed equity markets, Japan generally looks less compelling than Europe, based on relative valuations and the prospects for earnings recovery.

### Figure 2. In Europe, undervalued cyclical sectors offer potential buying opportunities

European sector P/Es:
Consumer Staples vs. Industrials and Consumer Discretionary




Based on MSCI Europe Index sectors. Last data point 3/31/2016. Source: FactSet.

Moreover, the weak economy is adding to political uncertainty, which tends to rattle equity markets. In the current environment, selectivity is crucial. We seek to identify Japanese companies with strong management teams, positive fundamentals, and the potential to outperform despite challenging market conditions.

### Bonds

The BoJ's dovishness should anchor the short end of the yield curve. Yields on long-dated debt could rise as investors take profits and the supply of government bonds increases due to a new fiscal stimulus package that is likely to be announced in May.

## Emerging markets

### Economy

In the second quarter, Chinese GDP growth should pick up slightly, lifted by increased fiscal spending and consumption. This improved short-term view, however, does not change the longer-term trend of deceleration in the world's second-largest economy. We are keeping a close eye on China's currency, the yuan, which has stabilized thus far in 2016 but could be vulnerable to renewed weakness. Other large EMs, such as Russia, Brazil, and Turkey, are facing significant internal and geopolitical concerns. On the positive side, prices for oil and other commodities have risen off their lows, while the U.S. dollar has weakened—factors that tend to benefit EM economies and markets.

### Stocks

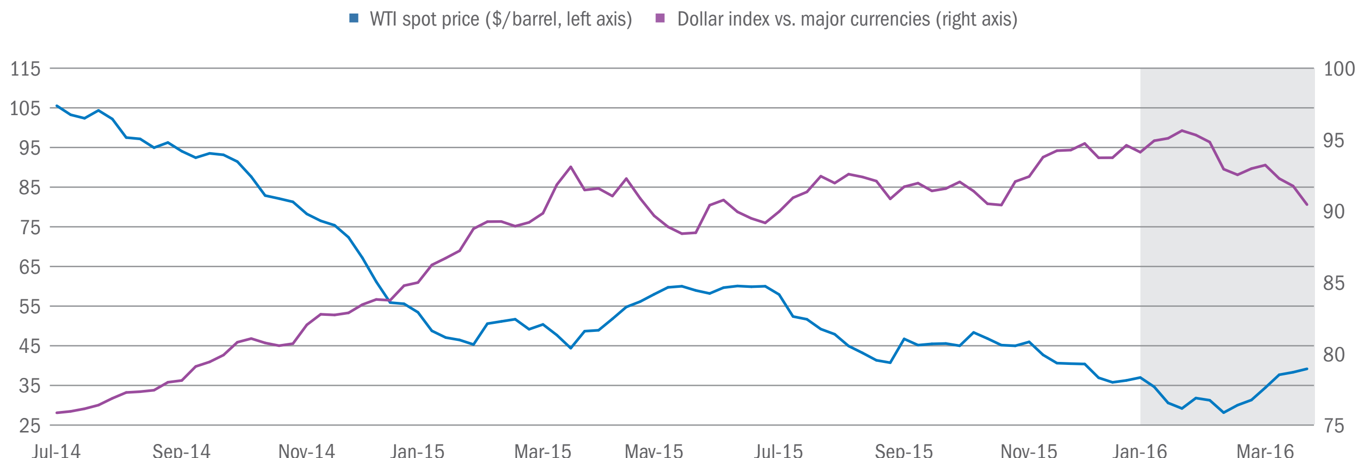
After five years of underperformance, EM equities outpaced their global developed counterparts by more than 6% in the first quarter of 2016. Whether this is a short-term bounce or a true inflection point remains to be seen, but in the first week of the second quarter, EM stocks resumed their decline. While we maintain an overweight stance in EM equities, we have become somewhat more cautious in the near term, reducing the scope of that overweight. Countries like Mexico, India, and the Philippines may offer the best opportunities to outperform.

### Bonds

Dovish central banks, a weaker dollar, and higher oil prices helped propel a substantial rally in EM fixed-income markets from mid-February to quarter-end. We think this performance may have legs going into the second quarter, as inflows continue and cash gets deployed. As the new issuance market opens up, however, EM debt may start to lose some steam. Furthermore, we would anticipate greater volatility as we get closer to the June Fed meeting and the possibility of a rate hike.

Figure 3. Higher oil prices and a weaker dollar could help boost EM activity in the near term

**Oil prices may have bottomed as U.S. dollar strength waned in Q1**
West Texas Intermediate spot price vs. trade-weighted USD index (100 = Mar 1973)




Weekly data through March 2016. Sources: EIA, Federal Reserve.

## Conclusion

In the U.S., our current forecast for 1.8% average GDP growth in 2016 represents a downshift from expectations at the beginning of the year. Additionally, subdued global trade, China's economic transition, and diminished growth prospects in emerging markets suggest that slower global growth is becoming the norm. We think the adjustment to this reality will take a few years, with developed markets being the primary beneficiaries.

### Figure 4. GDP growth forecasts (%)

| | Real GDP growth | | Forecasted real GDP growth (Seasonally adjusted annual rate) | | | | |
|---|---|---|---|---|---|---|---|
| | 2015 | 2016 | Q4 15 | Q1 16 | Q2 16 | Q3 16 | Q4 16 |
| U.S. | 2.4 | 1.8 | 1.4 | 1.2 | 2.3 | 1.7 | 1.8 |
| China* | 6.9 | 6.7 | 6.7 | 6.1 | 7.4 | 6.6 | 7.4 |
| Eurozone | 1.5 | 1.6 | 1.3 | 1.6 | 1.7 | 1.7 | 2.1 |
| Japan | 0.5 | 0.4 | -1.1 | 0.0 | 1.0 | 1.2 | 2.0 |

* Quarterly estimates for China's seasonally adjusted annual rate (SAAR) do not correspond to officially published YTD figures.
Sources: Haver Analytics, TIAA Global Asset Management.

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