Weekly Market Update

Equity markets continue their advance

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- We are in a bull market for equities that has yet to edge into euphoria.
- Risk preferences benefit higher-yielding fixed-income credits over Treasuries.
- Favorable unemployment headlines may be masking weaker labor market trends.
- Global monetary easing continues, boosting the dollar and lifting equity markets.
- The U.S. economy is on track to grow by 1.5% to 2% in the second quarter.

MAY 10, 2013

The U.S. equity market continued to rise during the past week, with the S&P 500 Index hitting another record high. A preference for risk returned to the market, evidenced by a rotation out of defensive sectors and back into cyclical stocks. Short-term trading sentiment remains very optimistic, but this is countered by longer-term bearishness as seen in low hedge fund net exposures and pension fund allocations to equities. On balance, we are in a bull market that has yet to edge into unrealistic euphoria. Outside of the U.S., developed- and emerging-market equities also climbed, buoyed in Europe by signs of economic bottoming and rumors of new European Central Bank (ECB) policies to promote lending in the southern eurozone, and in Japan by further weakening of the yen.

In fixed-income markets, an unexpectedly sharp decline in first-time unemployment claims boosted optimism about the U.S. economy. This positive news, combined with continued strong flows into nearly every category of fixed-income funds, benefited “spread sectors” (higher-yielding, non-Treasury securities) such as investment-grade and high-yield corporate credits, commercial mortgage-backed securities, and emerging-market bonds. In contrast, U.S. Treasuries posted modestly negative returns. The yield on the bellwether 10-year Treasury (which moves inversely to its price) rose during the week, touching 1.92% on the morning of May 10, up from 1.80% at the start of the week and 1.66% at the beginning of May.

Financial Services

Unemployment claims hit pre-recession levels, but challenges remain for labor markets

Weekly first-time unemployment claims dropped to 323,000, their lowest level since January 2008, while the four-week moving average, which smoothes out volatility in the weekly data, fell to 336,750. Continuing claims also fell to just over the psychologically important 3 million threshold. These levels theoretically correspond to monthly job growth in excess of 200,000, but we don't expect payrolls to move that high for the next few months. April's reported total of 165,000 net jobs created, while a positive headline number that pleased the markets, masked certain weaknesses, including an increase in temporary employment and a fairly significant decrease in hours worked.

These weaknesses indicate the potential impact of the Affordable Care Act on employment. Analysis by ADP, which tracks private payrolls by size of company, shows that small firms—those with about 50 employees, an important threshold for the health care law—are indeed pushing people into part-time roles and hiring temp workers rather than permanent staff. Because of this, we think new claims for unemployment insurance will need to fall to below historically "normal" levels in order to make up for the employment dynamics in the current cycle. Overall, job creation is likely to settle at around 150,000 to 200,000 per month before accelerating toward the end of the year to somewhere north of 200,000.

Central banks continue to cut interest rates, supporting markets

The trend of global monetary easing continued during the past week, with the Australian and South Korean central banks joining the ECB, India, Eastern Europe, Scandinavia, and much of the emerging-markets community in cutting interest rates and/or adopting other accommodative policy stances in recent weeks. Brazil is an anomaly, bucking the trend by raising rates 25 basis points (0.25%) in mid-April.

This massive flow of central-bank liquidity has been enthusiastically welcomed by global equity markets. Japanese stocks in particular benefited as the yen weakened even further against the dollar during the week, falling to the 100¥ per dollar level for the first time in more than four years. Year-to-date, the yen is down 16% versus the dollar.

Beyond monetary policy, there were other indications of modest economic improvement outside the U.S.:

- In Europe, the decline in manufacturing and service-sector activity eased slightly in April, based on the Markit Eurozone Composite Purchasing Managers' Index (PMI), and Germany saw better industrial production and factory order data.
- The Citi Economic Surprise Index for Europe, a measure of the extent to which economic data releases vary from consensus expectations, turned positive.
- In China, import and export readings improved, while inflation remained contained at below target levels.

Outlook

Overall, while the U.S. economy is not firing on all cylinders, it is running at a market-friendly speed. This is critical, because a sharp economic acceleration would trigger renewed fears that the Fed will taper off its asset purchases, pushing up long-term interest rates. For an equity market that has been bolstered by a favorable risk premium relative to extremely low rates, such a shift could represent a major headwind. The past week's rotation into cyclical stocks may indicate a stronger second half of the year for the economy. If this occurs, then the seeds of a market correction may indeed lie with stronger growth and higher rates.

For now, however, the market continues to grind higher as that threat has yet to materialize. In fact, we see evidence of a moderate slowdown in economic activity. Slower consumer spending has been winding its way through the economy, reflected in soft retail sales in March, which we expect will continue in April. Meanwhile, the federal budget sequester will likely trim GDP growth by about 0.5% (in line with our previous expectations), while tax increases and other government spending cuts should exert a combined 1.5% drag on second-quarter growth. This puts the economy on target to grow by 1.5% to 2% this quarter.

In fixed-income markets, barring a major geopolitical event, spreads between Treasuries and non-Treasury credits are likely to stay relatively narrow until the market believes the Fed will reduce its purchases of Treasuries and mortgage-backed securities. At that point, the potential for a repricing of fixed-income assets, particularly in riskier categories, could be realized. In the meantime, the benefits of the Fed's largesse, along with continued Treasury purchases on the part of the Japanese government to drive down the value of the yen, should offer strong support to spread products.

Financial Services

The information provided herein is as of May 10, 2013.

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.

C10643