Weekly Market Update

Volatile markets welcome jobs report that is not too strong, not too weak

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Equity and fixed-income markets are taken on another bumpy ride.
- Moderate U.S. employment growth eases fears of imminent Fed “tapering.”
- After healthy correction, Japanese equities may be poised to rebound.
- S&P 500 valuations are no longer stretched, and a renewed market rally appears likely.
- Second-quarter GDP growth may come in at the lower end of the 1.5%-2.0% range.

JUNE 7, 2013

Markets remained fixated on any signs of economic activity that would suggest a quicker-than-anticipated tapering of the Federal Reserve’s quantitative easing (QE) program. U.S. equities experienced wide daily and intra-day swings during the week. From its peak on May 21 to its June 6 close, the S&P 500 Index dropped 5.4%, raising the possibility that we finally may have seen the correction many have been predicting for months. However, in the immediate wake of the May U.S. employment report, released on June 7, U.S. equities surged, on track to erase their declines from earlier in the week. Meanwhile, Japanese equities continued their recent sharp decline.

Fixed-income markets had a turbulent week, with all “spread products” (higher-yielding, non-U.S. Treasury securities) posting losses through June 6. Particularly hard hit was emerging-market debt, which saw sharply increased fund outflows. In general, fixed-income investors were unwilling to take on more credit risk ahead of the May jobs report, fearing that a strong number might hasten the Fed’s unwinding of its asset purchases and thus reduce the liquidity that has supported bond market returns over the past year. U.S. Treasury markets were not spared a bumpy ride: After closing at 2.08% on June 6, the 10-year yield spiked to 2.15% after the employment data came out.

Financial Services

Volatile markets welcome jobs report that is not too strong, not too weak

We see no departure from the U.S. economy's current growth trajectory

The past week's data releases were not definitive enough to signal a shift in the pace of U.S. growth. As we had expected prior to its release, the May jobs report was a relative "non-event" from a macroeconomic perspective, as the increase in payrolls (+175,000) was neither significantly below nor far above consensus estimates of 150,000 to 165,000. Similarly, first-time unemployment claims dropped but remained within a range indicating modest improvement in the labor markets.

Among the week's other data releases:

- **Manufacturing** disappointed, with the ISM Purchasing Managers' Index (PMI) for May dipping to 49, below the 50 threshold separating expansion from contraction.
- **Non-manufacturing** activity accelerated slightly, to 53.7, based on the ISM index.
- **Productivity** for the first quarter improved only modestly.

These economic signals generally confirm our view of modest expansion. We do not expect stellar economic performance between now and the end of the second quarter. As a result, we do not foresee a rapid move by the Fed to taper its QE asset purchases. If the U.S. equity markets' end-of-week surge in response to May's moderate employment growth is an indication, the current environment of growth that is just strong enough (and just weak enough) to sustain the status quo is precisely what markets are hoping for.

European markets fall on ECB comments, rebound on U.S. jobs

European equity markets tumbled on June 6, disappointed that the European Central Bank (ECB) not only failed to cut interest rates (which would have been a surprise) but also indicating that further injections of liquidity were not needed at this time. Despite the market's disappointment, recent data releases tend to support the ECB's stance:

- European PMIs have generally been flat to up for the past few months, indicating that the decline in manufacturing and service-sector activity has begun to ease.
- Fiscal headwinds are ebbing across the southern tier of Europe.
- Unemployment appears to have peaked.

European equities bounced back on June 7, thanks more to the market-friendly implications of the U.S. employment report than signs of economic stabilization in the eurozone.

Volatile markets welcome jobs report that is not too strong, not too weak

Japan, China and emerging markets

The Japanese equity market extended its losses as the beneficial weakening of the yen continued to reverse course, largely due to political fumbling over economic reforms and extreme volatility in Japanese government bonds (JGBs). However, the Nikkei 225 Index is coming into a zone that may set the stage for a rally, particularly if Prime Minister Shinzo Abe clarifies recent policy statements to restart yen weakness. Moreover, Japan is seeing better economic data and earnings. Although we are skeptical of Japan's long-term ability to sustain growth through "Abenomics," there is potential for a resumption of market gains that could last several months.

Elsewhere in Asia, the Chinese economy continues to labor. We have been receiving discouraging reports about weaker demand, and the Shanghai "A" Share Stock Market Index has faltered. Emerging-market equities in general have also struggled, with local currencies hurt by fear of the Fed's tapering, weakening commodity markets, and inflationary pressures.

Outlook

Based on economic data released so far, we think second-quarter GDP growth may come in at the lower end of the 1.5%-2.0% range. This is a pace of expansion that would likely not require Fed tapering until the first quarter of 2014.

In U.S. equity markets, valuations are no longer stretched. Sentiment has come off extremely optimistic levels, and the percentage of S&P 500 stocks trading above their 50-day moving averages has declined from over 90% to about 50%. Moreover, earnings revisions have turned positive. While there are no guarantees, we believe the most likely scenario is one in which U.S. stocks resume their climb in 2013.

In fixed-income markets, it is difficult to predict how much asset prices may react to reduced liquidity caused by the Fed's eventual tapering, even if that eventuality is balanced by an improving economy. Our view is that spread products will continue to be volatile and dependent on economic data releases. Under any tapering scenario, however, asset classes that have benefited strongly from QE—including high-yield, emerging-market, and commercial mortgage-backed securities—are likely to weaken.

Financial Services

The information provided herein is as of June 7, 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.

C11031