WEEKLY MARKET UPDATE

Markets react to surprisingly robust employment growth

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Markets, initially wowed by strong jobs report, consider implications for Fed "tapering."
- Upward revisions to May and April payrolls signal ongoing momentum.
- European markets rebound as political and fiscal issues ease.
- We remain optimistic about the trajectory of equities for the balance of the year.
- Fixed-income volatility will continue, but interest-rate moves won't crimp growth.

JULY 5, 2013

U.S equity markets generally moved higher during the trading week shortened by the Fourth of July, after a period of marked volatility in June. A stronger-than-anticipated jobs report for June, improving earnings expectations and a less fear-driven interest-rate environment contributed to the week's positive mood. Despite political turmoil in Egypt and some renewed concerns about Europe's sovereign debt challenges, international markets also rallied from oversold positions.

In fixed-income markets, U.S. Treasuries and "spread products" (higher-yielding, non-Treasury securities) were largely unchanged until the release of the surprisingly robust June employment report. With the jobs data seen as a clear signal that the Federal Reserve will likely begin to "taper" its asset purchases sooner rather than later, the yield on the bellwether 10-year Treasury note spiked to 2.7% in early trading on July 5, while spreads (the difference between yields on spread products and the 10-year Treasury) widened. Fund flows remained negative in most fixed-income categories. At the same time, a dramatic slowdown in the issuance of new debt has given bond fund managers few new investment opportunities.

Employment gains cap week of positive U.S. data

The U.S. economy added 195,000 jobs in June, while May and April payrolls were revised significantly upward, to 195,000 and 199,000, respectively. These prior-month revisions are as important as the June number itself, because they reflect growing strength in the economy better than the Labor Department's models are able to measure. Job creation has been steady and quietly improving since

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January 2012. Average monthly job growth since the beginning of 2013 is now 202,000. The unemployment rate held steady in June, at 7.6%.

A number of other U.S. economic indicators released during the week were positive, including:

- auto sales, climbing to an annualized rate of 16 million vehicles in June;
- construction spending, up 0.5% in May and 5.4% compared with a year ago; and
- factory orders, which rose 2.1% in May, slightly ahead of forecasts.

In addition, the Institute for Supply Management's (ISM) manufacturing survey for June climbed to 50.9 from 49.0, breaching the important 50 threshold separating contraction from expansion.

This improvement is consistent with other data for May and June suggesting that economic momentum has continued to build after the pause seen in March and April.

European markets rally as political and debt fears ease

European markets were volatile entering July, against a backdrop of heightened political tensions in Egypt, Turkey and Brazil, along with renewed sovereign debt concerns in Greece, Slovenia and Portugal. Market jitters, however, gave way to a "relief rally" after the Bank of England and the European Central Bank (ECB) affirmed their commitment to keeping interest rates low for an "extended period." Additionally, Portugal's coalition government, on the verge of collapse following the resignation of the ministers of finance and foreign affairs, announced that it had reached an agreement to keep the coalition in place and avoid the need for new elections.

Although Europe's broader path to economic improvement has been anything but smooth, and the need for structural reforms remains pressing, the European Union has demonstrated a willingness to find solutions as individual issues flare up. Barring further deterioration of economic or fiscal conditions, our "base case" scenario is that the most recent crises will ultimately be resolved rather than lead to the breakup of the eurozone.

Cooling Chinese growth may help U.S. corporate profits

In China, liquidity pressures have eased in the banking system, but the key interbank lending rate remains elevated. This will hamper loans to local governments, which in turn could reduce infrastructure building and slow economic activity further. Although slower Chinese growth has put pressure on emerging markets, the deceleration has put downward pressure on many commodity prices, which should help bolster U.S. corporate profits as companies benefit from lower input costs. A notable exception to lower commodity prices is the price of crude oil, which has jumped to more than $100 per barrel due to the political crisis in Egypt.

Outlook

The past week's economic news does not alter our GDP forecast for the U.S. We continue to expect GDP growth of 1.5% in the second quarter. Our forecast for the remainder of 2013 remains 2.5%-3.5% in the third quarter and 3.0%-4.0% in the fourth quarter, in both cases with a bias toward the lower end of the range.

Although steady U.S. job creation should continue, we expect the unemployment rate to rise as the economy kicks into a higher gear. This is because formerly discouraged people tend to reenter the labor force when they see job prospects improve, creating a larger base of potential workers (i.e., a higher "participation rate"). As a result, the unemployment rate could tick up later this year and stay slightly elevated before easing back down in the second half of 2014. Such a development would be a signal of strength, not weakness, as long as the participation rate is improving.

We remain optimistic about the trajectory of equities through the balance of the year. The U.S. risk premium (i.e., the expected excess return of equities versus a risk-free alternative such as Treasury bills) is still quite wide and, as noted, earnings expectations are improving on low inflation and declining commodity prices.

In fixed income, emerging markets continue to be among the hardest-hit sectors and will likely be one of the last to improve. In contrast, high yield should recover sooner as the U.S. economy is on firmer footing relative to most of its global counterparts. In our view, fixed-income market volatility will remain high, but interest-rate moves will not be severe enough to crimp economic growth.

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