Weekly Market Update

Markets extend their recovery on “easier” Fed rhetoric

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ARTICLE HIGHLIGHTS

- The S&P 500 Index reaches a new high as Bernanke further calms tapering fears.
- Treasuries, as well as investment-grade and high-yield corporate bonds, recover.
- European markets extend their recent rebound as economic data improves.
- The U.S. economy should remain on its “good but not great” trajectory.
- We believe tapering will occur later than the market anticipates.

JULY 12, 2013

Equities continued their advance during the past week. U.S. economic releases were scant, but markets climbed as reassuring comments by the Fed soothed fears of imminent “tapering” and calmed interest-rate volatility, at least for now, while the outlook for corporate earnings improved. The S&P 500 Index gained more than 2.5% for the week through July 11. Foreign developed and emerging markets rose as well, roughly 3%-4%, heading into the week’s final trading day.

Fixed-income markets also responded favorably to the Fed’s supportive rhetoric. Both investment-grade and high-yield corporate bonds had positive returns, continuing to recoup some of the losses sustained over the prior weeks. U.S. Treasuries also rallied, with the 10-year yield falling from a 2.73% close on July 5 to roughly 2.5% in midday trading on July 12. Mortgage-backed securities also improved. Emerging-market bonds remained in a unique trajectory, with a more muted recovery.

GDP forecast unchanged amid a relatively quiet week for U.S. data

Second-quarter growth, although tepid overall, finished on a strong note. Momentum picked up against a backdrop of steadily improving labor markets, moderately rising wages, and mild inflation expectations. There were few market-moving data releases during the past week, but one indicator, consumer credit, is worth noting:

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- As measured by the Federal Reserve, consumer borrowing grew by more than $19 billion in May, indicating higher spending with credit cards and automotive finance companies.
- This was the largest monthly increase in a year, far exceeding consensus forecasts.
- It is increasingly evident that consumers are feeling better about their prospects and acting on those feelings.

We continue to expect 1.5% GDP growth for the second quarter. This reading could initially come in lower due to May’s weaker-than-expected wholesale inventory buildup (inventories tend to rise as companies ramp up to meet expected increases in demand), but we think the bias will be for upward revisions. Driven by continued momentum in jobs, income, spending, and housing, our forecasts for GDP growth are roughly 2.5% and 3%, respectively, for the third and fourth quarters.

European indicators and equity markets continue to improve

In Europe, economic conditions have improved, most notably in “peripheral” countries (those with smaller economies relative to Germany and France):

- Key data releases have surprised on the upside.
- Leading economic indicators have ticked up.
- Composite PMIs (Purchasing Manager Indexes)—key gauges of manufacturing- and service-sector activity—are showing improvement.

In addition, the European Central Bank (ECB) now sounds more accommodative with respect to interest-rate policy, which is a positive for financial markets. The MSCI Europe Index, for example, gained more than 4.5% during the past week through July 11. Nonetheless, fiscal and political headwinds remain, including electoral uncertainty in the second half of the year and the Standard & Poor’s recent downgrading of Italy’s sovereign credit rating to BBB (the lowest tier of investment-grade). Overall, Europe may be quieter but it is far from “fixed.”

Japan and China continue to present challenges

In Japan, the first-quarter euphoria surrounding “Abenomics” has dissipated on concerns that Prime Minister Shinzo Abe’s economic program lacks the credible structural reforms needed for long-term success. Given current valuation levels for Japanese equities, the government needs to demonstrate a strong commitment to reformist policy to maintain investor faith and support the market’s advance. We remain skeptical, but there are glimmers of growth: bank loans are growing, and the money supply is expanding.

The consensus forecast for growth in China continues to come down, and we now expect a second-quarter GDP reading below 7.5%. A more important, longer-term development is the slowdown in credit expansion and the deterioration of Chinese export and import growth. With China’s government embarking on a policy of economic rebalancing, it seems increasingly evident that the world’s second-largest economy is entering a new phase of slower growth. As China has slowed, materials prices have plunged. This has been one source of weakness in the emerging markets overall, as 40% of these markets are driven by the Materials sector.

Outlook

In equity markets, we remain optimistic that the S&P 500 can continue its advance and reach a new high before year-end. Given poor sentiment for equities in both China and the emerging markets, we would not be surprised to see rallies there. This view is supported by valuations in emerging markets, which have become very inexpensive.

The recent rise in the 10-year Treasury yield has narrowed a very wide risk premium for U.S. equities. In our view, however, 10-year rates would have to climb to 3.25%-3.5% for stocks to move toward “fair” valuation. Our baseline expectation is less dramatic, calling for a relative plateau at current rate levels. In addition, we take heart from the high-yield bond market, where rates have continued to back down from their June spike, and from rising inflation expectations, generally a reliable longer-term measure of the market’s faith in growth.

In fixed-income markets, sentiment has improved enough to support some new issuance activity, but secondary markets remain challenged. We believe there’s a slight bias for spreads between Treasuries and higher-yielding sectors to tighten over the summer, but we do not foresee an impetus for a significant move.

Moreover, while there has been tremendous market speculation that the Fed will begin tapering its asset purchases as early as September, we do not expect action until December or early 2014. Any rapid acceleration of growth in the economy could shorten that anticipated time frame, but for now there is no clear evidence to suggest growth will shift higher from its current “good but not great” trajectory.