Weekly Market Update

Markets shift into higher gear while economic data remains in neutral

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ARTICLE HIGHLIGHTS

- U.S. equity markets are performing better than the economy's trajectory would imply.
- Fixed-income markets latch on to further reassurances about the timing of Fed tapering.
- Lackluster June retail sales underscore weakness in the second quarter.
- Our outlook for U.S. equities remains positive, but Europe may offer better relative value.
- We have lowered our expectation for second-quarter GDP growth.

JULY 19, 2013

Despite data indicating slower growth in the second quarter, the U.S. equity market has recently behaved like it is anticipating real economic acceleration. During the past week, the S&P 500 Index not only continued its recovery off of recent lows but also hit another record closing high. Consumer Discretionary, Technology, and Materials—industry sectors that typically perform well when the economy is kicking into high gear—have been among the market leaders in July. Meanwhile, small-cap stocks, which also tend to respond better to faster growth, have outperformed their large-cap counterparts by more than 300 basis points (3%) for the month to date.

Fixed-income markets welcomed Federal Reserve Chairman Ben Bernanke's testimony reiterating that the pace at which the Fed will eventually taper its quantitative easing (QE) asset purchases will be determined by economic data and is not on a "preset course." Treasuries rallied, with the bellwether 10-year yield hovering between 2.5% and 2.6%, down from its 2.73% close on July 5. Improved performance of "spread products" (lower-rated, higher-yielding non-Treasury securities) has been strongest in high-yield and investment-grade corporate bonds, sectors that were among the hardest-hit in June's broad sell-off.

Latest U.S. data is uninspired

Consumer and housing data released during the past week proved disappointing, although markets have been taking any sign of a slowdown in the economic recovery as cause for hope that the QE spigot will remain open longer. On the

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other hand, production-related data continued to advance in June, suggesting further moderate improvement across the economy.

- June's retail sales number (+0.4%) was flat when removing autos from the figure, and sales actually shrank (-0.1%) when controlling for increased gasoline sales due to higher fuel prices.
- Housing statistics were mixed, with homebuilder sentiment improving dramatically in July, while housing starts and building permits declined in June.
- Stronger industrial production, capacity utilization, and employment data stood in contrast to softer indicators of consumer demand.

Inflation expectations have moved higher but remain well below this year's peak. Although the consumer price index (CPI) rose in June, the core CPI measure (which excludes volatile food and energy prices) climbed only modestly and even decelerated on a year-over-year basis from May.

Non-U.S. economies and markets are seeing some improvement

European bond and equity markets, and bank stocks in particular, rallied on July 18 after the European Central Bank (ECB) unveiled changes that will make it easier for banks to use asset-backed securities as collateral for ECB loans—a move designed to increase liquidity and stimulate lending to credit-strapped businesses. This could nudge economic activity in the eurozone and also help mitigate sovereign debt concerns in Spain and Italy, where government bond yields have been creeping higher.

In China, there was a heartening increase in the Shanghai "A" Share Stock Market Index during the week, a potentially positive indicator for the Chinese economy. Meanwhile, Japanese economic activity is picking up. Both consumer spending and capital spending by companies have exceeded expectations as confidence rises in Prime Minister Shinzo Abe's economic program. However, imminent elections in the upper house of Japan's parliament could affect the government's willingness and ability to follow through on needed "Abenomics" reforms.

Outlook

Taking into account weak retail sales at the end of the quarter and a lack of inventory spending by businesses, our expectation for second-quarter GDP growth has been revised downward, from 1.5% to 1.2%. Our forecast for the third quarter remains at 2.5%, while the fourth-quarter reading is likely to be around 3%. The second half of the year should be helped by a smaller drag from the government sector, as higher taxes and reduced spending are absorbed, while employment gains and rising home prices support further modest growth in consumption.

Markets shift into higher gear while economic data remains

We maintain our positive outlook for U.S. equities, believing that the S&P 500 Index could advance to a target level above 1700. That said, European equities look potentially more attractive than U.S. stocks, but also riskier. Cheaper valuations in Europe versus the U.S. underscore a potential relative value trade that bears watching.

In fixed-income markets, our view is that the economy will continue to improve but that further interest-rate increases will likely occur in relatively modest stages. Although a full recovery from the market turmoil that has transpired over the past several weeks is unlikely to happen quickly, we have already seen noticeable improvements in some sectors, with further healing likely, aided by low levels of new issuance (a favorable supply and demand factor) and stabilizing fund flows.