Weekly Market Update

U.S. equities surge to record highs amid deluge of data

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ARTICLE HIGHLIGHTS

- Major U.S. equity indexes hit all-time highs, shrugging off muted jobs report.
- Treasuries take a bumpy ride thanks to conflicting economic headlines and a focus on Fed comments.
- Advance GDP estimate for Q2 is above consensus, while prior-quarter revisions are mixed.
- Economic and market performance improves in Europe and Japan, with China a question mark.
- We continue to expect a modest pace of Fed tapering that avoids a severe interest-rate shock.

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Major U.S. equity indexes reached all-time highs during the past week, with the S&P 500 Index closing above the 1,700 threshold for the first time. Favorable economic data—particularly in housing, manufacturing and consumer spending—all pointed to continued steady but moderate growth, lifting U.S. equities to their record levels.

The U.S. market also benefited from a relatively strong second-quarter earnings season, as 69% of S&P 500 companies reporting so far have exceeded consensus expectations by an average of 3.2%. Healthy returns in non-U.S. markets were led by Europe (+1.1% for the week through August 1), while Japan (-1.4%) and the emerging markets (-0.7%) lagged, based on MSCI indexes.

The Federal Reserve offered no further clues about the timing of eventual tapering of bond purchases. Its latest economic assessment ("modest" growth) and interest-rate decision (no change from near-0% levels) left fixed-income markets to digest a slew of mixed economic headlines. With generally strong data releases tempered by a few downside surprises, including July's mildly disappointing employment report, U.S. Treasuries were volatile. The yield on the bellwether 10-year Treasury note surged 14 basis points (0.14%) on August 1 to close at 2.74%—a two-year high—only to ease back to 2.62% in early trading the next day. Meanwhile, high-yield corporate bonds outperformed their investment-

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grade counterparts, as their yield spread provides a buffer to the negative effects of rising interest rates.

Week's worth of U.S. data points to continued moderate growth, with some soft spots

Overall, the most recent batch of economic data indicates little change in the trajectory of U.S. growth, while inflation remains well below the Fed's 2% target.

- **Employment:** The week was capped by the Labor Department's July employment report. The U.S. economy added 162,000 jobs last month, fewer than expected, while payroll totals for May and June were revised downward. Although the unemployment rate dipped to 7.4% from 7.6%, the decline was due in part to more people leaving the workforce, rather than to robust job creation.

- **GDP growth:** The government's advance estimate of second-quarter GDP growth came in at 1.7%, above consensus forecasts of approximately 1%. First-quarter growth, however, was lowered to 1.1% from 1.8%. In addition, the Bureau of Economic Analysis revised all prior GDP calculations dating back to 1929. We will offer our perspective on these revisions in a future economic commentary.

- **Home prices:** The widely cited S&P/Case Shiller Home Price Index was up 12.2% in May compared with a year ago, offering more evidence of the housing market recovery. This favorable reading was countered somewhat by a decline in pending home sales (reflecting higher mortgage rates rise and tight housing supply) and lackluster residential construction activity. For a more in-depth look at the state of the housing market, read this analysis by TIAA-CREF's Chief Economist, Tim Hopper.

- **Manufacturing:** The Purchasing Managers' Index (PMI) published by the Institute for Supply Management jumped to 55.4 in July, its highest level in more than two years. Readings above 50 indicate economic expansion. The surprisingly large gain was fueled by sharp increases in the production, new orders and employment components of the index.

- **Consumer spending:** Consumers increased their spending in June at the fastest pace since February, but personal incomes lagged and consumer confidence edged down in July.

Europe and Japan continue to improve, but China remains hard to read

Many non-U.S. economies and markets have shown further glimmers of growth, although data out of China remains contradictory and muddled.

- **Europe.** European equity markets have rallied strongly (+7.4% in July) after a disappointing June, and government bond yields have stabilized following recent flare-ups in sovereign debt concerns. Among the "green shoots" of economic activity emerging in Europe are positive indicators in France, including slightly higher industrial output, increased consumer spending and an upgraded central bank forecast for second-quarter GDP growth. There have also been some signs of progress in employment markets: The

number of unemployed workers in the eurozone fell in June for the first time in more than two years. Against this backdrop, European equity valuations remain compelling on a long-term basis.

- **Japan.** Japanese equities have climbed on strong corporate earnings announcements and a weakening yen relative to the U.S. dollar, which helps Japan's export-led economy. Strong earnings growth in the current fiscal year should continue, but slower reported growth in fiscal year 2014 is likely to lead to profit taking later this calendar year.
- **China.** The Chinese economy continues to issue mixed signals. The government's official PMI, a key indicator of manufacturing activity, rose to 50.3 in July from 50.1 in June, but the PMI calculated by HSBC declined to 47.7 from 48.2 in June. Moreover, the China Consumer Indicator fell to 87.8% in July from 97.3% in June, the lowest level in 18 months. China's equity markets are eagerly awaiting greater clarity on potential stimulus measures to avoid further economic deceleration.

Outlook

In terms of investor sentiment, the percentage of S&P 500 stocks trading above their 50-day moving average suggests that the market is overbought, but not egregiously so. On the earnings front, companies continue to provide conservative guidance on third-quarter earnings, with 73% of S&P 500 constituents guiding below the midpoint of consensus earnings expectations. This is a positive because the lower bar for comparisons could set up the market for a favorable third-quarter reporting season. In the meantime, we would not be surprised to see the market consolidate some of its recent gains in the typically low-volume month of August.

In fixed-income markets, we continue to believe that the rate of Fed tapering will be modest, and that a severe interest-rate shock is unlikely. Flows into fixed-income mutual funds have turned positive again for most categories, indicating that yield spreads are likely in the weeks ahead.

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