TIAA-CREF Asset Management

U.S. equities pause for breath in quiet trading week

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ARTICLE HIGHLIGHTS

- U.S. equity market performance moderates after previous week's record highs.
- Fixed-income markets are stable as U.S. Treasury yields trend lower.
- Strong U.S. trade data could lead to upward revision in second-quarter GDP growth.
- Europe remains an attractive region for equity investing.
- Improving Chinese economic indicators could bode well for emerging markets.

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U.S. equity markets pulled back from the previous week's record highs, posting three consecutive daily losses before staging a modest recovery on August 8. This weakness was not unexpected following the bullish short term sentiment that held sway in July, when the S&P 500 Index climbed more than 5%. For the week through August 8, the S&P 500 returned -0.65%, while foreign developed- and emerging-market stocks returned 0.09% and -0.89%, respectively, based on MSCI indexes. Among developed markets, Europe (+0.79%) outperformed, while Japan (-2.10%) lagged.

In fixed-income markets, returns were generally flat. Based on Barclays indexes, the aggregate U.S. investment-grade bond market (+0.11%) and the U.S. Treasury sector (+0.09%) were marginally positive for the week through August 8, besting investment-grade (+0.07%) and high-yield corporate bonds (-0.12%). The yield on the bellwether 10-year Treasury bond fell 16 basis points (-0.16%) from 2.74% on August 1 to 2.58% on August 8.

U.S. economic indicators are scant but positive

There were few major economic releases during the past week, but what little data was reported generally showed improvement after a period of sluggishness.

- **Non-manufacturing activity** picked up substantially in July, according to the Institute for Supply Management's (ISM) monthly survey of purchasing

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managers in the service sector. The ISM index rose to 56.0% last month, from 52.2% in June. (Any reading above 50 signals expansion.)

- **First-time unemployment claims** rose by 5,000 in the most recent week, to 330,000, while the less volatile four-week moving average of claims declined by 6,250 to 335,000—the lowest level since November 2007.
- The **U.S. trade deficit** shrank by an unexpectedly large 22% in June, to its lowest level since 2009. Imports decreased while exports increased, which could help fuel an upward revision to the 1.7% GDP growth rate for the second quarter.

Other recent signs of improvement in the U.S. economy include positive analyst earnings revisions for U.S. companies, increased consumer credit levels, and an uptick in the leading economic index published by the Economic Cycle Research Institute (ECRI). Also favorable is the Citi Economic Surprise Index, a gauge of the extent to which recent economic data readings have diverged from consensus forecasts. This index surged from a mid-July low of -15.0 to +36.7 on August 7. (Higher index levels mean there have been more positive data surprises relative to estimates.)

Europe's economy continues to stir

As in the U.S., recent economic releases in Europe have also been positive. The Citi Economic Surprise Index for Europe has moved sharply higher, from a second-quarter low of -81.6 on April 29 to +43.2 on August 7. European equity markets have responded in kind, climbing nearly 10% in the third quarter to date, through August 8.

In our view, Europe remains an attractive region for equity investing. Relative valuations are compelling, particularly if earnings move toward normal levels. On a cautionary note, although European sovereign debt concerns have generally been calmed, France has seen a worrisome increase in government bond yields. This bears watching, since any destabilization in that market could hinder further progress.

Japan disappoints

Japan's economic and market performance has been disappointing. Thus far, details of needed reforms—the so-called "third arrow" of Japanese Prime Minister Shinzo Abe's economic program—have been uninspiring. Meanwhile, Japan's central bank has remained silent, and the yen has strengthened versus the dollar, a negative for export-led growth. Against this backdrop, Japanese equities have struggled, with the MSCI Japan Index returning -2.1% for the week through August 8. We believe this market may have further downside risk.

China's key indicators are better than expected

Recent economic releases in China have surpassed expectations.

- **Improved trade data.** Chinese exports rose 5.1% in July from a year earlier, rebounding sharply from June's 3.1% decline. At the same time, imports surged 10.9%. As a result, China's trade surplus narrowed, suggesting an improved balance of external and domestic demand.

- **Accelerating industrial production.** China's industrial production grew 9.7% in July from a year earlier, the fastest rate of growth since February.
- **Subdued inflation.** China's consumer price index remained tame in July, rising 2.7% from a year earlier—below consensus forecasts of 2.8% and well below the government's target rate of 3.5% for the full year. Mild inflation may provide cover for the government to boost stimulus efforts if economic growth continues to slow.

Amid these developments, China's 10-year bond yield has moved higher, indicating that that market is expecting better growth than the consensus believes. Copper prices, which are closely tied to China's growth prospects, have rallied off a recent low, and the Shanghai "A" Share Stock Market Index is striving to sustain some upward movement. An improving Chinese economy could provide the basis for a bounce in materials prices, which in turn could trigger a rally in emerging-market economies and stock prices.

Outlook

The positive U.S. economic releases over the past week support our expectations for stronger growth in the second half of the year. Importantly, crude oil prices have receded from their recent surge. If they move lower, consumers would have more real income to spend, further boosting the likelihood of second-half growth.

Although short-term trading sentiment remains bullish in U.S. equity markets, which could presage further market weakness, longer-term sentiment remains negative. Surveys show Wall Street strategists tilting their asset allocations away from equities, and hedge funds have lowered their net exposures to equities to below 50%. These contrarian signals have historically been associated with a subsequent rise in equity prices. In fixed-income markets, we believe the 10-year Treasury yield could continue to move lower. This would support the housing market via lower mortgage rates and support the already above-average U.S. equity risk premium (i.e., the expected excess return of equities versus a risk-free alternative such as Treasury bills).

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