Weekly Market Update

Markets turn slightly positive as volatile week draws to a close

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- U.S. equities end the week little changed, masking day-to-day volatility.
- Treasury yields rise on Fed tapering fears, then recede on downbeat housing data.
- Signs of expanding global manufacturing activity temper weak equity market sentiment.
- We expect European equity gains will continue as economic conditions improve.
- Our forecast calls for GDP growth to pick up modestly, approaching 3.5% by the end of 2013.

AUGUST 23, 2013

U.S. equity markets struggled to gain traction during much of the past week. For the week to date through August 22, the S&P 500 Index was essentially unchanged (+0.08%) but volatile day-to-day, hampered again by the inevitability of Federal Reserve tapering and the accompanying rise in interest rates. Foreign developed (-1.63%) and emerging-market (-3.72%) stocks fared worse, based on MSCI indexes.

Fixed-income returns were negative across most sectors amid quiet late-August trading. Reflecting the Fed's latest "taper talk," U.S. Treasury yields continued their upward climb. The 10-year Treasury yield closed at a two-year high of 2.90% on August 22 before edging back down toward 2.80% the following day in the wake of a weaker-than-expected July reading for new home sales. Fund flows continued to favor high-yield floating-rate loans, which offer protection against rising interest rates, while flows into fixed-rate bond categories remained light or negative.

U.S. housing trends remain in place, with a note of caution

There was little new economic news during the week, but three data releases are worth noting:

- **Existing home sales** climbed 6.5% in July, to their highest annualized rate since 2009. Housing-related stocks responded in kind, posting solid gains. Strong July sales were driven in part by homebuyers acting sooner rather than later to avoid a further rise in mortgage rates, but the robust pace of

TIAA CREF Financial Services

buying is also a continuation of a broader upward trend. July's increased demand drove home prices higher, with the median price up nearly 14% compared with a year ago.

- **New home sales** tumbled 13.4% in July, to their lowest annual rate since last October. This downside surprise suggests that the new home market may be taking a breather following a hectic spring, with buyers becoming a bit more hesitant in light of higher prices and mortgage rates. Because monthly housing data can be volatile, we are not reading too much into July's number. However, we continue to keep a close watch on the level of new home-buying, given the importance of the housing sector to the overall economy.
- The index of **leading economic indicators** rose 0.6% in July, to its highest level in five years, as measured by The Conference Board. Although this signals strength in the economy, we take the latest reading with a grain of salt, because most of the increase came from rising interest rates, a factor that currently is more indicative of market expectations about Fed policy than strength in the underlying economy. Many of the components of the leading index were actually flat to down.

European manufacturing and consumer confidence show improvement

Europe continued to signal a nascent recovery, evidenced by a number of favorable data points:

- **Manufacturing PMIs.** Based on **"**flash" (preliminary) August data, Purchasing Managers Indexes (PMIs), which gauge manufacturing activity, were better than expected in the eurozone (51.3), with Germany (52.0) leading the way. (Readings above 50 indicate expansion.)
- **Consumer confidence.** The flash consumer confidence indicator for the eurozone improved "markedly" in August, according to the European Commission, helping lift European equities as the week drew to a close.
- **British GDP.** Britain's second-quarter GDP growth was revised upward, to 0.7% from 0.6%, the best performance for Europe's third-largest economy since the third quarter of 2012. U.K. equities responded strongly, gaining about 1% over the last two trading days of the week.

We expect improving equity market performance in Europe to continue as economic activity picks up.

China's manufacturing also improves

Chinese manufacturing data was also better, with the August flash PMI edging into expansionary territory (50.1). Although this had little or no effect on the Shanghai Stock Exchange "A" Share market, which has moved sideways, the "Chinext" index (Chinese technology stocks) surged to a new all-time high, supporting the notion that there are strong pockets of growth in China.

Japanese data suggest a bumpy road ahead for "Abenomics"

Japanese Prime Minister Shinzo Abe's program to reinflate the economy continued to fall short of hopes.

- Japanese **manufacturing PMI** dipped in July, with growth decelerating to its slowest pace in four months.
- Japan's **leading index of economic indicators** plunged in June, after six consecutive months of improvement, according to The Conference Board.
- **Inflation expectations** fell, an ominous sign because higher inflation and a weaker yen are central to boosting Japanese export growth.

While Japanese equities rallied late in the week, in part due to an optimistic "Tankan" reading (a survey of local Japanese manufacturers), we remain cautious about the prospects for Japanese equities and see further downside potential.

Outlook

We continue to expect the U.S. economy to improve, but the pace of recovery is uncertain. Our forecast calls for GDP growth to pick up modestly, approaching 3.5% by the end of 2013, and to accelerate further as we move into next year. However, downside risks remain in the form of rising interest rates and a potentially negative market reaction to a premature or too aggressive tapering of the Fed's bond purchases.

In U.S. equity markets, the August market correction has been driven by tapering fear and higher interest rates. It appears to us that tapering is now almost fully discounted, while Treasury yields may have reached a ceiling. Meanwhile, extreme bullishness has been tamped down.

In fixed-income markets, once Treasury yields settle in a stable range, "spread products" (higher-yielding, non-Treasury securities) may stage a rally, offering some respite to battered fixed-income investors. An increase in mortgage rates above their current level of 4.5% on conventional 30-year loans, as well as continued fiscal drag caused by reduced government spending, could keep economic improvement—and thus interest-rate increases—relatively modest.