Weekly Market Update

Soft jobs data, Syrian tensions fuel market uncertainty

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- Equity markets rise in holiday-shortened trading week.
- Delayed action on Syria initially calms markets, while late-week rhetoric sparks renewed concerns.
- Disappointing employment growth is out of synch with broader evidence of U.S. strengthening.
- Treasury yields are volatile, spiking to 3% before retreating on tepid August payrolls.
- We continue to forecast moderate GDP growth for the third and fourth quarters.

September 6, 2013

U.S. equities rebounded from their August decline in a light trading week shortened by the Labor Day holiday. For the week through September 5, the S&P 500 Index was up roughly 1.4%, while foreign developed and emerging markets both rose more than 2%, based on MSCI indexes. Fixed-income markets struggled, with the Barclays U.S. Aggregate Bond Index posting a loss (-1.1%) and the yield on the 10-year Treasury surging to 3% before moving lower in the wake of August's weaker-than-expected employment report. Net flows into fixed-income funds were largely flat across most sectors, reducing pressure to sell assets to meet redemptions. Current market updates are available here.

U.S. economy continues to strengthen, but lackluster jobs growth muddies the water

Most of the U.S. economic data released during the week was favorable, suggesting that the economy picked up again last month after a July pause. On balance, the latest releases are in line with our expectations for stronger growth in the second half of the year.

- **Manufacturing** activity was robust as measured by the Institute for Supply Management (ISM), whose Purchasing Managers Index (PMI) climbed to

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55.7 in August—its fastest pace in more than two years. (Readings above 50 signal expansion.)

- The **service sector** of the economy also surged, with the ISM nonmanufacturing index reaching an all-time high of 58.6.
- **Auto sales** jumped in August to an annual rate of 16.1 million units, the highest sales rate since 2007. Autos represent one of the single largest manufacturing sectors of the U.S. economy, and increased demand in this sector should lead to healthier employment gains and growth in related industries as well.

The notable exception to August's positive momentum was the subpar monthly payrolls report. At 169,000, the number of jobs added last month was well below consensus forecasts. Moreover, job totals for July and June were revised downward by a combined 74,000. This weak level of job creation was surprising in light of initial unemployment claims that have continued to trend lower over the past several weeks (generally an indication that monthly job creation is firming). It is too early to tell whether the softness we have seen over the summer months signals a lasting slowdown in the labor markets, with broader implications for the economy, or is merely a speed bump. In our view, the bulk of economic evidence suggests that improved jobs growth should resume in September.

Europe and China also show improvement

European economic data continues to suggest that the region is slowly emerging from recession. PMI readings for Spain and Italy were upbeat, and equity markets rallied, particularly in the financial sector. We are likely to hear increased chatter about Germany's upcoming election. Although Chancellor Angela Merkel remains the likely victor, opposition parties have attracted attention and support, decreasing the odds of an easy victory. Any increase in political uncertainty could disrupt market sentiment.

PMI was a positive surprise in China, hitting 51 in August. Chinese equities have continued to move higher, along with the 10-year government bond yield. Emerging markets, which often take their cue from China, have rallied in kind — a trend that we believe may have legs, particularly if export demand from the U.S. and Europe builds.

Outlook

Despite the soft August employment report, we have made no changes to our U.S. forecast, which calls for moderate GDP growth in the 3% range for the next two quarters. Strength in manufacturing (especially autos), along with improvements in consumer demand and better-than-expected productivity growth, among other factors, should continue to lead to modest gains in income, spending, and hiring as we move forward.

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Although stronger economic signals prompted the 10-year Treasury yield to spike to 3% in the past week, we believe a rate “shock” above current levels is unlikely in the near term. That said, an increase to 3.25% or higher would not only diminish the relative attractiveness of equities versus bonds, but also increase the risk of slower economic growth. The housing sector has already felt the effect of higher rates, which have contributed to weaker demand for mortgages and a slower pace of home-price appreciation.

Overall, we remain generally positive on equities. In fixed-income markets, we think “spread products” (higher-yielding, non-U.S. Treasury securities) are likely to rally modestly once Treasury yields are able to remain stable for a few months. In the meantime, geopolitical uncertainty and the timing and pace of Federal Reserve “tapering” will remain key macro drivers of equity and fixed-income market performance.

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