Weekly Market Update

Markets move higher as debt deal is reached

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ARTICLE HIGHLIGHTS

- Resolution of debt ceiling debate lifts the S&P 500 Index to a new high.
- U.S. Treasuries and other bond-market sectors also rally.
- Economic impact of the government shutdown will delay Fed tapering timeline.
- Global growth in 2014 could be stronger than many currently expect.
- We expect rising equity and stable fixed-income markets heading into year-end.

OCTOBER 18, 2013

As in the past several weeks, all eyes were on Washington as the government shutdown and debt ceiling debates went down to the wire. The deal reached by Congress and signed into law on October 17 reopens the federal government through January 15, 2014 and lifts the debt ceiling limit through approximately February 7, 2014. While still only a temporary fix, the agreement eliminates both the direct drag on economic activity caused by the shutdown and the imminent risk of a potential U.S. government default.

Equity markets welcomed the end of the latest political standoff, with the S&P 500 Index hitting a new record high and the MSCI foreign developed- and emerging-market indexes climbing 2% and 1%, respectively, for the week through October 17. Fixed-income markets also rallied. Based on Barclays indexes, the broad U.S. investment-grade bond market returned 0.54% for the week through October 17. Investment-grade and high-yield corporate bonds were up 0.80% and 0.63%, respectively. High-yield funds saw significant inflows, but emerging-market debt funds saw outflows. The yield on the bellwether 10-year Treasury note declined, closing at 2.61% on October 17.

Current market updates are available here. For more perspective from TIAA-CREF on the government shutdown, debt ceiling debate, and other political issues that could affect markets and the economy, visit our Washington Watch page.

Financial Services

Assessing the economic impact may take time

Although the extent of the economic damage caused by the shutdown and the debt ceiling uncertainty remains to be seen, all real-time indicators of economic activity that we follow have slowed sharply in the face of the Washington fiscal debate. Many government economic releases have been delayed due to the shutdown, making a thorough assessment difficult. At the very least, it is apparent that consumer and business confidence have suffered, which will weigh on GDP growth in the months ahead.

Against this backdrop, the Federal Reserve is likely to delay the tapering of its bond purchases. This would support fixed-income assets, particularly “spread products” (higher-yielding, non-U.S. Treasury securities) that have been among the chief beneficiaries of the Fed’s bond-buying program. Notably, yields on high-yield bonds have been moving lower, indicating little or no economic concern from that sector of the market. As for equities, we expect some negative earnings guidance to accompany this month’s corporate earnings season, but we believe the equity market can and will look through that negative news if it hits.

Europe, China and Japan: signs of progress mixed with notes of caution

International equity markets joined the U.S. in posting solid gains during the past week, with the MSCI Europe and MSCI Japan indexes gaining 2.17% and 1.37%, respectively, through October 17. Although non-U.S. markets have continued to move higher, we are keeping an eye on a number of issues in key regions.

Europe. Beyond the domestic political challenges that face the European Union, there are economic factors in play that warrant attention. Economic growth has improved, but the Citi Economic Surprise Index for Europe—a gauge of the extent to which recent economic data readings have diverged from consensus forecasts—has turned negative since September. If this weaker trend continues, the market may face poor earnings releases. Among the recent concerns: the euro has appreciated (which hurts exports), credit has contracted, and consumer confidence has remained depressed

China. After some better-than-expected indicators in recent weeks, Chinese economic data was again mixed. Exports were softer, total credit contracted in September, and company surveys weakened. Our concern is that the economy will continue to decelerate into 2014.

Japan. Japanese real interest rates are now firmly negative for the first time in history, which means the yen is likely to depreciate further. A weaker yen is a primary requirement to jumpstart export growth. This may well support the equity prices of exporters, but we remain concerned that the government has not yet enacted key reforms necessary to produce sustainable domestic growth.

Outlook

As we head into 2014, a potentially powerful addition to U.S. growth is the reduced impact of fiscal drag, i.e., the negative effects of curtailed government spending. In 2013, reduced government spending and tax increases lowered GDP growth by

1.7%, based on some estimates. That effect should ebb next year, which would meaningfully enhance growth. Additionally, not only has the debt ceiling now been raised into 2014 with some flexibility for the Treasury to spend through March, but the agreement also puts into place mechanics to automatically increase the ceiling unless two-thirds of the Senate vote against that.

Given these conditions, U.S. equity markets appear poised to continue moving higher through year-end. A concern is that the market may be approaching extended (overvalued) levels, particularly given how well equities generally performed despite the wrangling in Washington. For now, we are not overly concerned, because short-term sentiment has been subdued, limiting the risk of an overbought market. Sentiment is likely to rebound quickly, however, given the most recent market spike. That could make stocks vulnerable to a renewed period of weakness in November, especially if earnings disappoint.

We expect fixed-income markets will trade within a relatively narrow range over the next few weeks, as investors wait for clues from government economic releases that were delayed by the government shutdown. While U.S. growth has been at least moderately hurt by the shutdown, likely causing a further delay in the Fed's tapering timeline, we think stable to improving economic activity in Europe, China and Japan, as well as in the U.S., could lead to global growth in 2014 that is stronger than many currently expect. In our view, market interest rates will rise in the coming three to six months, but fixed-income markets will not react as violently as they did earlier this year, because upcoming rate increases are likely to be more gradual.