TIAA-CREF Asset Management

# 2014 Market Preview

## The end of easy money

## Executive Summary

**Daniel Morris, CFA**
Global Investment Strategist


- **The timing and pace of tapering—and the U.S. Federal Reserve's communication about it—will be key drivers of market volatility in the year ahead.**
- **Equity market valuations appear reasonable, with the U.S. trading only slightly above its long-run average and many markets outside the U.S. trading below their long-run average. Earnings growth may slow, but should still be strong enough to sustain modest equity price appreciation.**
- **Emerging markets equity may face difficulties as quantitative easing (QE) tapering provokes a withdrawal of foreign investment and a stronger dollar. Valuations, however, are more attractive than in most developed markets.**
- **Core fixed income will struggle to produce gains in 2014, but income from high-yield bonds and other riskier assets will provide some cushion against rising rates.**


Central bankers will remain in the global economic driver's seat in 2014 as they attempt to ease their respective countries onto the exit ramp from extraordinary monetary policy. The timing and speed of "tapering" (the reduction in purchases of U.S. Treasuries and mortgage-backed securities by the Fed), will be a critical determinant of financial market volatility both domestically and internationally. The impact on the U.S. economy, however, may be less significant than many believe.

In 2014, we will see the end of easy money not only from central banks (Japan excepted), but also from financial markets. Equities returned 150% from March 2009–December 2013, as measured by the MSCI All Country World Index, and they increased by more than 25% in 2013 (see Exhibit 1). Thanks to these strong returns, valuations are now slightly above average, by our measures, meaning long-term returns will be closer to historical averages (see Exhibit 2). There were also good returns to be made in some types of fixed income, e.g., high-yield debt and peripheral eurozone country debt. For example, Spanish government bond returns topped 10%, and European high-yield debt rose by almost as much. Normalizing interest rates means that fixed-income asset classes with this kind of return potential will be much harder to find.

Financial Services

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## Exhibit 1: Global asset returns

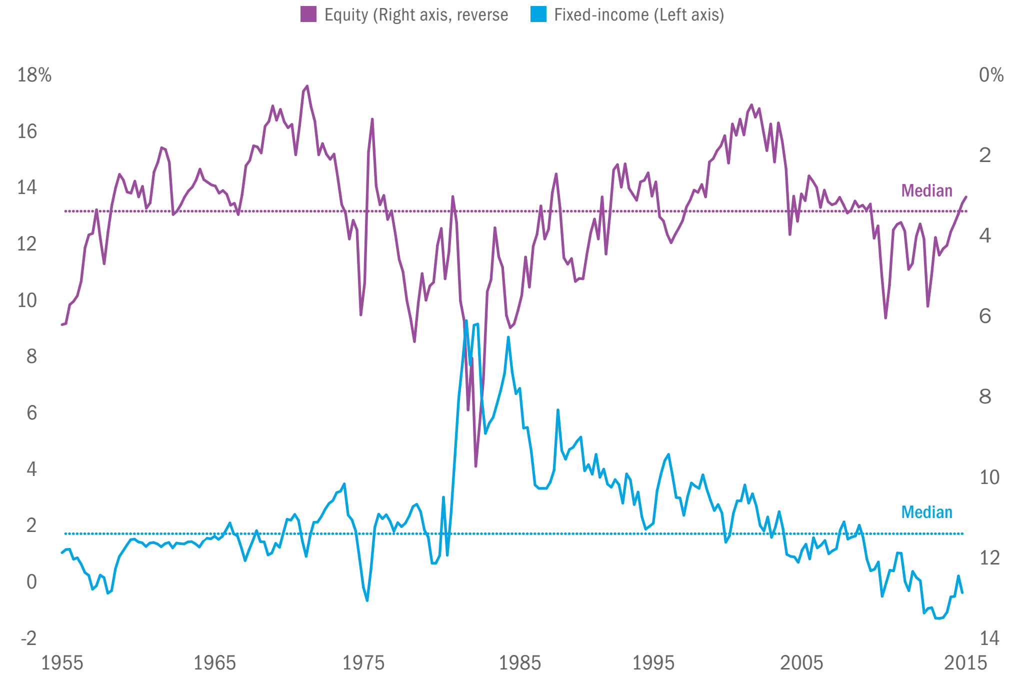
| | Market Value ($tr) | Relative P/E (%)* | Dividend Yield (%) | Total Return (%) 4Q 2013 | Total Return (%) 2013 (local) | Total Return (%) 2013 (USD) |
|---|---|---|---|---|---|---|
| **Equities** | | | | | | |
| Global (ACWI) | 35.4 | -7 | 2.4 | 7.9 | 26 | 23 |
| Small/Mid Cap | 11.6 | 3 | 1.9 | 7.0 | 30 | 27 |
| Growth | 17.8 | 7 | 1.6 | 8.0 | 26 | 24 |
| Value | 17.6 | 7 | 3.2 | 7.8 | 26 | 23 |
| High Dividend | 9.8 | 1 | 3.9 | 5.8 | 19 | 19 |
| Developed Markets | 31.7 | -5 | 2.4 | 8.5 | 30 | 27 |
| U.S. | 17.2 | 8 | 1.9 | 10.3 | 33 | 33 |
| Europe | 8.7 | 2 | 3.2 | 6.0 | 22 | 26 |
| Japan* | 2.8 | -13 | 1.7 | 9.6 | 55 | 27 |
| Asia ex-Japan | 1.6 | 0 | 3.7 | 3.2 | 17 | 6 |
| Emerging Markets | 3.7 | -18 | 2.6 | 3.0 | 4 | -2 |
| Asia | 2.3 | -23 | 2.4 | 3.6 | 6 | 2 |
| Latin America | 0.7 | 11 | 3.0 | 1.4 | -4 | -13 |
| EMEA | 0.7 | -13 | 3.2 | 2.5 | 8 | -5 |

| | Market Value ($tr) | Yield (%) | Total Return (%) 4Q 2013 | Total Return (%) 2013 (local) | Total Return (%) 2013 (USD) |
|---|---|---|---|---|---|
| **Bonds** | | | | | |
| Multiverse | 44.2 | 2.3 | 0.4 | 0.1 | -2.2 |
| Treasury | 22.6 | 1.6 | 0.1 | 0.1 | -4.3 |
| USA | 5.9 | 1.5 | -0.8 | -2.7 | -2.7 |
| Eurozone | 6.6 | 2.0 | 1.2 | 2.2 | 6.9 |
| Core | 4.0 | 1.5 | 0.0 | -1.3 | 3.2 |
| Periphery | 2.5 | 2.8 | 3.2 | 8.6 | 13.5 |
| Japan | 6.2 | 0.6 | 0.2 | 2.1 | -16.0 |
| Agencies | 3.0 | 2.1 | 0.2 | -0.2 | -2.1 |
| Inflation-Linked | 2.1 | n.m. | -1.0 | -4.2 | -3.2 |
| Securitized | 6.7 | 2.8 | -0.1 | -0.4 | 0.4 |
| Corporate (IG) | 7.1 | 2.9 | 1.0 | 0.1 | 0.3 |
| Industrial | 3.4 | 3.1 | 0.8 | -1.4 | -0.8 |
| Financial | 3.0 | 2.7 | 1.2 | 2.0 | 1.7 |
| High Yield | 2.0 | 5.8 | 3.4 | 6.5 | 7.3 |
| Emerging Markets (USD) | 1.3 | 5.3 | 1.2 | -4.1 | -4.1 |
| Sovereign | 0.5 | 5.5 | 1.0 | -6.0 | -6.0 |
| Corporate | 0.4 | 5.5 | 1.7 | -1.8 | -1.8 |
| Emerging Markets Sovereign (local) | 1.7 | 5.6 | -0.3 | -2.5 | -4.3 |

* Relative P/E compares current next 12-month P/E versus average since 1987 or earliest data available, except Japan, which is from December 2000.

Sources: MSCI, Barclays, and TIAA-CREF Asset Management.

## Exhibit 2: Equity and fixed-income valuations




Last data: 1/31/2014. Note: Fixed-income valuation is represented by the real fixed-income yield, defined as the 10-year U.S. Treasury or equivalent high-grade yield, less expected CPI inflation. Equity valuation is represented by the real earnings yield of the S&P 500 Index, which is the inverse of the index's price/earnings ratio, adjusted for inflation expectations.

Sources: Barclays, Standard & Poor's, IBES, Russell, Oxford Economics, Bloomberg, Tullett Prebon Information, and TIAA-CREF Asset Management.

Thanks to strong returns, equity valuations are now slightly above average, by our measures, meaning long-term returns will be closer to historical norms.

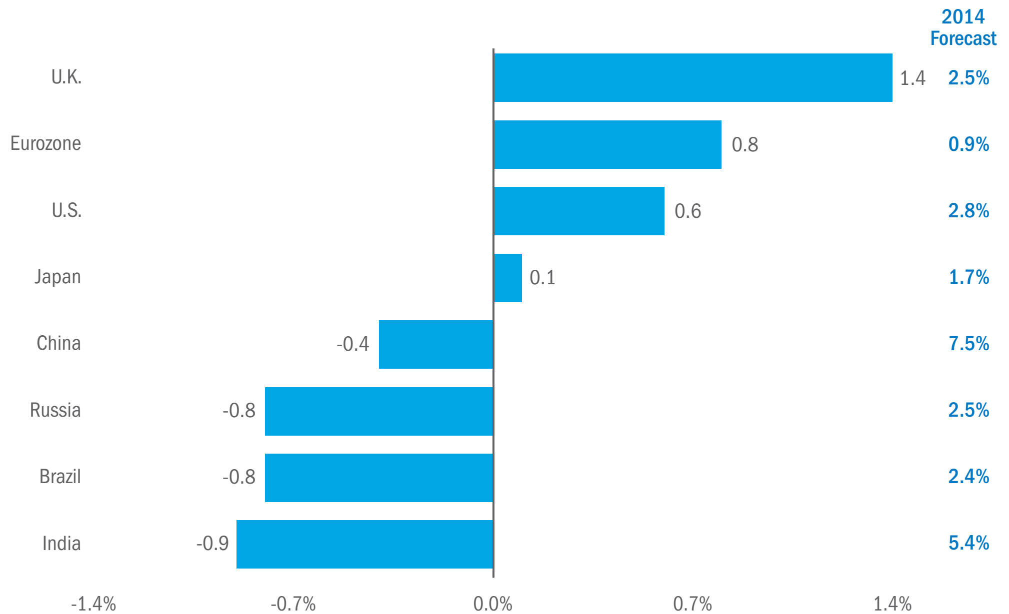
# Global

**Economy**

The slow but steady recovery from the global crises of the last six years continues, but at a varying pace around the world. Consensus forecasts are for the U.S. economy to expand by 2.5% by the end of 2014 (growth in real terms, that is, adjusted for inflation; our Chief Economist's forecast is 2.8%), and expectations have risen only modestly over the last six months (see Exhibit 3). The outlook for Europe has improved more, but from such low levels that the eurozone economy is expected to be merely 1% larger in 2014 than it was in 2013. Expectations for emerging markets growth have been falling as countries face problems ranging from tempering excessive credit growth (China), to falling oil prices (Russia), or large current account deficits (India).

## Exhibit 3: GDP growth forecasts

**Change in next 12-month forecasts over last six months and 2014 forecast**

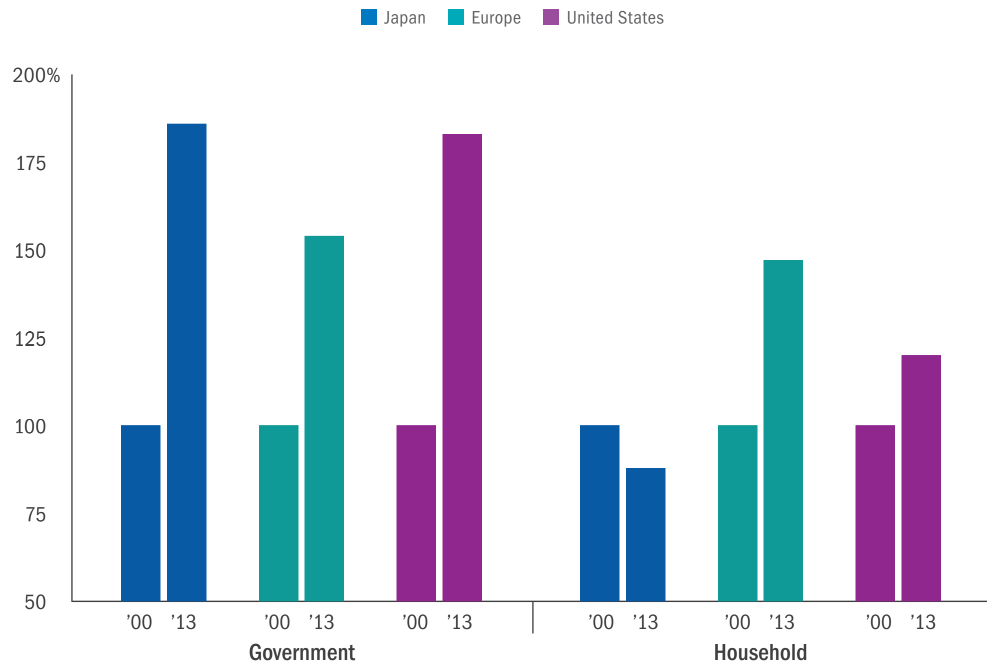



Last data: 12/31/2013.
Sources: Blue Chip and TIAA-CREF Asset Management.

The most important factor explaining the lackluster economic growth rates is that many economies are still burdened by heavy debt levels.

The most important factor explaining the lackluster growth rates is that many economies are still burdened by heavy debt levels despite years of government spending cuts, corporate write-downs, and consumer retrenchment. Much of this activity has simply shifted the burden from one part of the economy to another. For example, individuals who default on their mortgage reduce their own debt level but increase that of the banks. As a result, many major economies still have significantly more debt than they had in 2000, with debt levels nearly 90% higher in some cases (see Exhibit 4). Global growth rates will remain subpar until this debt mountain has been eroded, which, like the natural version, will take many years.

## Exhibit 4: Debt outstanding as a percentage of GDP (2000 = 100)




Last data: 6/30/2013.

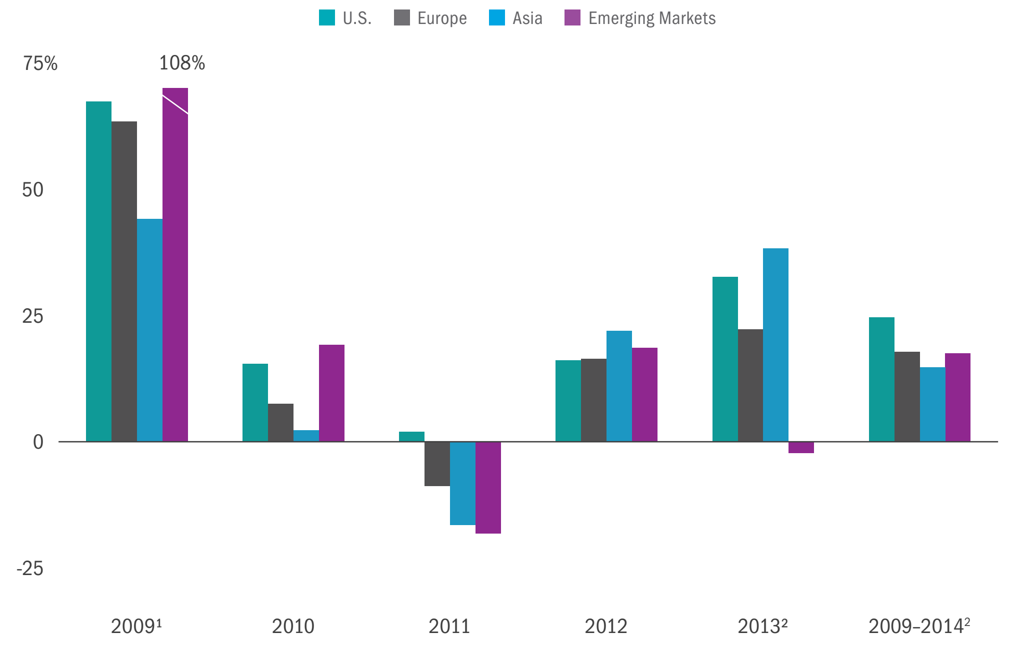
Sources: Bank of Japan, UK Office of National Statistics, Federal Reserve Board, national statistics agencies, and TIAA-CREF Asset Management.

The impending deceleration in monetary policy stimulus will likely weigh on equities, but modest returns are still possible.

**Equities**

Global equity markets racked up another year of double digit gains in 2013, bringing the cumulative total return since the low of March 2009 to 150% (local currency terms as measured by the MSCI All-World Index; the return is 170% in U.S. dollar terms). The champion of the rally has been the U.S., which has performed well both in the "risk on" periods like 2009, as well as during periods of turbulence like 2011 (see Exhibit 5). The magnitude of the returns and the length of the rally have caused some to question whether equities can continue to appreciate. While the impending deceleration in monetary policy stimulus will likely weigh on equities, we believe that a combination of reasonable valuations, steady earnings growth, and the continuing cyclical recovery of the global economy will promote sustained, albeit modest, returns ahead.

Exhibit 5: Regional equity market total returns (%), 2009-2014




Last data: 1/31/2014. Note: All returns are in local currency except for emerging markets, which are in U.S. dollars.[1] From 3/9/2009. Past performance does not guarantee future results. Index returns do not guarantee future results, and it is not possible to invest directly in an index.[2] Annualized.

Sources: MSCI and TIAA-CREF Asset Management.

We expect large-cap U.S. equities to continue their outperformance relative to other regions. Valuations are only slightly higher than in other developed markets, and U.S. corporations are far more adept at improving earnings in a low growth environment. While all equities are at risk of Fed tapering, the likely reversal of investor fund flows back toward the U.S. means that U.S. equities should prove more resilient.

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**Fixed Income**

If the environment for equities remains supportive, that for fixed income may well become more challenging. Beyond changes in monetary policy, improving economic growth should also contribute to rising yields, and valuations for core fixed income remain poor (see Exhibit 2). High-yield and peripheral European country debt were practically the only major segments of the fixed-income market to post meaningfully positive returns in 2013 (see Exhibit 1). With yields in the eurozone for many peripheral countries arguably near or below fair value, there is little potential for returns of the same magnitude in the future. Segments of the markets that offer either high enough yields to offset falling prices (such as high-yield and leveraged-loan funds), or those with floating rates or short duration, will continue to be the most attractive. Longer term, however, investors must worry about the risk associated with some of the higher yielding parts of the market, as companies have rushed to issue debt at terms perhaps more advantageous to them than to those providing the funding. This situation highlights the importance of credit research in identifying the stronger credits in high-yield bonds as opposed to simply buying securities based on their yield.

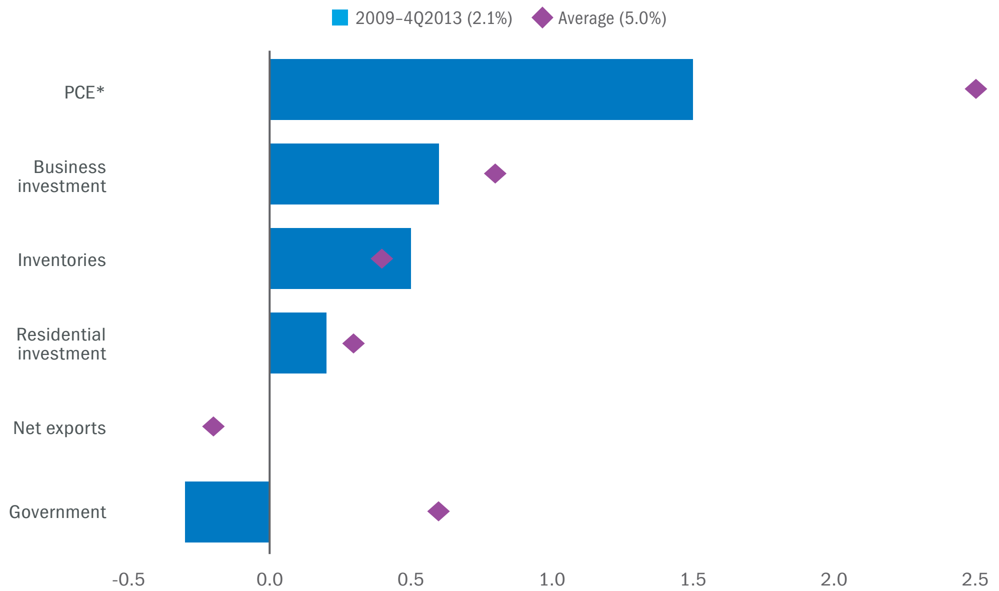
## U.S.

**Economy**

The sub-par performance of the U.S. economy since the end of the recession has primarily been the result of consumers paying down debt with whatever income they have. Real household income was growing at just over 2% annually from 2000 until the crisis began (on par with previous decades), but since 2008 the growth rate has been 0.14%. This leaves little room for indulgent spending. In typical recoveries, the U.S. economy grows at 5% (in real terms, seasonally adjusted annual rate), with consumer demand accounting for half of that growth. In this recovery, GDP growth has been only 2.1% because household spending has managed to add just 1.5% (see Exhibit 6).

The U.S. economy may never return to the 5% growth rates it managed in the past, but there are several key drivers that should support rising growth rates for years to come.

### Exhibit 6: U.S. GDP growth: current vs. traditional recoveries




Last data: 4Q2013. Note: Data is SAAR (seasonally adjusted annual rate). Average is for non-recessionary periods since 1947.

* Personal Consumption Expenditures.

Sources: BEA and TIAA-CREF Asset Management.

Other factors that explain low GDP growth rates are government spending cutbacks and weak business investment. Corporations continue to hold large amounts of cash, which is widely believed to have dampened the recovery since companies have opted not to invest it. Business investment has in fact been below average, but not as much as one might think; It has contributed 0.6% to GDP growth in this recovery versus 0.8% normally. Government spending, meanwhile, has declined at the local, state and federal levels, despite the federal government's large stimulus in 2009. This supports the argument that the stimulus package was not large enough, though this view has to be set against the already large amount of debt outstanding.

The positive news for the economy is that much of the (consumer) fiscal retrenchment has taken place and households are in a position to increase spending, to the degree that incomes recover and unemployment continues to fall. Prior to the recession, households were devoting nearly 14% of their income to servicing their debt burden, the highest level as far back as data is available (1980). This percentage has now fallen to its lowest level over the same period, to under 10%. With so much of pent-up demand remaining in the economy, consumers are certainly willing—and increasingly able—to spend more. The recovery in the housing market will also provide a key support for the economy. Housing prices have been rising at nearly an 11% annual rate since early 2012. This is important not only for those homeowners who are "underwater" (meaning the balance of their mortgage is greater than the fair market value of their home), but for the psychological boost it provides. Even those homeowners who have no mortgage or do not intend to sell their house feel more financially secure and are more likely to spend if they know that home prices are rising.

New home construction has also recovered dramatically from the lows of 2009, but is still nearly 40% below the level of 2000, well before the housing boom began. Housing starts are more significant economically than housing sales as the construction of a new home requires materials, labor and, eventually, household furnishings.

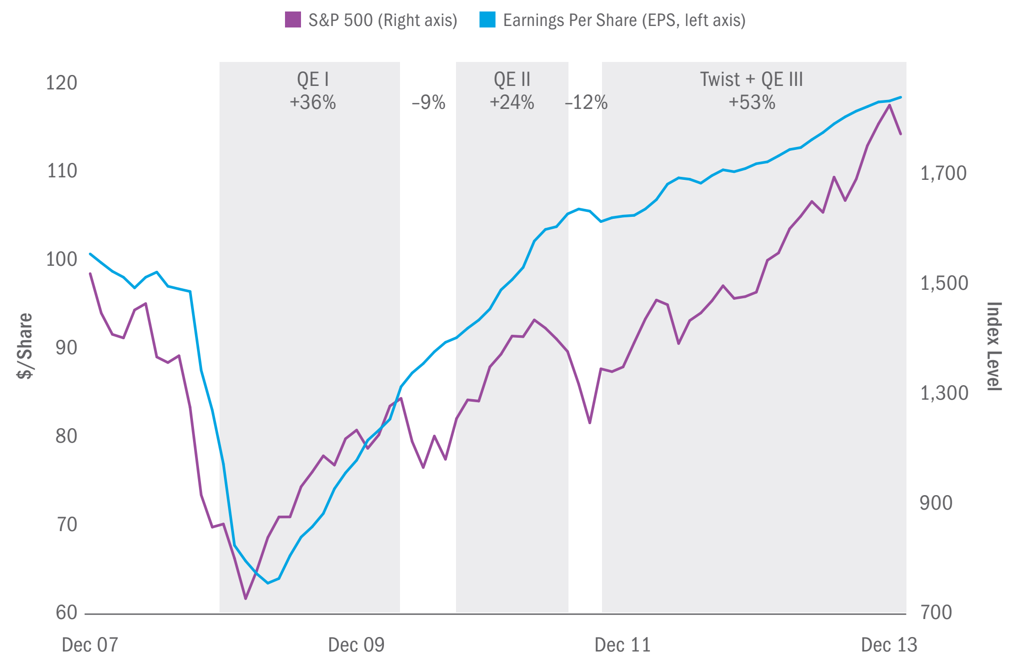
The U.S. economy may never return to the 5% growth rates it managed in the past, but there are several key drivers that should support rising growth rates for years to come.

The inevitable end of the current QE program may lead to another downturn, but the market should subsequently recover.

**Equities**

The dramatic increase in the U.S. money supply thanks to quantitative easing ($2.9 trillion since December 2007, a more than four-fold increase in M0), has undoubtedly boosted equity prices. The benefit, however, seemed to work only when quantitative easing (QE) was underway. When the first two rounds of QE (QE I and II) ended, the market corrected, though there were other factors at play, not least the eurozone crisis (see Exhibit 7). This suggests that the inevitable end of the current QE program (QE III) may lead to another market downturn, and we would not be surprised if it did. The question is whether, without a QE IV, the market will subsequently recover.

## Exhibit 7: QE, S&P 500 Index performance and expected earnings




Latest data: 1/31/2014. Note: EPS is consensus next 12-month estimate. Past performance does not guarantee future results. It is not possible to invest directly in an index. “Twist” refers to Operation Twist, a program conducted by the Fed that involved selling short-term Treasuries in exchange for buying the same amount of longer-term bonds.

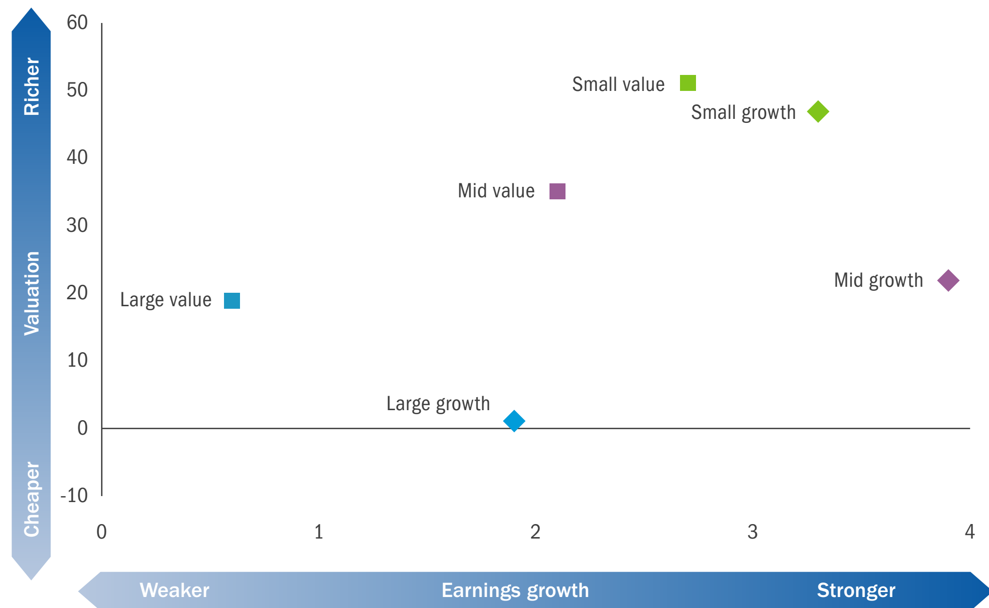
Sources: Standard & Poor’s and TIAA-CREF Asset Management.

We believe that, as it was following QE I and QE II, any downturn will be short-lived. Underlying earnings will continue to rise, and valuations do not pose a threat. As Exhibit 7 illustrates, while the S&P 500 has risen sharply since March 2009, earnings have kept pace. Those corporate earnings, however, have themselves been boosted by QE-induced low interest rates, both by allowing corporations to refinance outstanding debt at lower cost, and by increasing the net present value of future earnings. But the assumption that tapering will take place only as economic growth improves suggests that earnings can continue to grow despite higher interest rates. It is likely, however, that the rate of equity appreciation will be significantly less than it was in 2013 as some of the froth in the market is removed.

While valuations for the large-capitalization indexes are slightly above average, those for mid- and small-capitalization indexes are substantially so (see Exhibit 8). Earnings revisions are particularly poor for small caps, and it is hard to see medium-term returns matching historical averages given current multiples. In the environment we anticipate over the next year—namely rising interest rates accompanied by modest market returns overall—we would have a slight preference for value stocks. The key driver of the performance of growth relative to value is often the returns of the technology sector compared to financials. There is little reason to believe the tech sector will see significant gains over the next year. Valuations do favor technology stocks, but the earnings outlook for financials is stronger. And while the burden of bank regulation remains an ever-present concern, rising interest rates should boost income, and capital markets activity looks set to increase. The technology sector, meanwhile, faces still-anemic corporate investment and fierce competition in the consumer sector.

The 10-year Treasury yield is likely to rise above 3% over the next year, due not only to the end of QE, but also to stronger economic growth.

### Exhibit 8: U.S. equity earnings revisions and valuation by size/style




Last data: 1/31/2014. Valuations are based on each category's forward P/E relative to its long-run average.

Sources: Bloomberg, MSCI, and TIAA-CREF Asset Management.

Despite the length of the equity market rally, we believe it is too soon to think about rotating out of the economically sensitive cyclical sectors and into defensive high-dividend stocks. Industrial sector stocks should benefit from rising corporate investment and trade activity as Europe recovers. Consumer discretionary stocks should see a boost from pent-up demand and a recovery in household incomes. High-dividend yielding stocks, on the other hand, offer relatively little pickup in income compared to historical averages (the spread between the dividend yield of the MSCI USA High Dividend Yield Index and that of the MSCI USA Index is just 1.1%), and valuations for high-yielding stocks still look stretched following demand from investors seeking income at any price.

Within the investment-grade universe, corporate bonds are likely to offer the least negative returns.

**Fixed Income**

With the 10-year Treasury yield likely to rise above 3% over the next year, due not only to the end of QE, but also to stronger economic growth, fixed-income investors face the challenge of protecting the value of their portfolios. Many have already moved into shorter-term bonds offering either less interest rate risk or into those assets such as leveraged loan funds, which offer higher interest rates. In 2013, this allocation was wise as leveraged loans and high-yield debt were two of the year's best performing fixed-income asset classes. While they will still be affected by rising rates, their comparatively generous yields should help offset any price decline and suggest they should also outperform in 2014. Exhibit 9 illustrates the expected total return for different types of fixed-income asset classes given a 1% increase in interest rates. Long-duration assets obviously suffer the biggest price decline, but the coupon on high-yield and emerging market debt helps these asset classes generate positive returns after a year. (Duration measures a bond's sensitivity to changes in interest rates.)

Exhibit 9: Impact of a 1% rise in interest rates

Last data: 1/31/2014. All fixed-income sectors are represented by their respective Barclays indexes. Past performance does not guarantee future results. It is not possible to invest directly in an index. Index returns do not include fees or expenses. FRN=floating-rate notes.

Sources: Barclays and TIAA-CREF Asset Management.

Within the domestic investment-grade universe, corporate bonds are likely to offer the least negative returns. Corporate debt spreads have narrowed as benchmark Treasury yields have risen, and this process has some scope to continue as spreads are still above pre-crisis levels, if not by much. ("Spreads" refers to the difference in yield between two comparably dated fixed-income asset classes.) Financial sector bonds were the most resilient in 2013 compared to bonds in the industrial and the utility sectors, at least partly because their average duration tends to be shorter. This characteristic should help them hold up better as yields continue to normalize.

We expect the national economy to support commercial real estate market returns that are roughly in line with their historical long-term average of 9.1%, with some upside potential to perhaps 10%.

## Real Estate

**Martha Peyton**
Head of Global Real Estate Strategy & Research

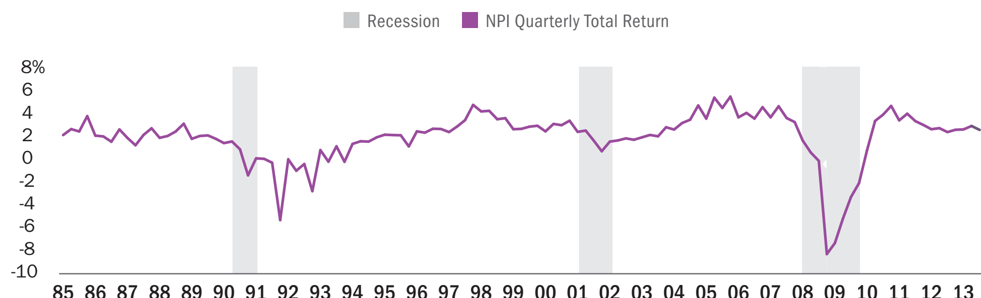
Commercial real estate investment in the U.S. is well-positioned to benefit from the stronger economic growth expected in 2014. The NCREIF National Property Index (NPI), a widely used benchmark of commercial real estate performance, has been producing double-digit gains, most recently 11% over the four quarters ended December 31, 2013. The real estate cycle is now in its 15th quarter of recovery (see Exhibit 10).

The drivers of performance are shifting as the real estate cycle matures. Capital appreciation is becoming less dominant, while net operating growth is strengthening and is well above its long-term average. The improving economy in 2014 should further boost net operating income growth, especially among markets and property types that are benefiting from higher occupancy rates, recovering rents, and limited new supply. Stronger economic growth will also help expand the geographic scope of favorable real estate investment performance, as more and more localities absorb enough excess space to ignite upward movement in rents. On balance, we expect the national economy to support NPI returns roughly in line with the benchmark's historical long-term average of 9.1%, with some upside potential to perhaps 10%.

On a sector basis, industrial properties should benefit because of their close correlation with economic growth. Stronger trade flows resulting from the improving eurozone economy should help, too. Almost all metropolitan area industrial markets are posting better occupancy rates, with some of the major Pacific and Gulf port markets such as Houston now above 90%. Office properties also offer good potential for 2014, even though performance has lagged other property types so far in this cycle. As a sector, office is poised for recovery because efforts to squeeze more employees into existing space appear to be reaching a limit. Rising demand for space will not benefit all locations equally; office tenants are increasingly targeting locations in denser areas with plentiful amenities, public transportation, and walkability to residential areas.

The apartment sector is furthest along in its cycle and offers a less compelling investment opportunity ahead, particularly in metropolitan areas with abundant new supply. In some apartment markets, increased new supply has already resulted in rising vacancy rates and a corresponding halt in rent growth. For retail properties, investment prospects vary by sub-sector. High-quality regional malls are booming and should continue to do so as stronger economic growth bolsters consumer spending. Lower-quality malls and neighborhood retail centers will be less buoyant, partly due to their dependence on local retailers who continue to have trouble securing credit.

### Exhibit 10: Economic and real estate cycles




Source: NCREIF as of 12/31/2013. Past performance does not guarantee future results. Index returns do not include fees or expenses. It is not possible to invest directly in an index.

# Europe

**Economy**

The "crisis" part of the eurozone crisis, that is, the risk that there will be a chaotic breakup of the currency union, looks to be past us, but the underlying dilemma the region faces remains. The agglomeration's fundamental economic flaw—linking economies with disparate cultures and political systems without fiscal union—will continue to weigh on the region's economic growth. Lacking their own currency or interest rate to facilitate economic adjustment, uncompetitive countries must resort to "internal" devaluation (a fall in labor and production costs) and economic reform. Europe will certainly see a cyclical recovery as the region inevitably recovers from the recession. But whether it will be able to significantly increase growth rates depends on the willingness and ability of each country to liberalize labor laws, restructure product markets, and promote trade. This is by no means guaranteed.

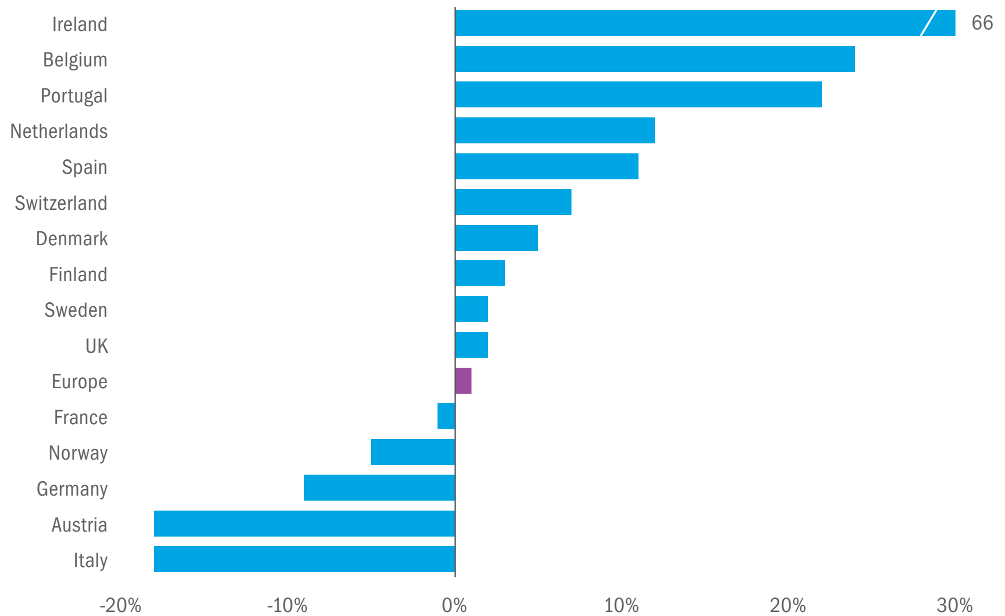
Valuations on average across Europe are only slightly better than in the U.S., but below the surface there is wide variation across the countries.

**Equities**

As an investment destination, however, the region's multinationals remain attractive as they are not entirely bound by the constraints of the country in which they are domiciled. Exports to countries with higher growth rates such as the emerging markets and the U.S. will help boost revenues. Valuations on average across the region are only slightly better than in the U.S., but below the surface there is wide variation across the countries, creating opportunities for active portfolio management (see Exhibit 11).

## Exhibit 11: European equity valuations

**Current forward P/E ratios relative to each country's long-term median P/E**




Last data: 1/31/2014.
Sources: IBES and TIAA-CREF Asset Management.

Earnings growth remains a problem nonetheless. While country domicile may not limit revenue growth, it can constrain earnings. When global economic growth is subdued, the primary way for a company to increase earnings is to increase margins and become more productive. This is more difficult in Europe than in the U.S. thanks to restrictive labor markets and higher barriers to commerce. Consequently, earnings expectations have dropped three times as much as in the U.S.

**Fixed Income**

The European high-yield debt market is not as large as that in the U.S., and yields are well below historical norms, but it still offers generous yields compared to investment-grade benchmarks. European high-yield bonds should also be less vulnerable to tapering in the U.S. as fund flows in Europe have not been driven by central bank policy to the same degree. The European Central Bank has in fact been unwinding much of its stimulus over the last year. One of the most profitable trades in Europe will not be replicable in 2014, however. The decline in yields for countries in the eurozone periphery (Spain, Italy, Portugal, Ireland), led to strong returns, but with yields now near or below fair value, further price appreciation in 2014 will likely be limited.

## Japan

Japan's goal to end deflation has apparently been met.

**Economy**

Japanese Prime Minister Shinzo Abe's plan to revitalize the Japanese economy faces significant challenges in the next year as the program's three arrows continue to fly through the air. (The three arrows are 1) defeating deflation through QE and inflation targeting, 2) fiscal stimulus, and 3) economic reform.) On one hand, the first arrow has apparently already succeeded as core inflation has turned positive and market inflation expectations have jumped sharply. But it is not certain that this will prove sustainable as inflation is now greater than wage growth. Add the government's planned (and necessary) consumption tax, which goes into effect in April, and consumer demand could fall sharply, renewing pressure on prices. The long-term effect of QE on inflation is also uncertain as a four-fold increase in the U.S. money supply has done little to boost inflation expectations, and Japan plans merely a two-fold increase.

The second arrow, fiscal stimulus, poses its own problems. The stimulus program of ¥5.5 trillion ($52 billion), intended to offset the tax hike, is risky given the country's enormous debt levels. One reason debt is so high is because of previous governments' stimulus packages, which had little noticeable benefit for the economy. If interest rates on Japanese government debt rise, either because of increased worries about the sustainability of the debt burden, higher inflation, or stronger growth, holders of the debt could face significant losses.

The only arrow that can truly spur economic growth in the long run is reform, and here the outlook is mixed. The dismantling of the country's rice output policy, which has paid farmers to reduce crops since 1970, is encouraging. The government seems committed to signing the Trans-Pacific Partnership (TPP) and making the country's powerful farming lobby unhappy will be a necessary prerequisite, but an agreement is far from certain. Proposals for special economic zones have been watered down and will offer far less liberalization than was hoped for. And there seem to be few initiatives to address one of the key problems facing the country, namely a declining population, either through increased immigration or greater female participation in the labor force. Companies likewise need to become more productive, but without changes to labor laws and even culture, this will be hard to achieve.

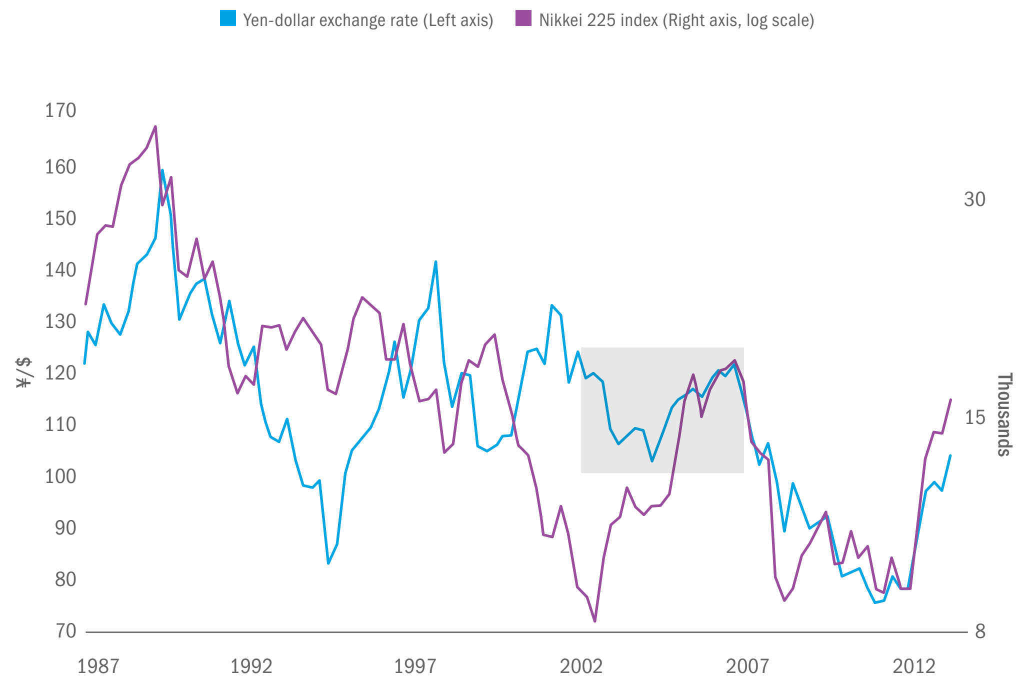
Japan is the third largest economy in the world (it was surpassed by China in 2010), so stronger growth would have a significant benefit for the rest of the world. The Prime Minister is at least attempting to deal with the country's problems, but investors will have to see how many of his arrows hit the bull's eye.

The correlation between the yen and the Japanese stock market has been extremely high for the last several years and is likely to remain so.

**Equities**

Investor doubts about the ultimate success of the government's program did not prevent the Japanese stock market from posting dramatic gains in 2013, up over 50% in local currency terms (26% in U.S. dollars). How likely is it that it can continue to outpace other developed markets? At least in the short term it will depend on further depreciation of the yen. The correlation between the currency and the Japanese stock market has been extremely high for the last several years and is likely to remain so (see Exhibit 12). Encouragingly, there is room for further weakness. As the Federal Reserve continues to taper its money printing, the dollar should strengthen further, benefiting the yen. Despite the sharp fall in the yen from the highs it hit in 2011-2012, it has really just been returning to the pre-crisis range of 100-125 yen/dollar that it moved in from 2002-2007. (See the shaded area in Exhibit 12.) Another positive is that despite the Nikkei's rally, Japanese equities are comparatively inexpensive, with the current P/E ratio of the index low relative to non-Japanese equity markets. The falling exchange rate will not be enough to drive superior returns indefinitely, however. Exhibit 12 also shows the correlation between the exchange rate and the stock markets is at times negative. But over the next year, barring a significant change in monetary policy in either the U.S. or Japan, or a slowdown in the pace of reform, Japan looks set to hold on as a top performing stock market in the developed world.

### Exhibit 12: Japanese stock market performance and exchange rate




Last data: 1/31/2014. Sources: Bloomberg and TIAA-CREF Asset Management. Past performance does not guarantee future results. Index returns do not guarantee future results, and it is not possible to invest directly in an index.

# Emerging Markets

**Economy**

Disappointing growth in emerging markets has led some investors to question the long-term outlook, and investment thesis, for the region. While the term fits awkwardly with countries as diverse as China, Brazil, and now Greece, the idea was that lower income countries had greater potential to increase productivity, deploy labor, and derive superior returns from capital, with the resulting increase in wealth driving consumer demand. The thesis remains valid but its application will need to be more nuanced in the future as countries with divergent fiscal and monetary policies develop in different ways. Countries with large current account deficits, such as Turkey and India, are particularly vulnerable as tapering leads to a return of investor fund flows to the U.S.

**Equities**

Emerging equity markets nonetheless have tended to outperform their developed market counterparts over time, except when there has been an economic or market shock such as the Mexican peso crisis or the eurozone crisis. What has been unusual about the underperformance of emerging market equities over the last year is that it has occurred during a fairly benign economic period. Encouragingly, this underperformance can be explained by fundamentals. In contrast to what economic theory predicts, emerging market corporations have been less successful recently at increasing their earnings than companies in developed markets. This has naturally led to an underperformance of their stock prices (see Exhibit 13).

What has been unusual about the underperformance of emerging market equities over the last year is that it occurred during a fairly benign economic period.

Exhibit 13: Profitability and returns, emerging versus developed markets

Last data: 1/31/2014. Note: Return on equity is based is based on next 12-month consensus estimates. Emerging Markets are represented by the MSCI Emerging Markets Index. Developed Markets are represented by the MSCI World Index. Past performance does not guarantee future results. Index returns do not include fees. It is not possible to invest directly in an index.

Sources: IBES and TIAA-CREF Asset Management.

While the cycle of relatively poor profitability may be turning (and we believe it certainly will at some point), emerging markets face the additional burden of a slowdown in quantitative easing in the U.S. and a rising dollar. Over $30 billion flowed into emerging market equities in 2013 (and over $150 billion into emerging market debt), as investors sought out higher growth and yields. Rising interest rates in the U.S. make taking the currency and political risk less necessary. So even if earnings growth recovers, equity markets may struggle as fund flows leave the region.

On a longer term horizon, however, emerging markets are still appealing. We believe the basic premise of better growth remains intact, and, unlike many developed markets, parts of the emerging market universe are still attractively valued. Countries in Asia in particular are trading at multiples 20% below their average since 1987, and earnings revisions are better than in other regions. Finally, the latest reform proposals out of China auger well for higher growth in the world's second largest economy and raise the prospect of new avenues for investors to take advantage of that growth. Now may be a good time to add to positions in Asian emerging markets, with the understanding that 2014 may nonetheless be turbulent.

**Fixed Income**

The increase in emerging market debt yields following May's "taper tantrum" restored some value to fixed-income markets. Spreads today of 300-400 basis points (bps) on U.S. dollar debt is well above what investors used to receive prior to the financial crisis when they were often below 200 bps. While emerging market debt performed poorly last year, we believe the prospects are better in 2014. Yields today are not far below where they were pre-crisis, so the risk to prices is smaller compared to core fixed income such as Treasuries and investment-grade corporate debt. Local currency debt is probably less vulnerable to the effects of tapering and is likely to offer a somewhat higher yield than U.S. dollar debt (outside of Asia). High-yield emerging market debt even offers the prospect of declining yields, a rare situation these days. The biggest risks are the same as they are for emerging market equities, namely fund flows and currency depreciation (for local currency debt). Fundamentally, however, the returns on emerging market debt remain attractive as we see little prospect of an increase in defaults. So for those investors who can accept some volatility, the income from emerging market debt remains appealing.

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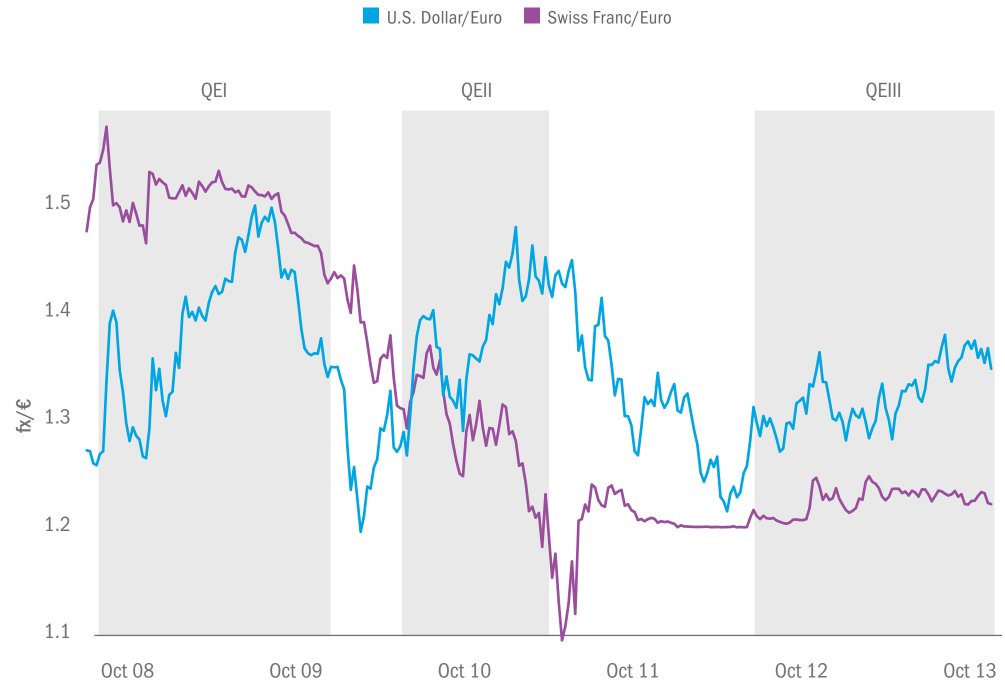
## Currencies

With the Federal Reserve now slowing the printing press, there should be less pressure on the dollar and, in fact, it should strengthen against the currencies of most of our trading partners.

Normally when the supply of something increases its value falls, but the U.S. dollar increased 3% in value against the currencies of the country's main trading partners in 2013, despite a jump of more than $1 trillion in the U.S. money supply. The strength was largely due to the depreciation of the yen, whose value decreased thanks to the Bank of Japan's efforts to increase the country's own money supply and due to the weakness of many emerging market currencies, which have suffered as fund flows reverse out of the region. But against the currencies of other U.S. trading partners the dollar dropped in value, from 4.5% against the euro to 1.1% against the Korean won.

The strength of the dollar against the euro overstates the value of Europe's currency, however. It has been somewhat of a mystery how a currency whose existence has repeatedly been called in question could be worth 4% more than it was prior to the crisis. The answer is that QE-induced dollar weakness has flattered the euro's value. Against other currencies, notably the safe-haven Swiss franc, the euro is worth substantially was before the crisis (see Exhibit 14). With the Federal Reserve now slowing the printing press, there should be less pressure on the dollar and, in fact, it should strengthen against the currencies of most of our trading partners as funds flow back to the U.S. and growth outpaces that of most other countries.

### Exhibit 14: Euro exchange rates




Last data: 1/31/2014. Sources: Bloomberg and TIAA-CREF Asset Management.

## Conclusion

More than six years after the onset of the global financial crisis, investors still face a challenging and unusual financial landscape. While the impact of the mortgage market meltdown and eurozone crisis has largely subsided, the measures by central banks to address the crisis continue to have a potent effect on markets. The uncertainty about the timing and means of tapering (and eventually of unwinding) QE means that asset allocation is particularly problematic. Easy returns will be difficult to uncover. Investors will find themselves continuing to take more risk for less reward in fixed income, searching for value in equities, and increasingly exploring alternative assets to generate portfolio gains.

More than six years after the onset of the global financial crisis, investors still face a challenging and unusual financial market landscape.

**Daniel Morris, CFA**
Global Investment Strategist

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