Weekly Market Update

Markets are mixed in wake of recent weakness in U.S. data

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- U.S. equities fall shy of erasing January's losses.
- High-yield and other riskier bond sectors continue to fare better than Treasuries.
- Housing activity still reflects the negative impact of extreme winter weather.
- Despite recent weak data, the U.S. economy is poised for improving growth.
- European equities post third consecutive weekly gain.
- Chinese manufacturing declines, but markets generally take the news in stride.

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U.S. equities edged slightly lower during the President's Day-shortened trading week, attempting to look past a spate of weak housing data and other mixed economic releases, many of which continued to reflect weather-related distortions. The S&P 500 Index declined on Feb. 20 after the Federal Reserve's January meeting minutes indicated no let-up in the pace of Fed tapering or changes in forward guidance on interest rates, despite the recent softness in U.S. data. The market rebounded the next day amid some positive signals but slipped to end the week down about 0.1%. Based on MSCI indexes, foreign developed-market equities rose during the week, while emerging-market stocks posted losses.

Fixed-income markets continued to focus on the Fed and the trajectory of the U.S. economy. On balance, economic fundamentals appear to be stable or improving, even in the face of the extreme winter weather that has blanketed much of the nation. Given this generally favorable outlook, which the Fed shares, demand for safe-haven assets weakened, causing Treasury prices to fall and their yields to rise modestly.

"Spreads"—the difference between Treasury yields and those of higher-yielding, non-Treasury securities—were stable to slightly narrower in most riskier fixed-income categories, including high-yield bonds, leveraged loans, commercial mortgage-backed securities, and emerging-market debt. When spreads narrow, or tighten, this generally indicates improved economic conditions to the extent that investors are more comfortable taking on added risk without demanding a higher yield as compensation for that risk.

Financial Services

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Current market updates are available here.

Recent releases have disappointed, but U.S. economic data is poised to improve

Much of the U.S. data released in recent weeks has been mixed to negative, reflected in a sharp downturn in the Citi Economic Surprise Index. This index is a gauge of the extent to which economic data readings have diverged from consensus forecasts. (Lower index levels mean there have been more negative than positive data surprises relative to estimates.)

Housing indicators were weak across the board:

- **Homebuilder confidence** plunged in February, largely due to "unusually severe weather conditions," according to the National Association of Home Builders/Wells Fargo index
- **Housing starts** were down 16% in January, to a seasonally adjusted annual rate of 880,000, versus consensus forecast of about 945,000
- **Existing home sales** declined 5.1% in January and were at their slowest pace since July 2012

On the manufacturing front, the week's mixed data included:

- Weaker-than-expected levels of **regional manufacturing activity** as measured by the Empire State and Philly Fed indexes for February
- A positive upside surprise in the Markit "flash" (preliminary) **Purchasing Manager's Index (PMI),** which jumped to a nearly four-year high of 56.7 in February, from 53.7 in January (readings over 50 indicate expansion)

Among the week's other economic releases:

- **First-time unemployment claims** fell by 3,000 to 336,000 in the most recent week, while the four-week moving average of claims increased slightly.
- The Bloomberg **Consumer Comfort Index**, a weekly measure of consumer attitudes about the economy and personal finances, ticked up.
- The **Leading Index of Economic Indicators** published by The Conference Board rose 0.3% in January, indicating stable to stronger underlying economic conditions and a "resilient" economy for the first half of 2014

Overall, we expect to see some improvements in U.S. data as the effects of the unusually cold winter fade. Employment, housing, retail sales, and manufacturing are all areas that have been hampered by the weather and could rebound significantly in the spring.

As Europe's economy holds steady, equities gain for third consecutive week

European equities rose for the third week in a row; the MSCI Europe Index is up 5.5% for the month to date. Europe's economy is generally in a holding pattern, based on data released during the past week. Although preliminary Markit PMI readings for the eurozone as a whole were somewhat lower than expected in January, both manufacturing- and service-sector activity remained in the expansion zone above 50.

A notable laggard was France, where the manufacturing and services PMIs ticked down to 48.5 and 46.9, respectively. The weakening French economy has begun to put upward pressure on the nation's sovereign debt yields, which have widened substantially relative to Germany's. Rising yields could help intensify the French government's earnest focus on the economy. In the meantime, France's equity market looks increasingly attractive compared to Germany and has the potential to meaningfully outperform if France enacts further labor reforms.

Italy saw a change in government during the past week. Prime Minister-designate Matteo Renzi is seen as a more aggressive reformer than his predecessor Enrico Letta, and his promised focus on political and economic reforms, if enacted, could make that equity market attractive as well.

Weak Chinese data doesn't panic investors

China also released weaker data: The MNI, a lead indicator of Chinese business sentiment, dipped, while the PMI estimate published by HSBC fell to 48. Chinese equities weathered these downbeat readings reasonably well. Overall, though, Chinese activity appears to be slowing, and the central bank has moved to try and control the pace of credit use.

Outlook

Despite the past week's marginal decline, the S&P 500 Index has been incrementally working its way back up toward last month's high of 1850. We continue to believe that if US equities can move through that level, a further advance to new highs is possible this spring. If the 1850 level is not breached, it is possible that the market could fall back sharply to last October's levels, although we think this is unlikely.

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In fixed-income markets, while it is apparent that Fed tapering will continue apace, we could see the Fed begin to focus less on jobs numbers per se and more on absolute levels of inflation, which remain low. Against this backdrop, and absent any geopolitical or economic shocks, we still anticipate a relatively stable year for fixed income, with modestly positive returns.

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The information provided herein is as of February 21, 2014.

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