Weekly Market Update

U.S. equities climb as the economy appears poised to transcend weather woes

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Article Highlights

- February ends on an upbeat note, lifting U.S. stocks into positive territory for the year to date.
- Most fixed-income sectors also perform well.
- Fourth-quarter U.S. GDP growth is revised downward, but we see signs of resilience ahead.
- Europe's equity markets edge higher, while Japanese shares continue to struggle.
- Emerging markets are in rally mode for now, but more bouts of volatility may be in store.

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After three days of flirting with a new record high of 1850, the S&P 500 Index finally closed above that threshold on Thursday, February 27. The index then moved even higher the following day. Recent market behavior had been heavily influenced by weakening U.S. economic data and volatility in emerging markets, but by mid-week, some improved readings on the economy—along with Federal Reserve chair Janet Yellen's benign Senate testimony—provided a boost to equities. As the week drew to a close, the S&P 500 appeared to be headed for a nearly 5% gain in February, more than offsetting January's decline. European equities also rallied during the week, while the Japanese market continued to flounder.

It was a generally positive week for fixed-income markets. Treasury prices edged higher, pushing yields lower, although this rally faded in the wake of better-than-expected economic data released on Friday, February 28. "Spreads"—the difference between Treasury yields and those of higher-yielding, non-Treasury securities—tightened across most sectors. When spreads 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. Emerging debt markets have stabilized in recent weeks, but we continue to monitor several factors that could affect performance in these markets, including rising interest rates later in the year, a potential slowdown in China, and continued fund outflows.

Financial Services

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While recent U.S. data has been soft, forward-looking signs are more optimistic

As we noted last week, disappointing U.S. economic releases have led to a sharp drop in the Citi Economic Surprise Index from its mid-January peak. This index measures 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.)

Extreme winter weather has undoubtedly hampered growth in the past few months, but the fact remains that the U.S. economy has slowed. U.S. GDP growth for the fourth quarter of 2013 was revised downward, to 2.4% from 3.2%, although this revision was expected and did not trouble markets.

In her February 27 testimony before a U.S. Senate panel, Janet Yellen noted that it was still too early to gauge precisely how much of the economy's recent underperformance has been caused by bad weather and how much is due to an outright slowdown. Yellen added that, despite recent softness in economic data, only a "significant change" in the Fed's outlook for moderate, steady growth would cause the Fed to pause or alter its current pace of tapering.

On balance, we expect to see the economy improve going forward. This view is supported by favorable leading indicators, better consumer sentiment, and high-yield spreads that have continued to tighten. For additional perspective, see "Why the economy's winter blues won't last" by TIAA-CREF Chief Economist Tim Hopper.

European equities continue to rise despite growth and deflation concerns

European equity markets meandered for much of the past week before rising solidly on February 28. Markets were focused primarily on whether the European Central Bank (ECB) will cut interest rates at its scheduled March 6 policy meeting. Such a move has been widely anticipated as a necessary step to address the twin challenges of very low growth and possible deflation.

However, February's inflation reading, while a low 0.8%, was slightly higher than consensus expectations. This could take pressure off the ECB to lower rates for the time being. Even if the ECB does cut rates, it may not be enough to counter extremely low levels of bank lending, double-digit unemployment, a currency whose strength is unjustified by economic fundamentals, and government complacency among various member nations.

Emerging markets capture attention, with all eyes on Ukraine and China's currency

Emerging markets remained a focus of investors globally, with Ukraine, Turkey, and Brazil among the nations garnering negative headlines. Despite political and economic uncertainties, it appears that emerging-market equities are currently in rally mode, buoyed by attractive relative valuations and compelling long-run expected returns. As we have noted before, while these markets offer select opportunities, we may well see further volatility as fiscal imbalances get worked out.

Meanwhile, China remained under scrutiny as its currency, the yuan, has depreciated sharply. This is related to the Chinese government's attempt to curb foreign-exchange speculation prior to the yuan moving to a freer exchange rate. (Historically, the yuan has not been permitted to float freely against other currencies.) The yuan's recent weakening, along with poor housing data, led to a sharp price drop for the Shanghai Stock Exchange A Share Market index at mid-week, followed by a bounce.

Japan equities continue to underperform

Japanese equities appeared to be marking time during much of the past week amid uninspiring economic news. Growth recently slowed to 1% in the fourth quarter of 2013, as higher import costs from a weaker yen created a drag on trade. Moreover, current first-quarter GDP estimates may well be vulnerable to downward revision. If that occurs, it could spark additional moves by the Bank of Japan (Japan's central bank) to weaken the yen in an effort to stimulate growth. On balance, we remain leery of Japanese equities, even though a move by the Bank of Japan to weaken the yen will likely drive the market higher.

Outlook

With the S&P 500 closing at a new high above the 1850 level, we believe the path to 1900 looks clearer. Fixed-income markets appear to be in what could be termed a "sweet spot," as U.S. economic releases are weak enough to encourage continued accommodative Fed policy, yet strong enough to support strong corporate earnings growth and credit quality.