Weekly Market Update

U.S. equities advance to new highs in holiday-shortened week

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Article Highlights

- U.S. equity benchmarks set new record highs, led by higher-risk growth categories.
- Foreign developed and emerging markets also rally.
- U.S. Treasury performance suffers amid generally favorable economic news.
- June's U.S. employment report surprises on the upside, with an interesting twist.
- The U.S. economy ended the second quarter of 2014 on an upbeat note.

July 3 2014

Equities

U.S. equities continued to climb during the week, and several major indexes hit new all-time highs. While market gains were broad, investors especially favored more aggressive categories, as small-cap and growth-oriented shares outperformed value and dividend-paying sectors such as utilities and real estate investment trusts (REITs).

For the week through July 2, European equities also rose (+1.2%), helped by a softer euro, while the Japanese market (+1.7%) advanced as the yen weakened and the economy continued to show signs of resilience. Emerging markets were broadly higher (+1.5%) at mid-week, with China (+2.0%) benefiting from improving economic data. (All returns are based on MSCI indexes.) We think there is room for more upside in emerging markets, given attractive valuations.

Fixed income

Amid stronger U.S. economic reports during the week, demand for safer assets weakened, reflected in falling prices and rising yields for Treasuries. The yield on the bellwether 10-year Treasury climbed steadily from its prior-week close of 2.54% and in early July 3 trading stood at 2.68%—a two-month high. "Spread" products (higher-yielding, non-Treasury fixed-income assets) generally held

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steady, with the exception of mortgage-backed securities, which modestly underperformed due to heavy supply and profit-taking.

Current market updates are available here.

Better-than-expected employment growth claims the spotlight, but there are caveats

The U.S. economy added 288,000 jobs in June, far more than consensus estimates, and the national unemployment rate declined to 6.1%, its lowest level since September 2008. While this is certainly welcome news, 25,000 of the 288,000 total represented teachers who were still in session because of weather-related extensions to the school year—a final twist to the harsh winter's impact on economic data and a complicating factor not accounted for by the Labor Department's seasonal adjustment models. In effect, this means the June jobs report is inflated, while July's number will be muted as the 25,000 jobs are removed from the count.

Perhaps more important than June's total are the upward revisions for April and May— especially April, with revised job growth of 304,000. Monthly payroll gains for the year through June are now averaging more than 230,000, a healthy clip. However, average hourly earnings remain just 2% above year-ago levels, indicating that wage growth is still muted. In order to spark a meaningful increase in consumer demand and spending, employment growth along the current trajectory will have to translate to higher wages in the second half of the year.

Beyond the jobs report, other U.S. data released during the week included:

- **Pending home sales**, which jumped 6.1%, to their highest level in eight months.
- **Auto sales**, which surged to a much-higher-than-anticipated annualized rate of 17 million, the fastest pace since January 2006.
- **Manufacturing and service-sector activity,** which was essentially flat in June, based on Purchasing Manager Indexes (PMIs) published by Markit and the Institute for Supply Management (ISM). Despite a lack of upward movement, all of these indexes remained solidly above the 50 level that separates contraction from expansion.

Outlook

Various indicators of U.S. market sentiment suggest that equity investors, while not yet overly bullish, are moderately optimistic. A continued market climb accompanied by further optimism could set the stage for a pullback during the seasonally slow summer months. While we remain constructive on the U.S. market and believe the S&P 500 Index is still on track to rise above the 2,000 level this year, a market consolidation or correction during the summer is a possibility.

Fixed-income markets are currently assessing the degree of momentum in the economy and weighing that against Federal Reserve Chair Janet Yellen's desire for a high degree of confidence in the economic recovery before the Fed begins raising short-term interest rates. In our view, even with June's robust employment report, we would still need to see several more months of strong job gains before the Fed would consider a rate hike any earlier than the second half of 2015.

In non-U.S. bond markets, peripheral European countries such as Portugal have been raising funds with ease and at relatively narrow spreads over higher-quality German bonds. Emerging-markets debt, which returned over 9% in the first half of the year, has also benefited from strong demand, with new-issue supply still being readily absorbed. While these and other fixed-income asset classes are unlikely to replicate their strong first-half performance, we do not expect a disorderly rise in interest rates in the months ahead. Accordingly, the risks of investing in bonds and equities appear fairly well balanced.

Overall, the U.S. economy ended the second quarter of 2014 on an upbeat note and remains on track for modest improvement as we move into the third quarter. For an in-depth analysis of the U.S. and global market landscape, read the mid-year outlook prepared by TIAA-CREF's Chief Economist Tim Hopper and Global Investment Strategist Daniel Morris.

The next Weekly Market Update will be published on Friday, July 11.