Weekly Market Update

Geopolitical tensions cause a stir, but equity markets rebound

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- Conflicts in Ukraine and the Middle East dominate the week's headlines.
- U.S. Treasuries extend rally amid volatility in equities and higher-risk fixed-income assets.
- In Europe, the economy disappoints, but concern over Portugal's banking sector wanes.
- Better-than-expected Chinese economic data provides some balance to world growth.
- We have lowered our forecast for second-quarter U.S. GDP growth to 3% from 3.6%.

July 18, 2014

Equities

Major equity indexes rose through midweek before tumbling 1% or more on July 17 amid a spate of disconcerting geopolitical headlines. The sell-off reversed the next day, however, with the S&P 500 recouping much of Thursday's losses by midday on July 18. European markets grappled with disappointing economic releases, although anxiety over the Portuguese bank issue that triggered the prior week's volatility ebbed. It has become apparent that the bank's difficulties are not a sign of broader systemic problems.

Fixed income

Treasuries rallied and volatility measures surged on the uncertainty sparked by events in Ukraine and the Middle East. The yield on the bellwether 10-year Treasury fell sharply on July 17 as investors sought safe havens. In contrast, risk aversion caused yields to rise in many higher-risk fixed-income categories, particularly high-yield and emerging-market debt. By midday on July 18, the 10-year Treasury yield had begun to inch higher as markets stabilized.

Current market updates are available here.

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Global events roil the markets, but economic impact is muted for now

On July 17, a number of geopolitical shocks—the downing of a Malaysian Airlines passenger jet over Eastern Ukraine, the levying of new U.S. sanctions against Russia, and a sharp escalation of hostilities between Israel and Hamas—outweighed corporate earnings and economic data releases as a driver of market performance. Despite investors' short-term reaction to the turmoil, it is important to remember that these events are regional in nature and not closely related to broader economic trends. The longer-term picture remains one of economic fundamentals that, on balance, are improving.

U.S. economic news is mixed, with a slight negative bias

The week's mixed bag of data releases fit a familiar pattern, providing evidence of a slow U.S. recovery, hampered by stubborn pockets of inertia. In short, the economy is growing, but the quality of growth is somewhat lacking. In particular, the housing market and consumer spending have underperformed expectations since the first quarter.

- **Housing.** Housing starts slumped 9.3% in June to their lowest level in nine months, some of which may relate to extremely wet weather in the South. Building permits, a forward-looking indicator, also fell, and mortgage application volume disappointed. Summer is typically the season in which housing activity accelerates.

- **Retail sales.** In June, retail sales grew at a lower-than-expected 0.2% rate, the slowest pace in five months. Year-over-year retail sales growth also indicated softness in consumer-related activity. Adding to this lackluster picture was a July drop in the Consumer Sentiment index published by the University of Michigan and Thomson-Reuters.

On the plus side:

- **First-time unemployment claims** moved lower again, to just 302,000, while the four-week moving average of claims fell to 309,000—the best reading since June 2007.

- **Regional manufacturing indexes surged.** Both the Empire State and Philly Fed survey readings far exceeded forecasts, with both measures hitting multi-year highs in July.

Europe's economic growth wavers, although leading indicators look better

In our view, the recent market disruption caused by Portugal's Banco Espirito Santo demonstrates that the European Central Bank's asset quality reviews (known as "stress tests") are a genuine and valuable exercise in identifying and correcting European banks' balance-sheet deficiencies. A robust testing program is critical to jump-starting the region's "credit transmission mechanism," i.e., the link between easy monetary policy and bank lending that supports the real economy.

Another issue facing European markets is tepid second-quarter economic growth relative to expectations. Some leading indicators, however, suggest a better growth trajectory in the second half of the year. On balance, we find some European equity valuations, especially for banks, to be attractive. A significant caveat for the region is that the Russia/Ukraine conflict remains a wild card.

Improving Chinese economic data suggests targeted stimulus is working

China's targeted stimulus programs appear to be having a positive effect. Based on data released in the past week, China's second-quarter GDP growth came in at 7.5% year-over-year (8.1% at a seasonally adjusted annual rate, the measure we use in the U.S.). Further, lending growth has accelerated through the first half of 2014, along with consumer spending. Chinese equities have responded well and technically look attractive at current levels. We expect GDP growth in the 7%-7.5% range for the remainder of this year.

Outlook

The most recent economic releases suggest that U.S. GDP growth for the second quarter will come in weaker than originally anticipated. While the economy is expanding, there have been enough negative data surprises to warrant a revision to our outlook. We have therefore reduced our second-quarter GDP growth forecast to 3% from 3.6%.

For U.S. equities, we think trend may still be higher, in part because second-quarter earnings have so far been better than expected while sentiment has become much more cautious. That said, further advances will likely be accompanied by more volatility. We also caution that the S&P 500 has reached key intermediate target levels and is at or above fair value. Against this backdrop, a summer correction or another bout of "de-risking" remains probable.

Fixed-income markets have been focused on geopolitical risks, while tending to ignore signs of economic strength that could drive up U.S. interest rates in coming months. While we expect higher U.S. rates by year-end, the magnitude of the potential increase appears to be waning, as the rate differential versus European and other government holdings remains high by historical standards. This may drive global capital flows toward the U.S. market, providing support for Treasuries.