Weekly Market Update

Equity markets look to stabilize after end-of-July selloff

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Article Highlights

- Fear of the Fed's tightening timeframe drives U.S. and global stock markets lower.
- Ongoing geopolitical tensions and a default by Argentina add to the sense of market unease.
- Despite some volatility, U.S. Treasury yields end the week essentially unchanged.
- U.S. GDP growth surprises to the upside, putting the economy back on track.
- July's employment report offers more signs of optimism for the labor markets.

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Equities

U.S. equities sold off late in the week, with the S&P 500 Index down 2% on July 31 to finish the month with a 1.4% loss. The sharp downturn occurred as investors, particularly hedge funds, rushed to "de-risk" portfolios following the July 30 release of the Federal Reserve's July meeting minutes that some interpreted as hawkish (i.e., implying a sooner-than-anticipated Fed rate hike).

Also weighing on the U.S. market were Argentina's credit default, ongoing Middle East violence, and the Ukraine conflict—including the potential impact of new sanctions against Russia and the subsequent selloff in European equities. Most stock markets added to the week's losses in Friday trading, getting August off to a rocky start.

Fixed income

U.S. Treasury yields were volatile but ended the week about where they began. The yield on the bellwether 10-year Treasury note spiked 10 basis points on July 30 in the wake of the Fed's meeting minutes and better-than-expected U.S. GDP growth. At the same time, a stronger U.S. dollar versus major currencies encouraged global flows into Treasuries, likely muting what otherwise would have been a steeper rise in yields.

Performance of "spread products" (lower-rated, higher-yielding non-Treasury securities) was generally flat to slightly negative, with high-yield credits

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underperforming the most as investors took profits and retail outflows continued. Emerging-markets debt fared somewhat better: inflows remained positive and geopolitical events, though worrisome, appeared to be contained.

Current market updates are available here. For additional insights into the week's events from TIAA-CREF Global Investment Strategist Dan Morris, view the Weekly Market Perspective Video.

Deluge of U.S. data shows the economy is essentially back on track

A heavy week of data releases was highlighted by a surprisingly strong GDP reading for the second quarter and a July employment report that was modestly below expectations but nonetheless offered reasons for optimism.

- **U.S. GDP** grew by 4% in the second quarter, according to the government's advance estimate. First-quarter growth, while still negative, was revised upward, to -2.1% (from -2.9% previously). The GDP report puts the economy back on track, but at a pace that is no better or worse than its average growth rate in 2013. Excluding a sharp increase in business inventory spending, the economy grew at a 2.3% annual rate in the second quarter—essentially where it was before the first quarter's weather-driven contraction.

- **U.S. monthly payrolls** rose by 209,000 in July, the sixth consecutive month in which job gains exceeded 200,000. The unemployment rate ticked up slightly, from 6.1% to 6.2%, but this reflected an increase in the number of people entering the work force—a positive sign.

- **First-time unemployment claims** climbed to 302,000 but remained near post-recession lows. Meanwhile, the previous week's figure was revised downward to 279,000, the lowest level in 14 years.

- Gauges of **consumer optimism** were mixed. The Conference Board's Consumer Confidence Index rose to a seven-year high in July, while the Thomson Reuters-University of Michigan Consumer Sentiment Index retreated slightly from June's reading.

Meanwhile, housing again proved to be a weak link:

- **Pending home sales** fell 1.1% in June and were 7.3% below their year-ago level.

- **Home prices** dipped 0.3% in May, according to the S&P Case-Shiller 20-City Composite Index.

Overall, housing was responsible for 0.2% of second-quarter GDP growth, when it should be contributing closer to 0.5%. Given muted home-price appreciation and levels of activity, we expect housing to remain a relative underperformer for the rest of the year.

Europe presents challenges—and buying opportunities

In Europe, earnings have disappointed and inflation expectations remain weak. Anxiety over the potential impact of new U.S. and European sanctions against Russia during the past week added to the stress, driving the region's equity markets sharply lower. That said, on balance we think the recent correction is a buying opportunity.

In fixed-income markets, spreads on European sovereign debt widened slightly, partly on concerns about continuing financial challenges at one of Portugal's largest banks. However, the relatively minor widening indicated that the risk of a systemic problem for eurozone banks remains low. Additionally, the region's low-inflation outlook continues to create steady demand for sovereign debt.

Outlook

The U.S. economy has improved, but we think the improvement is less than that implied by the 4% headline GDP growth rate. For now we are maintaining our growth forecasts of 3.2% and 3.5% for the third and fourth quarters, respectively, as labor and production metrics continue on their stable growth path. Moreover, despite the markets' anxiety over Fed policy, there is nothing in the most recent economic data to suggest that the Fed will move to raise short-term interest rates before the second half of 2015.

Recent apprehension in the equity market is based partly on prior instances of Fed tightening. In 1994 and 2004, the 2-year Treasury yield spiked 150 to 300 basis points as the Fed moved to raise short-term interest rates, and U.S. equities subsequently corrected by up to 10%. We are not yet convinced that a repeat of this pattern is imminent. In fact, it would not surprise us to see the S&P 500 rebound from here before correcting from a level above 2,000. Even then, we believe such a correction would offer buying opportunities into year-end.

In fixed-income markets, given the prospect of modestly higher Treasury yields and wider spreads in the second half of 2014, we maintain our view that most gains for U.S. bonds were realized in the first half of the year. In addition, we continue to believe that current risks to bonds are primarily price-related and not a reflection of fundamental problems. Defaults remain low, and shareholder-friendly events (such as mergers and acquisitions) that can harm bondholder value have been relatively contained compared to similar points in past recoveries. Accordingly, we continue to keep a close watch on flows, sentiment, and the direction of interest rates.

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