Weekly Market Update

U.S. equities endure another volatile week

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Article Highlights

- Geopolitical concerns fuel a flight to safety, benefiting U.S. Treasuries and other fixed-income assets.
- In equity markets, sector rotations suggest recent volatility is not simply a broad "risk off" trade.
- The U.S. economy continues to improve, while European data releases disappoint.
- Amid consistently strong employment indicators, we now project 4.3% U.S. GDP growth in 2Q.
- China's stronger-than-expected export growth provides a lift to Chinese equity markets.

August 8, 2014

Equities

U.S. and international equities remained volatile during the past week. Markets continued to grapple with fear of accelerated monetary tightening by the Fed, weak economic data out of Europe, escalating tensions in Ukraine and Iraq, and the potential spread of the Ebola virus. Although the S&P 500 Index was down 0.75% for the week through August 7, it began staging a solid comeback on August 8. Non-U.S. markets underperformed, particularly in Europe, where the Ukraine crisis hits closest to home. Emerging-market equities, while negative, held up better than their developed-market counterparts.

Favorable economic data and better-than-expected earnings releases were among the positive factors tempering U.S. stock price declines. More than 75% of S&P 500 companies that have reported second-quarter results so far have beaten estimates (typically, the percentage is 60%). Earnings growth has averaged 10% for the quarter, versus original estimates of 5%.

Fixed income

U.S. Treasuries rallied and credit spreads (the difference between yields on Treasuries and yields on lower-rated, higher-yielding securities) widened. Ongoing geopolitical concerns dominated fixed-income markets, while several

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positive U.S. economic releases were largely ignored. A broad flight to quality was evident as fund flows turned negative across non-Treasury fixed-income sectors.

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.

Another week of strong U.S. economic data

The U.S. economy continues to improve, highlighted in the past week by a number of positive data releases:

- **First-time unemployment claims** dipped below 300,000, to 289,000, while the less volatile four-week moving average fell to 293,500. Steady improvement in this series indicates a labor market that is returning to normal and an economy that should continue to accelerate.
- The index of **non-manufacturing activity** published by the Institute for Supply Management came in at a robust 58.7 for July, well above consensus expectations. (Readings above 50 indicate expansion.) This is a sign that demand for goods and labor should strengthen.
- **Factory orders** climbed a better-than-expected 1.1% in June on a seasonally adjusted basis, beating expectations.

Europe's recent negative surprises do not alter our longer-term outlook

Softer manufacturing data for Europe, a decline in German factory orders, and Italy's slide into recession (-0.8% GDP growth in the second quarter) have contributed to a negative tone in the region. Corporate earnings releases have also disappointed, with only about half of European companies beating expectations, while forward guidance has been poor. Apprehension over Ukraine and the potential impact of U.S. and European sanctions and Russian counter-sanctions continue to weigh on markets.

Nonetheless, we have not changed our expectation for 1% GDP growth across Europe for 2014, and we expect conditions to stabilize as the year progresses. The primary risk to this forecast is the Russia-Ukraine standoff. Tit-for-tat sanctions could slow growth across the continent, and a severe or protracted trade war could push the entire region into recession. That said, there is still time for cooler heads to prevail, and most sanctions thus far have been moderate. Moreover, we continue to believe that if the eurozone economy were to slip further, the European Central Bank would initiate some form of quantitative easing to jolt the region out of its economic doldrums. That would likely trigger a sharp rise in European equities.

China improves, while Japan loses ground

In China, a July surge in export growth and an unexpected drop in imports helped the Shanghai market close the week on a high note after a three-day losing streak. In contrast, Japanese equities sold off to end the week. Exporters led the decline, as the yen—typically seen as a safe-haven currency—strengthened in response to geopolitical events. (A stronger yen makes Japanese products more expensive in overseas markets, hurting exporters.)

Outlook

Falling unemployment claims and stronger monthly job growth set the stage for further gains in employment, wage earnings, and the labor participation rate in the second half of 2014. As more people re-enter the workforce, the unemployment rate will continue to tick up or move sideways, but this only signifies broadening gains and should be viewed as positive. Overall, our estimate for second-quarter GDP growth has increased to 4.3%, while expectations for the third quarter remain at 3.2%.

We have been encouraged by the general resilience of the U.S. equity market. Recent volatility has not been driven solely by broad-based risk aversion to macroeconomic and geopolitical events—although that certainly is a factor. Instead, we have seen small caps beginning to outpace large caps, as well as rotations out of sectors that have outperformed during the Fed's long period of quantitative easing. For example, higher-yielding sectors such as Utilities have recently sold off more than others, which is unusual in a declining market.

Historically, stock prices have corrected five months in advance of the Fed's first move to raise interest rates. While the simple onset of tightening does not automatically lead to the end of a bull market, volatility does rise, and the subsequent rate increases eventually lead to the end of the cycle—hence, the market's fixation on the timing of that first rate hike. We continue to believe that the Fed will not begin raising rates until mid to late 2015.

In fixed-income markets, the general dislike of uncertainty is currently in play, as the varying potential outcomes of current geopolitical events remain unknown. Many institutional fixed-income fund managers have been inclined to realize their year-to-date gains and to sit on the sidelines until there is further clarity. In this environment, we have seen high-yield spreads widen, exacerbated by limited summertime liquidity. We believe spreads are poised to widen further but that at least a partial recovery is likely later in the year.