Weekly Market Update

Equity markets temper weekly gain on heightened Ukraine fears

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Article Highlights

- Equity markets waver as the Russia-Ukraine conflict heats up.
- U.S. Treasuries rally and fund flows turn positive for high-yield bonds.
- Despite mixed data releases, the U.S. economy continues to improve.
- The current environment in Europe reinforces the prospects for more monetary stimulus.
- Both Europe and Japan are likely to rebound from poor second-quarter GDP growth.

August 15, 2014

Equities

U.S. equity markets moved higher for most of the past week before turning volatile on August 15 in response to disconcerting headlines out of Ukraine. Importantly, small-cap stocks—which sold off in July as investors sought to “de-risk” their portfolios—continued their recovery. Small caps led both large caps and the broader S&P 500 Index for the month to date through August 14.

European equities, which had generally risen during the week, also reversed course on August 15, finishing the week with a loss. Although geopolitical events have cast a pall over sentiment, U.S. equities have proven resilient. Earnings have improved, and economic data, on balance, indicates a U.S. economy that is still on track.

Fixed income

Amid mixed economic data, U.S. Treasuries rallied strongly beginning at midweek, with prices rising and yields falling. News of a military engagement in Ukraine drove a flight to safety that pushed Treasury yields even lower as the week came to a close. The yield on the bellwether 10-year note was down by as much as 9 basis points on August 15, touching 2.31% in midday trading. High-yield bond spreads narrowed during the week, underscoring our belief that July’s spread widening was driven by investor de-risking rather than an imminent economic slowdown. In addition, flows turned positive for high-yield funds, indicating a possible improvement in coming weeks.

Financial Services

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Weaker-than-expected GDP data out of Europe fueled a rally in European sovereign bonds, with the yield on the German 10-year security closing below 1% for the first time. The differential between U.S. and European rates will likely drive additional fund flows into Treasuries, putting more downward pressure on U.S. yields. Meanwhile, lower global rates have been supportive of emerging-markets debt.

Current market updates are available here.

The U.S. economy is still on track

U.S. data releases were mixed, but there was nothing to indicate a change in direction for the economy.

- **Labor market conditions continued to improve.** The employment component of the NFIB small-business optimism index strengthened in July, and job openings as reported by the U.S. Labor Department rose in June to their highest level since 2001. Although weekly first-time unemployment claims ticked up marginally, employment indicators remain consistent with monthly job creation well in excess of 200,000.

- **Retail sales disappointed,** coming in flat (+0.1% excluding autos) for the month of July. This data series has been volatile in 2014, and we do not place too much emphasis on a single month's reading. However, if weak results continue, we would become concerned about the implications for third-quarter growth.

- **Consumer sentiment declined.** The University of Michigan-Thomson Reuters index of consumer sentiment fell in August to its lowest level since last November. Stock market volatility and international worries outweighed positive jobs growth and lower prices at the gas pump.

For additional economic insights from TIAA-CREF Chief Economist Tim Hopper, view the Weekly Market Perspective Video.

Despite Ukraine worries and poor GDP data, Europe has scope for improvement

Eurozone markets have been volatile due to the Russia-Ukraine situation, which has triggered sanctions and counter-sanctions that are having some impact on trade and sentiment. Second-quarter GDP growth rates for Germany and France were announced during the week and surprised to the downside, coming in at -0.6% and +0.1% respectively. These readings were not entirely unexpected, given recent lackluster Purchasing Manager Indexes (PMIs), industrial production, and sentiment survey data.

In our view, the current environment only reinforces the bias toward monetary easing in Europe. Although the European Central Bank (ECB) held rates steady at its August 7 meeting, ECB President Mario Draghi reiterated a commitment to "using unconventional instruments within its mandate, should it become necessary." Moreover, we anticipate that the U.S. economy will help bolster Europe's growth prospects in the second half of 2014, as gathering momentum stateside provides a lift to European exporters. Also helping will be the effect of lower oil prices and a

weaker euro. We are maintaining our forecast of 0.9% GDP growth for Europe this year.

Japanese growth should resume following a negative second quarter

Japan's -6.8% GDP growth in the second quarter was expected and entirely related to the April 1 sales tax increase that pulled spending activity forward into the first quarter. Some Japanese officials noted that there could be a delay in the implementation of a second consumption tax increase scheduled for October 2015. In the meantime, business spending on capital goods, business investment and wages are all growing, while sentiment indexes are holding up and hiring is on the rise. We expect to see Japanese growth rebound in the second half of the year, to the 2.5%-3% range.

Outlook

In the U.S., Federal Reserve Chair Janet Yellen is expected to maintain a dovish tone in her upcoming comments at the Fed's annual Jackson Hole, Wyoming summit. While we remain confident about the U.S. economy's growth trajectory and believe that long-term rates will rise this year, the increase in rates will likely be moderate, with the 10-year Treasury yield potentially staying below 3%.

We continue to believe that the S&P 500 Index can move higher, perhaps to a level above 2,000, before having to contend with a potential correction of up to 10%. Attempting to forecast the effect of a deepening crisis in Ukraine is difficult at best, although equities would likely be susceptible to correction in the event of Russian escalation. Despite the August 15 flare-up, however, we think the odds still favor a period of reduced tensions and no widening of the conflict, particularly given the economic pain that is being felt. If this view is correct, then Europe's recent growth slowdown will recede in the rear-view mirror, and European equities may again begin to deliver favorable results.

Financial Services

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