Weekly Market Update

European monetary policy and U.S. jobs dominate the week's market landscape

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Article Highlights

- U.S. equities are volatile amid shifting dynamics and a downside surprise in employment growth.
- Mixed performance in bond markets reflects varying economic, geopolitical and policy headlines.
- August's weak job report should be taken as an anomaly, and we expect an upward revision.
- ECB interest rate cuts and expanded monetary stimulus prompt a rally in European stocks.
- We are maintaining our forecast of 3.4% U.S. GDP growth in the third quarter.

September 5, 2014

Equities

U.S. equities started the new month in decidedly mixed fashion. The S&P 500 Index alternately inched higher and edged lower before finishing at a new record high to end the holiday-shortened Labor Day week. Apprehension over the extended nature of the market's run, along with worries that the Federal Reserve might accelerate its rate-tightening schedule, took a toll. On the morning of September 5, equities initially trended lower in response to a weak August jobs report but regained footing at midday, perhaps in hopes that the disappointing employment numbers might forestall an early Fed rate hike.

In Europe, interest-rate cuts and new monetary stimulus measures unveiled by European Central Bank (ECB) President Mario Draghi on September 4 prompted a sharp drop in the euro, lower government bond yields and a strong stock market rally. Japanese equities were propelled higher thanks to a weaker yen that fell below ¥105 to the dollar. In China, better-than-expected Purchasing Managers' Index (PMI) readings contributed to a rise in the Shanghai Stock Exchange "A" Share Index. Other emerging equity markets generally rose as well.

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Fixed income

Treasury prices fell during the week, and yields rose, on mostly positive economic releases, a modest decline in geopolitical tensions and the ECB's stimulus announcement. The yield on the bellwether 10-year note stood at 2.46% in afternoon trading on September 5, up from the previous week's closing level of 2.35%.

Performance was slightly negative for most "spread" products (higher-yielding, lower-rated non-Treasury securities), as heavy new issuance of high-yield and investment-grade corporate bonds weighed on the markets. Agency-backed mortgages, however, outperformed on confidence that market volatility (and mortgage prepayments) will remain low; lack of new origination supply also bolstered this high-quality sector. In emerging markets, local currency debt was boosted by the prospect of enhanced liquidity stemming from the ECB's expanded easing policies. Investment-grade bonds continued to enjoy strong positive fund flows, outpacing high-yield flows.

Current market updates are available here.

For additional insights on market developments from TIAA-CREF Global Investment Strategist Dan Morris, view the Weekly Market Perspective Video.

August payrolls aside, other U.S. indicators point to stronger growth

According to the Labor Department, the U.S. economy added only 142,000 jobs in August, far below consensus forecasts and the lowest monthly total since last December. We are skeptical of the August report, as it does not align with any other data points released this month. Moreover, we expect to see an upward revision next month. We also believe the Fed will not alter the path or timing of its interest-rate policy based on the August figure. There is too much other corroborating evidence that economic growth is accelerating, including the following releases from the past week:

- **Manufacturing** grew robustly in August, with the Markit PMI rising to 57.9, from 55.8 in July. (Readings above 50 indicate expansion.) A similar manufacturing index published by the Institute for Supply Management (ISM) rose to 59—its best reading since March 2011.
- **Service-sector activity** also expanded in August, based on both the Markit non-manufacturing PMI and the ISM non-manufacturing index, which reached 59.5 and 59.6 (a multi-year high), respectively.
- **Construction spending** increased 1.8% in July, after an upward revision to June's result. Manufacturing and power-related construction saw the largest gains, supporting the thesis that capital expenditures are expanding at a faster pace as we move forward.
- **Vehicle sales** surged to a seasonally adjusted annual rate of 17.53 million in August, a nine-year high.

- **The U.S. trade deficit** narrowed in July, with relative strength on the export side supporting the thesis that global growth is somewhat stronger than markets currently believe.

Aggressive ECB monetary easing stops short of quantitative easing

ECB President Mario Draghi followed up on his recent "dovish" Jackson Hole speech by pulling the trigger on new monetary stimulus policies: cutting the ECB's policy rates by 10 basis points (0.10%) to spur lending, and broadening the central bank's asset purchases to include asset-backed securities, mortgage-backed securities and covered bonds (high-quality debt instruments backed by cash flows from a pool of mortgages or public-sector loans).

These measures, while substantive, stopped short of full-blown quantitative easing, which would likely involve ECB purchases of eurozone sovereign debt in the secondary market. (By charter, the ECB is prohibited from purchasing sovereign debt directly from issuing countries.) In announcing the new policies, Draghi clearly conveyed his intent to increase the size of the ECB balance sheet going forward, stating that near-term inflation continues to deteriorate and economic activity remains muted.

Outlook

Notwithstanding the August jobs report, U.S. data releases for the month have been consistent with a GDP growth rate well north of 3.5%. However, we will wait for further evidence of stronger expansion before raising our third-quarter growth forecast above 3.4%.

Some of the recent equity market volatility reflects a transition from low growth, maximum liquidity and low interest rates to higher growth, less liquidity and higher interest rates. This process actually started last year with the "taper tantrum," later echoed in the spring of 2014 as high-momentum stocks sold off, first in the U.S. and then in Europe. While we expect volatility to rise from here, we believe the U.S. market is likely to continue its upward climb.

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In fixed-income markets, credit fundamentals are strong for both high-yield and investment-grade debt, with default trends stable and U.S. economic conditions supportive of relatively good performance into year-end. We believe that, in general, higher-risk fixed income categories are currently priced fairly but offer little potential for price appreciation. Overall, equities currently appear to be a better value than debt, although for most investors an appropriate level of fixed-income exposure remains an ongoing need for diversification purposes.