Weekly Market Update

U.S. equity markets climb on Fed's supportive tone

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Article Highlights

- The Fed's continued low-rate pledge spurs the S&P 500 to a new record high.
- We remain wary of the gap between the market's and the Fed's respective views on the likely pace of monetary tightening.
- European equities breathe a sigh of relief as Scotland votes "no" on independence.
- Following lukewarm demand for its new low-cost lending program, the ECB may be pushed closer to quantitative easing.
- China's slowing growth prompts more central bank stimulus.

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Equities

Equity markets rallied during the past week, spurred on by the Federal Reserve's assurances that interest rates would stay low "for a considerable time" after the projected end of the Fed's bond- buying program next month. The S&P 500 Index reached a new record high, gaining approximately 1.5% for the week.

Scotland's decision to remain in the United Kingdom, coupled with prospects for additional monetary easing by the European Central Bank (ECB), provided a lift to European equities. In Japan, the Nikkei 225 Index climbed to its highest level since late 2007 as the yen fell to a multi-year low against the dollar.

Current market updates are available here. For additional TIAA-CREF insights on market developments, view our Weekly Market Perspective Video.

Fixed Income

Fixed-income markets were relatively muted. U.S. Treasury yields generally traded within a narrow range amid the Fed's continued supportive tone and mixed economic data. Based on Barclays indexes, returns for "spread products" (higher-yielding, lower-rated non-Treasury securities) were flat to slightly negative for the week through September 18. Positive fund flows continued to support investment-grade corporate bonds, while outflows weighed on high-yield corporate debt.

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Uncertainty leading up to the Scottish referendum hurt emerging debt markets, which rely heavily on European investment flows. These markets feared potential long-term disruptions in those flows if a "yes" vote in Scotland were to lead to further secessionist sentiment and instability in Europe. Lower-quality, higher-risk emerging-market bonds fell the most during the week but began recovering following the "no" outcome.

Takeaways from the Fed's meeting are supportive of markets, but there is a caveat

Despite a great deal of market trepidation ahead of the Federal Reserve's Open Market Committee meeting on September 17, the meeting's outcome turned out better than investors had expected. Markets had feared a more "hawkish" turn in the Fed's policy statement, bracing for language suggesting a sooner-than-expected hike in short-term interest rates after the Fed concludes its asset purchases in October. The Fed, however, renewed its pledge to keep rates low, and the first rate hike is still not likely until June 2015. Additionally, the press release included a reference to inflation running below the Fed's 2% target, providing additional support for continued accommodative monetary policy.

Of concern, though, were the Fed's projections of the pace of its inevitable rate increases, which are more rapid than market expectations. The risk is that the gap between the market's and the Fed's respective views on the speed of monetary tightening could lead to a repeat of last summer's "taper tantrum" if U.S. economic growth exceeds expectations. That could result in a sharp rise in Treasury yields as the market rushes to close the gap, potentially leading to a period of destabilizing volatility.

Europe's attractive equity market would benefit from eventual ECB quantitative easing

On September 18, the ECB announced that eurozone banks had tapped the region's new targeted longer-term refinancing operations (TLTRO)—a source of inexpensive loans—for only €82.6 billion euros ($106.9 billion), far less than forecast. Market reaction to this tepid demand was favorable, though, because it raises expectations that the ECB may be forced to implement outright quantitative easing (QE) in order to increase liquidity and bolster growth. The possibility of eventual QE led to further weakening of the euro, helping European exporters and increasing the allure of the region's stocks.

We view Europe as an especially promising destination for equity investing. Corporate profit margins are well below their 2007 peaks, leaving ample room for expansion. European shares are trading at steep (20% to 25%) discounts to normalized levels, and 60% of European stocks offer dividend yields greater than those of their companies' corporate bonds.

China's slowing growth prompts more central bank stimulus

China's central bank injected more than $80 billion into the Chinese banking system this week, a sign the economy is indeed slowing more than expected. China has been buffeted recently by a slowdown in its real estate market, industrial production, exports and even consumer spending. While the central bank has used targeted lending tactics to provide stimulus to certain sectors of the economy, these actions have not stemmed the slowdown in aggregate activity, and most forecasters are now lowering their 2014 expectations. We are keeping our forecast for 2014 Chinese GDP growth at 7.3%, which is now roughly in line with market consensus.

Outlook

Markets may already be adjusting to the improving U.S. economy, as yields on the 2-year and 10-year Treasury notes have moved steadily higher from their August lows. Looking to year end, we believe the 10-year yield will rise but is likely to remain below 3%. Its climb should be limited by stronger demand from non-U.S. investors seeking higher yields and a strengthening currency, given benign U.S. inflation and low-yielding options in Europe and Japan.

We expect investment-grade corporate bonds to perform well as rates rise, underpinned by low default levels and little risk from mergers and acquisitions activity. For the remainder of the year, our fixed-income focus will be on the degree of the slowdown in the Chinese economy, any sharp economic surprises (up or down) in the U.S., and inflation forecasts in Europe.