Weekly Market Update

U.S. equity markets endure a turbulent ride

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Article Highlights

- The S&P 500 rallies back from a sharp selloff but can't erase the week's losses.
- U.S. Treasuries benefit from risk aversion in fixed-income markets.
- Increased business spending lifts U.S. GDP growth rate to a post-recession high.
- The dollar continues its upward climb, a trend we see continuing.
- Despite recent volatility, we expect the S&P 500 to reach higher target levels by year-end.

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For much of the past week, September lived up to its reputation as being the worst month for stocks. The S&P 500 Index posted sizable losses in three out of five trading sessions, with a nearly 2% drop on September 25 — its largest one-day decline in almost two months. (For the month through September 25, the index returned -1.75%, underperforming its long-term September average of approximately -1%.) The market rebounded sharply the next day, but not enough to erase the week's earlier losses.

European equities were also volatile during the week, finishing in modestly negative territory. In local currency terms, markets in Europe have recently outperformed the U.S., but a softer euro has trimmed those gains when translated into dollar terms. The situation is similar with Japanese equities, given the yen's slide to a multi-year low against the dollar.

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

Fixed Income

U.S. Treasuries rallied modestly amid equity weakness. During the September 25 stock market selloff, the yield on the bellwether 10-year Treasury note dipped from 2.57% to 2.52%. (Bond prices and yields move in opposite directions.) Based on Barclays indexes, most "spread products" (higher-yielding, lower-rated non-Treasury securities) underperformed Treasuries for the week through September 25, as investors grew more risk-averse. In emerging markets, local currency debt performed poorly during the week, as the U.S. dollar continued rallying on the relative strength of the U.S. economy and the accompanying anticipated rise in U.S. interest rates.

Final estimate of second-quarter U.S. GDP growth signals an improving economy

According to the U.S. Commerce Department's third and final estimate, the U.S. economy grew at an annual rate of 4.6% in the second quarter, up from prior estimates of 4.0% and 4.2%. Increased business spending was a major reason for the upward revision.

Other positive data released during the week included:

- **Manufacturing activity,** though unchanged in September, remained at a 52-month high, based on the 57.9 "flash" (preliminary) reading of the Markit Purchasing Managers Index. (Readings above 50 indicate expansion.) Additionally, durable goods orders rose 0.7% (excluding the volatile transportation sector) in August, while orders for "core" capital goods increased 0.6%. We believe these signals of rising business investment will help bolster third-quarter growth and support the U.S. labor market.

- **First-time unemployment claims** ticked up, but by less than most forecasts, and remained near an eight-year low.

- **Consumer sentiment,** as measured by the final September reading of the University of Michigan-Thomson Reuters index, stayed at its highest level in over a year.

Housing data, however, was mixed. New home sales rose modestly and home prices continued to edge higher, while existing home sales dropped. This activity level is in line with our expectation that housing will slowly improve for the remainder of this year and possibly next, providing support—but not a significant tailwind—for the broader economy.

Outlook

On balance, the U.S. economy keeps moving in the right direction. It looks increasingly like the advance estimate of third-quarter GDP growth will come in close to our estimate, in the range of 3.1% to 3.5%. An area of particular interest is the strength of the U.S. dollar. Much of the dollar's recent firmness can be attributed to expectations that the central banks of Europe and Japan will be easing monetary policy as the Fed tightens at home. A successive round of Fed speeches and meeting minutes have reinforced the reality of coming interest-rate hikes, reflected in currency flows toward the U.S. We expect the trend of dollar strengthening to continue in the near term.

In equity markets, theories abound to explain September's historically subpar equity performance. In our view, the month is treacherous primarily because many companies must "true up," or reconcile, their full year's earnings compared to previous forecasts. This year, other reasons include optimistic short-term trading sentiment, the strengthening dollar, falling commodity prices, the end of the Fed's asset purchases in October, apprehension about the pace of eventual Fed tightening, and a downward turn in inflation expectations and direct measures of economic growth.

Given this year's surge in equity market indexes to successive new highs, the latest retrenchment and bouts of volatility are not surprising. We could see another small correction (1%-3%) in the S&P 500 before it regains its footing and reaches higher levels prior to year-end. It's unclear which sectors would lead that advance, however. For most of 2014, the S&P has been driven by defensive groups like Telecommunications, Utilities, and Consumer Staples, while small caps and cyclical shares have lagged in anticipation of sluggish economic growth and wariness of Fed tightening. This trend could potentially reverse into 2015 as apprehension of the Fed begins to ebb and if we see a normalization of economic growth to more self-sustaining levels.

In fixed-income markets, we believe rising rates will accompany elevated levels of volatility, presenting opportunities for outperformance as specific bonds and bond sectors become less correlated. Increasing dollar strength makes exports to the U.S. more attractive, benefiting the global economy overall, while making U.S. exports less affordable. This could slow the U.S. expansion enough for the Fed to raise rates more gradually than it might care to. We continue to believe that a disorderly increase in rates is unlikely, which would mean better opportunities to add exposure to fixed income during the fourth quarter.