October 2014

TIAA-CREF Asset Management

4th Quarter 2014 Investment Outlook: Turning Point

Executive summary

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- The long-anticipated transition to a post-QE world may have finally begun; many trades that benefited previously from the Fed's policies are likely to see poorer returns over the next year
- A steady U.S. recovery still argues for ongoing gains in equity markets, but relative performance may be better internationally
- Rising U.S. interest rates and dollar favor domestic-oriented sectors in the U.S. and exporters abroad; emerging markets, however, may face a bumpy adjustment
- Geopolitical events will occasionally provide support to core fixed-income, but interest rates should march higher over the next year

Asset class preferences

Equities ↑
Large Cap ↑
Mid Cap ↓
Small Cap ↓
Growth ↓
Value ↑
Developed Markets ↓
United States* ↓
Europe* ↑
Japan ↑
Emerging Markets ↑
Cyclical Sectors[1] ↑

Fixed Income ↓
Government Debt ↓
United States ↓
Eurozone ↑
Core[2] ↓
Periphery[3] ↑
Treasury Inflation-Protected Securities (TIPS) ↓
Munis ↑
Corporate (IG) ↑
Residential Mortgage-Backed Securities (RMBS) ↑
High Yield ↑
Emerging Markets ↑

Data as of 9/30/2014. * = change in rating. ↑ = overweight; ↓ = underweight. [1] Energy, Materials, Industrials, Consumer Discretionary, Financials, Information Technology. [2] Core = Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands, Slovakia. [3] Periphery = Cyprus, Ireland, Italy, Malta, Slovenia, Spain. Please note the forecasts above concern asset classes only, and do not reflect the experience of any product or service offered by TIAA-CREF. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, political and economic developments. Past performance is not an indicator of future results.

TIAA CREF
Financial Services

Global asset returns

	Market Value ($tr)	Relative P/E (%)*	Dividend Yield (%)	Total Return (%) 3Q 2014	Year to Date	Last 12 Months Local	Last 12 Months USD
Equities							
Global (ACWI)	$36.7	-7%	2.5%	0.9%	6.7%	15.1%	11.9%
Small/Mid Cap	12.1	2	2.0	-2.0	4.2	11.4	8.3
Growth	18.5	2	1.7	1.5	6.4	15.0	11.7
Value	18.1	6	3.3	0.3	6.9	15.3	12.1
High Dividend	9.8	4	3.9	-3.4	4.1	10.1	10.1
Developed Markets	32.7	-4	2.4	0.9	6.8	15.9	12.8
United States	18.4	7	2.0	0.9	8.2	19.3	19.3
Europe	8.6	4	3.3	-0.2	5.2	11.5	6.4
Japan	2.7	-15	1.8	5.9	3.0	12.8	0.9
Asia ex-Japan	1.6	-2	4.0	-0.9	2.7	6.0	1.5
Emerging Markets	3.9	-14	2.8	0.7	5.5	8.6	4.7
Asia	2.5	-20	2.4	0.6	5.9	9.7	9.4
Latin America	0.7	15	3.4	2.3	5.8	7.2	-0.7
Europe, Middle East, and Africa (EMEA)	0.7	-9	3.3	-0.5	4.1	6.7	-4.9

	Market Value ($tr)	Duration (years)	Yield (%)	Total Return (%) 3Q 2014	Year to Date	Last 12 Months Local	Last 12 Months USD
Bonds							
Multiverse	$46.6	6.3	2.1%	1.0%	5.2%	5.6%	1.4%
Intermediate (1–10 years)	37.3	4.4	1.8	0.5	3.7	4.1	0.2
Long (10+ years)	9.3	14.2	2.9	3.0	11.8	11.9	6.6
Government	23.5	7.0	1.3	1.5	5.3	5.4	-0.2
United States	6.1	5.3	1.5	0.3	3.1	2.3	2.3
Eurozone	6.8	6.9	1.0	2.9	10.1	11.4	4.0
Core	4.2	2.9	0.7	2.7	8.5	8.5	1.3
Periphery	2.7	3.8	1.5	3.3	12.6	16.2	8.5
Japan	6.3	8.3	0.5	0.6	2.2	2.3	-8.5
Agency	3.0	5.0	1.8	0.7	4.3	4.6	0.5
Inflation-Linked	2.3	12.4	0.0	0.9	6.5	5.0	4.8
Securitized	6.7	5.2	2.4	0.5	4.5	4.4	2.9
Corporate (Investment Grade)	7.5	6.2	2.6	0.6	5.7	6.8	4.4
High Yield	2.2	4.2	6.0	-1.7	4.3	7.8	6.5
Emerging markets	3.4	5.3	5.4	0.1	6.1	7.2	4.4

	Exchange Rate	Change (%) 3Q 2014	Year to Date	Last 12 Months
Currencies				
Euro	$1.26/€	8.4%	9.1%	7.2%
Pound	$1.62/£	5.5	2.2	-0.1
Yen	¥110/$	8.3	4.4	11.8
Canadian dollar	CAD1.12/$	4.9	5.2	8.7
Swiss franc	CHF0.96/$	7.7	7.4	5.7
Emerging market basket†	NM	5.2	3.7	4.9

ACWI = MSCI All Country World Index. IG = Investment grade. EM = Emerging markets. All returns are in local currency unless otherwise indicated. Equity categories are for the respective MSCI index. Bond categories are for the respective Barclays index, except for emerging markets, which are for Bank of America Merrill Lynch indices. *Relative P/E compares current 12-month forward P/E (price/earnings) ratio versus median value since 1987 (except Latin America since 1992, EMEA since 1997, Small/Mid Cap and High Dividend since 1999, and Japan since 2000). † Weighted average of currencies in MSCI Emerging Markets and JP Morgan GBI-EM indices. **It is not possible to invest in an index. Performance for indices does not reflect investment fees or transactions costs.** Data as of 9/30/2014. Sources: MSCI, Barclays, Bank of America Merrill Lynch and TIAA-CREF Asset Management.

United States

Economy

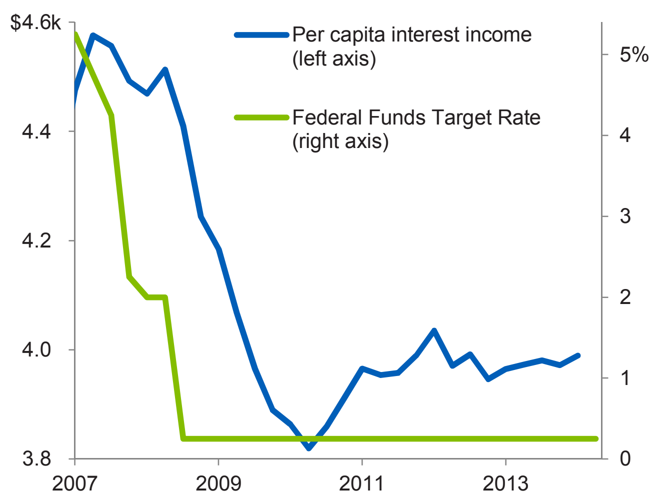
The U.S. economy continues to recover at a measured, modest pace — more like a tortoise than a hare. We forecast that by the end of the year annualized GDP growth will reach 3.5%, which seems strong compared to the 2.1% average rate since 2009, but is disappointing compared to the post-war average of 4.3%. The biggest barrier to a more vigorous economic expansion remains the consumer. Personal consumption expenditures (PCE) have grown by just 1.6% over the last four quarters, a full percentage point below historical norms. The consequences of the Great Recession and the Federal Reserve's measures to address it continue to sap demand from both debtors and creditors. Thanks to quantitative easing (QE), interest rates have been depressed and are expected to stay low "for a considerable period of time." As a result, those households with savings have seen a sharp fall in interest income, which directly translates into less consumption. In 2007, just prior to the financial crisis, annual personal interest income averaged $4,600 per person, compared to under $4,000 today (see Figure 1).

The impact of the recession on debtors has been much greater, as households devote a larger share of their income to paying down debt. Household leverage (liabilities as a percent of assets) has fallen from a peak of 20% in 2008 to 15% currently, but this is largely due to an increase in asset values rather than a fall in liabilities (which are only 4% lower). Even with this decline, the current amount of leverage is still above 2000's level. Thanks to the reduced interest rates, however, the burden of servicing this debt is as low as it's been since 1978, and credit growth has recovered. Consumer demand is nonetheless unlikely to return to long-run average rates for many years, both because households will need to continue reducing debt levels, and because rising interest rates will increase the cost of servicing that debt. The U.S. economy will consequently be hard pressed to grow at a historically average pace over the next couple of years.

Equities

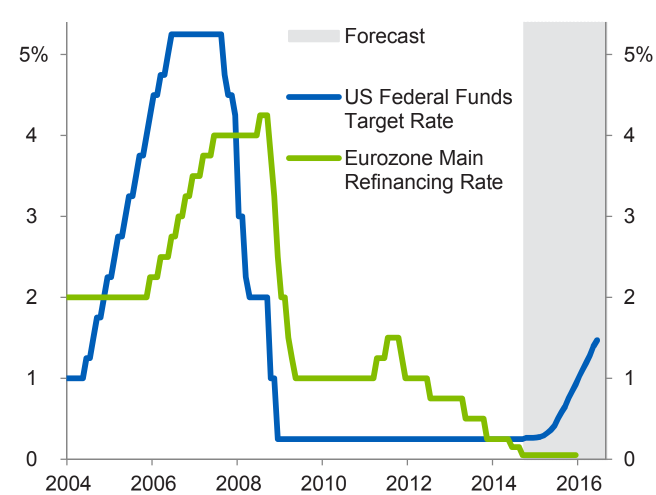
With this subdued economic outlook, one might think U.S. equities will be challenged to match the gains of recent years, and we would agree. Margins are at historical highs and — while unlikely to drop significantly before the next recession — there is little room for them to expand further. Revenue growth will roughly match nominal GDP (around 5%), which, combined with dividends and share buybacks, leads to expectations for high single-digit returns for the next several years. The biggest challenge facing the market is the impending rise in interest rates by the Fed at a time when most other central banks are maintaining or further loosening stimulative monetary policies (see Figure 2).

Figure 1: Interest income and interest rates



Data as of 9/30/2014. Sources: BEA, TIAA-CREF Asset Management.

Figure 2: Central bank policy rates



Data as of 9/30/2014. Sources: Bloomberg, TIAA-CREF Asset Management.

Nonetheless, a rise in U.S. interest rates should not pose a significant risk to medium-term equity market appreciation, though the first signals of an imminent rise are likely to lead to a selloff (the U.S. market generally corrects around four months before a rate rise by 5 to 10% and then rises). The increase in rates will be a reflection of the underlying strength of the economy, and even a forecasted federal funds rate of 1.4% by the middle of 2016 will still be well below historical norms. The only times when a tightening cycle by the Fed has resulted in sustained, negative equity market performance was when the Fed was raising rates in order to tame inflation, which is certainly not the case today.

Fixed Income

With the end of QE in October, bond yields may finally begin to move toward "normal" rates. Yields are still likely to be lower than historical averages as the long-term potential growth rate for the U.S. economy has arguably fallen, and U.S. government bonds offer a high yield compared to European and Japanese equivalents, meaning demand for U.S. bonds will remain strong. The impact on the value of fixed-income investments of rising rates is a function of the duration and the size of the change for each type; not all fixed-income yields are going to move by the same amount. If we use average yields from 2004–2006 as a benchmark for what normal rates might be, and assume yields move just halfway toward those rates from where they are today over the next year, we can estimate the price change and total return (see Figure 3).

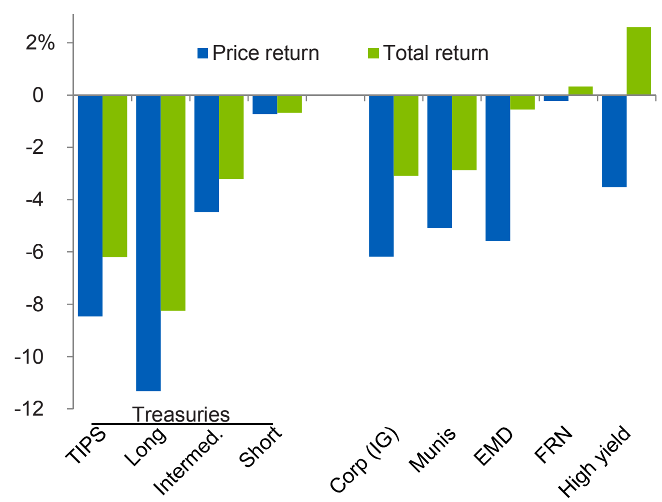
Longer-dated, high-duration assets naturally suffer the biggest price declines, but those assets with a higher current yield — such as emerging-market and high-yield debt — offer enough income to eventually post positive or only slightly negative returns after one year. As long as the economy continues to grow modestly, we do not expect a significant increase in credit risk, so spreads should not widen much. Similarly for emerging-market debt, absent a downturn or crisis in issuing countries, spreads should remain near current levels. Core holdings of U.S. government and investment-grade corporate debt will provide portfolio protection in case of unexpected market turbulence, but marginal allocations should favor higher-yielding assets.

Europe

Economy

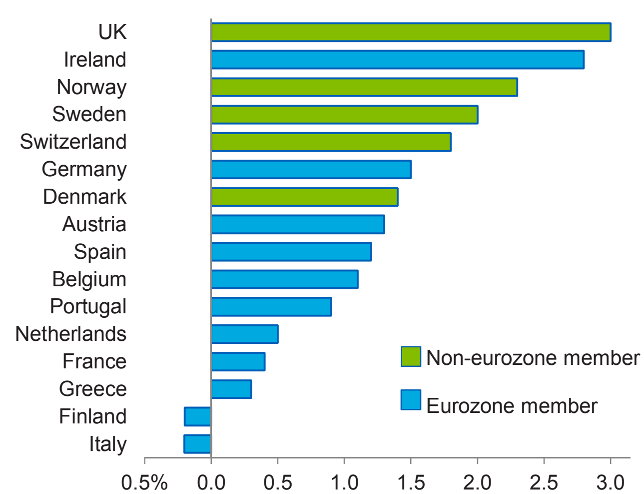
There is a divergence not only between the U.S. and Europe in monetary policy, but also in growth rates within Europe between the eurozone and the rest of the continent. Those countries with their own currencies (and interest rates) are forecasted to grow much faster than almost all the other countries in the eurozone (see Figure 4).

Figure 3: One-year fixed income returns for projected* increase in interest rates



Data as of 9/30/2014. *Assumes rates increase by half the difference between the current yield on the respective index and the average of yields from 2004–2006. TIPS = Treasury Inflation-Protected Securities; EMD = Emerging-market debt; FRN = Floating rate notes. Sources: Barclays, TIAA-CREF Asset Management.

Figure 4: Forecasted 2014 GDP growth rates

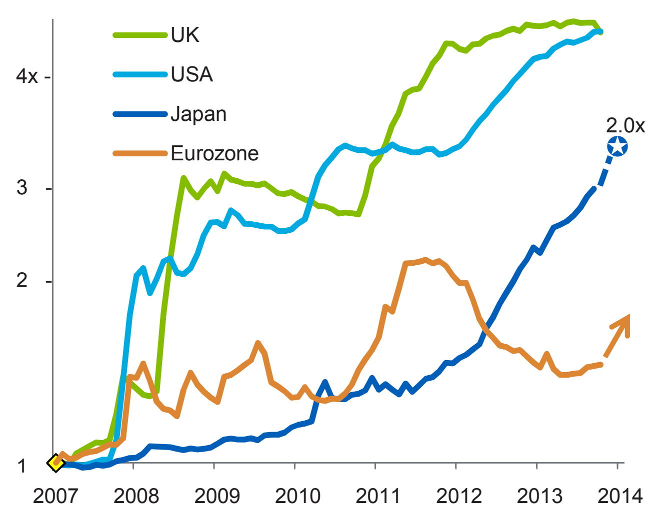


Data as of 9/30/2014. Sources: Bloomberg, TIAA-CREF Asset Management.

The exception, Ireland, shows that it is in fact not the currency, but lack of economic flexibility, that is the primary driver of this divergence. The Irish economy is much less regulated than the rest of the region and has consequently been able to snap back from the depths of the financial crisis. Germany has managed to maintain strong exports despite the high value of the euro thanks to previous liberalization of its labor market. Reform efforts in the rest of Europe have so far been disappointing. Italian Prime Minister Matteo Renzi is focusing his efforts on constitutional rather than labor market reform. In France, President François Hollande recently appointed a new Prime Minister to implement more growth-oriented economic policies, but with low popularity and resistance within his own party, it is not clear how many of these he will be able to implement.

As a result, the latest initiative from the European Central Bank (ECB) to inject liquidity into the economy through its Targeted Longer-Term Refinancing Operation (TLTRO) program and through the purchase of asset-backed securities is unlikely to have much impact on the economy absent accompanying economic reform. The eurozone suffers as much from a lack of demand for credit as a lack of supply, and companies and households are unlikely to see the need for credit without the prospect of higher growth rates, irrespective of the interest rate level.

Figure 5: Monetary base



Data as of 9/30/2014. Sources: U.S. Federal Reserve, Bank of England, European Central Bank, Bank of Japan, TIAA-CREF Asset Management.

The next salvo expected from the ECB is true quantitative easing. The various ECB programs over the last several years have had at times the same effect as QE in other countries — namely, increasing the money supply and lowering interest rates — but their scale has been far smaller than in other countries (see Figure 5).

Discussions are now of potentially €1 trillion ($1.3 trillion) in asset purchases, though the mechanics of the program are unclear and there is political opposition, particularly in Germany. Given that interest rates are already extremely low, and banks already have ample liquidity, the only way that a QE program in the eurozone may help economic growth is through the depreciation of the euro. Now that the U.S. has stopped printing its own currency, a large increase in the supply of euros should lead to a fall in its value, thus boosting the region's exports. There are two caveats, however. First, in the U.K., the British pound fell sharply in value relative to the currencies of its trading partners during 2008, and exports did rise. The euro, by contrast, strengthened by 9% over the same period, but German net exports increased by more than they did in the U.K. So one cannot simply assume that a depreciating currency alone leads to higher export growth. The second caveat is that almost half of eurozone exports are to other countries within the eurozone, so the value of the euro will have no impact on export levels but will depend on demand, which is likely to remain weak.

The risk that the eurozone faces without further market liberalization is many years of "lost" growth similar to what Japan experienced after its own property bubble burst in 1990. There are numerous parallels between the two regions: deep recessions following excessive credit expansion, rigid labor markets, a dysfunctional banking system, and falling inflation. There are enough differences, however, to suggest that the eurozone will not suffer as badly, even if the region is unlikely to return to pre-crisis rates of growth. The ECB is much more active than the Bank of Japan, which took decades before finally launching any substantial stimulus program. In particular, the Asset Quality Review currently underway in Europe should force banks to recognize bad loans and eventually free up the system to expand credit again. The euro has depreciated slightly in real, trade-weighted terms since 2006, while the yen strengthened by nearly 50% in the years following the crisis. The eurozone will see a cyclical recovery just as the U.S. and other parts of Europe have, but it is likely to be weaker than in those countries, and the longer-term outlook remains dim.

Equities

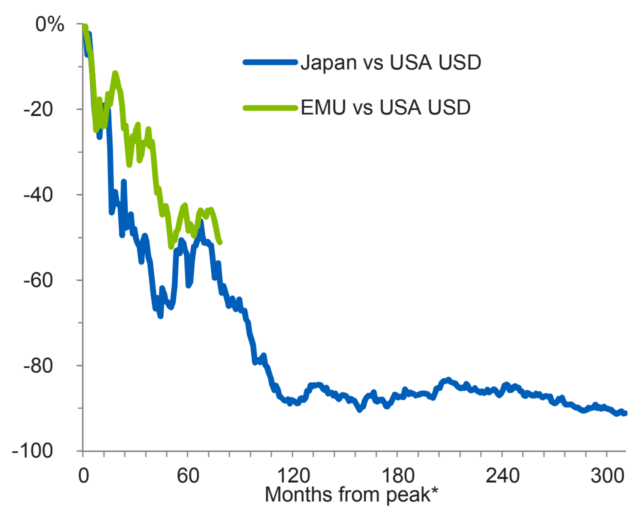
This somber economic forecast means this may actually be a good time to overweight European equities relative to the U.S. Sentiment is currently very negative toward the region, with investors redeeming over $10 billion from Europe-dedicated mutual funds since July. The earnings outlook is finally brightening, however, as analysts raise their forecasts for earnings growth. The market is still about 15% below its 2007 highs (about 25% in U.S. dollar terms). Margins in the U.S. are near historical highs, while they have room to rise in Europe. Valuations modestly favor European equities, which are trading at a 12% discount to U.S. markets, compared to a long-run average of 9%. Interest rates are going to be rising in the U.S., while the ECB is likely to embark on some sort of QE. The liquidity generated from QE has generally been positive for equity markets based on the experiences not only of in the U.S. but also in the U.K. and Japan. The possibility of a break in the value of the euro below the 2010 low of $1.22, however, suggests that a hedged strategy is likely to reap the most gains.

The longer-term outlook for eurozone equities in particular, however, will depend on further economic reform so that companies can restructure their operations to improve profitability. The resistance to efforts by Air France's management to expand its low-cost airline is an example of the obstacles to liberalization. If companies are not able to improve earnings growth, the region may see sustained underperformance relative to the U.S. market, similar to what occurred in Japan following the end if its credit bubble (see Figure 6).

Fixed Income

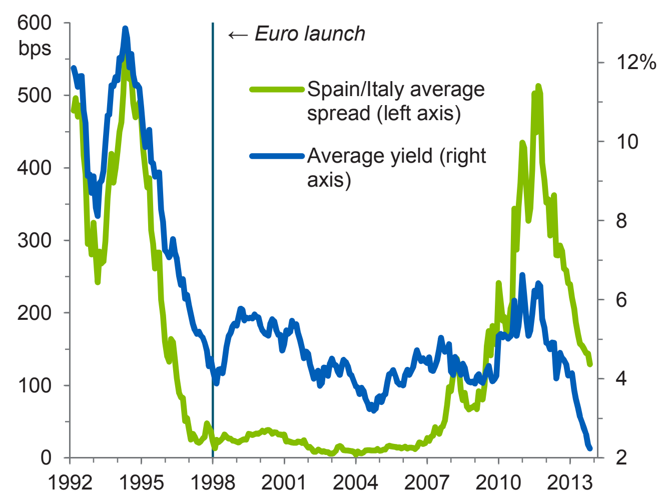
Yields on government debt for many of the countries in the eurozone have already fallen to historic lows, partly in anticipation of quantitative easing by the ECB (see Figure 7). Yields on 10-year German debt are barely above 1% and Spain and Italy's yields are about 125 basis points higher. Given the prospect for interest-rate hikes in both the U.S. and the U.K., eurozone debt should continue to outperform that of other developed markets. The spread between peripheral countries and core markets such as Germany is still high compared to levels reached following the launch of the euro. As Germany has comparatively less debt outstanding and is moving toward a budget surplus, it will be issuing little debt, so peripheral markets should outperform the core. The ECB is unlikely to risk buying corporate debt, so government debt is also likely to benefit more than corporate debt from central bank actions. Corporate bond spreads over equal duration government debt have fallen to around 90 basis points, compared to 50 basis points prior to the financial crisis; however, given weak growth, there is a chance of increased credit risk, so spreads are unlikely to decline much further.

Figure 6: Equity market relative performance



Note: Indexes in USD. *Japan market peak November 1988. Eurozone peak March 2008. Data as of 9/30/2014. Sources: MSCI, TIAA-CREF Asset Management.

Figure 7: Government bond yields and spreads



Note: Spreads are over equal duration German bonds. Data as of 9/30/2014. Sources: Bloomberg, TIAA-CREF Asset Management.

Japan

Economy

Economic growth in Japan has swung sharply over the previous two quarters, as businesses and consumers ramped up consumption in the first quarter in anticipation of the consumption tax hike that took effect on April 1. In the second quarter, demand plummeted far more than forecasters had expected, with GDP declining by nearly 2% (see Figure 8). The economy has yet to benefit meaningfully from Prime Minister Shinzo Abe's economic reforms, which will take time to have any significant effect. As a point of comparison, Germany's comparatively strong growth over the last few years is at least partly due to reforms initiated almost a decade ago. Forecasts for Japan's GDP growth in 2015 are still for only 1.3%, which is less than the average from 2000 to 2007.

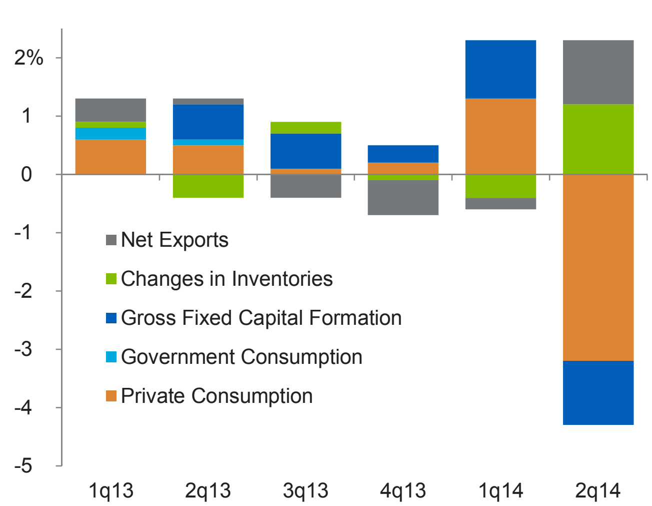
The purpose of the April tax hike was to begin to address Japan's chronic budget deficits, and the hike was certainly fiscally prudent, even if the immediate economic impact was worse than expected. The drop in GDP, however, makes it more likely that the Bank of Japan will extend its QE program. This should support further yen weakness and stronger net exports, which in the most recent quarter rose at the fastest rate since 2009. The absolute rate of taxation in Japan is not high compared to other developed countries, so we believe that once the shock of the tax hike has passed, the higher consumption tax rate will not prove to be a heavy burden on the economy.

Equities

The renewed depreciation of the yen, triggered by the imminent end of QE in the U.S., has quickly fed through to renewed gains for Japanese equities (see Figure 9). With the prospect of more money printing from Japan, and the yen still relatively strong compared to pre-crisis levels, there is room for further market advances. Corporate earnings growth has not been driven solely by yen depreciation, however. Foreign sales for companies in the MSCI Japan large-cap index are greater than for the small-cap index (47% vs. 37%), and the large-cap index is more correlated with the exchange rate. But earnings for the more domestic-oriented, small-cap companies have grown by more than they have for the export-oriented large-cap companies, suggesting that the recovery is more broad based and sustainable.

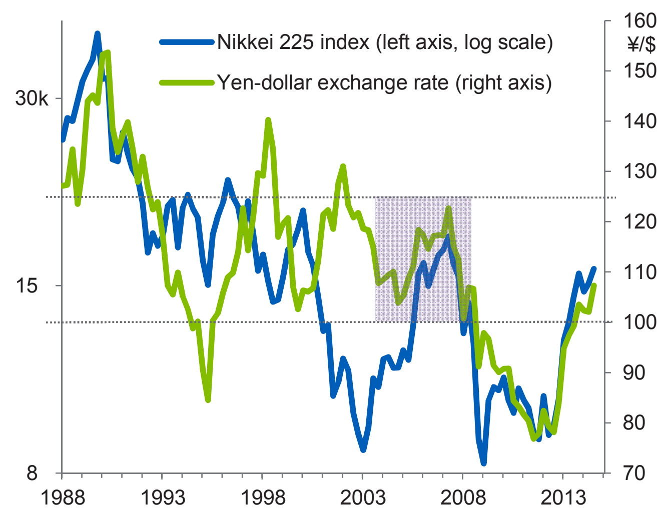
Return on equity for Japanese corporations is still low by international standards (9% vs. 12% for Europe and 16% for the U.S.), but it has risen more since 2012 than it has for the other regions, as companies begin to take advantage of the opportunities created by Abenomics. As in 2012, however, a strategy which hedges the currency is key to capturing equity market gains.

Figure 8: Japanese quarterly change in GDP



Data as of 9/30/2014. Sources: Japan Cabinet Office, TIAA-CREF Asset Management.

Figure 9: Yen-dollar exchange rate and equity index



Data as of 9/30/2014. Sources: Bloomberg, TIAA-CREF Asset Management.

Fixed Income

Yields are now so low on Japanese government bonds (JGBs) — approximately 0.5% for the 10-year issue — that quantitative easing can have little additional impact on bond prices. Rising inflation expectations argue for higher yields at some point in the future, and more immediately there is the potential for increased sales of JGBs by the Government Pension Investment Fund (GPIF) to buy equities. The GPIF currently has 53% of its $1.2 trillion portfolio invested in domestic bonds and 33% in equities (both domestic and international), but the allocation to bonds could fall as low as 40%, posing a further risk for JGB prices. Given the size of the fund, this could lead to a significant amount of cash moving between asset classes, with a potentially significant boost for the domestic equity market.

Emerging Markets

Economy

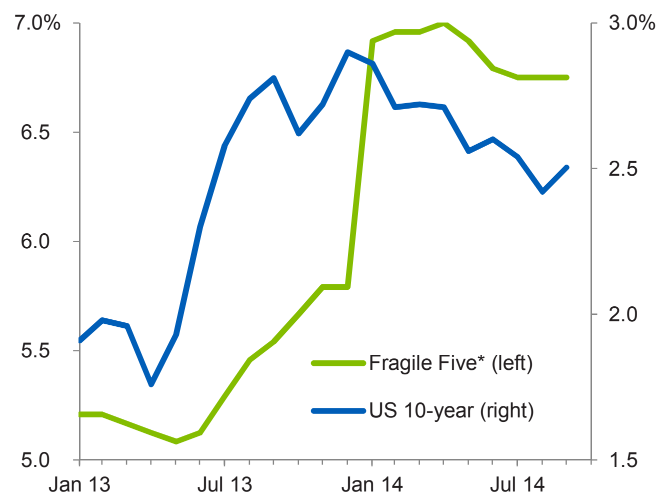
Growth in the largest emerging-market economy, China, is unlikely to hit the government's target of 7.5% (though the official result may say otherwise). Weaker growth in China has global implications. Tepid industrial and construction demand have fed through to falling prices for coal and iron ore, which has led to softer exports for other emerging-market countries such as Brazil. A broader risk to emerging-market growth is the prospect of an increase in U.S. interest rates, which has already led to a selloff in emerging-market currencies. As we saw last year during the "taper tantrum" (when markets reacted to the initiation of the QE tapering program by the Fed), funds tend to leave riskier emerging market assets when U.S. rates are rising — almost $70 billion was pulled from emerging-market debt and equity markets in the second half of 2013. This puts heavy pressure on currencies, so central banks — particularly in countries with large current account and/or fiscal deficits — are obliged to raise interest rates to defend their currencies. Interest rates for the "fragile five" countries (Brazil, India, Indonesia, South Africa, and Turkey), all of which have large deficits, have all increased since last year, even as economic growth remains weak (see Figure 10).

With the adjustment of U.S. interest rates just beginning, emerging markets are likely to see further turmoil and ongoing challenges to sustain the higher growth rates they've become accustomed to.

Equities

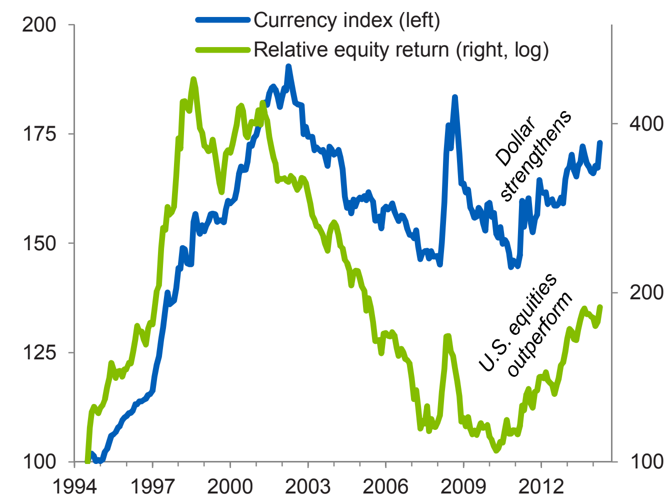
Much of the performance of emerging-market equities this year has been driven by the results of political elections, anticipating reforms to come from market-friendly candidates who have either won elections (in Indonesia and India), or are hoped to do so (Brazil). Corporate earnings have yet to follow suit, however, as earnings expectations have remained flat for the last year, while they have moved up in Europe (they were already rising in the U.S. and Japan). While more recent fund flows indicate that investors have warmed again to emerging markets, thanks to valuation concerns in the U.S. and Russia-Ukraine fears in Europe, sentiment could easily swing again if the recent run-up in the dollar persists, as we believe it will. When the dollar is strengthening, emerging-market equities generally underperform (see Figure 11).

Figure 10: Interest rates



Data as of 9/30/2014.*Brazil, India, Indonesia, South Africa, Turkey. Sources: Haver Analytics, TIAA-CREF Asset Management.

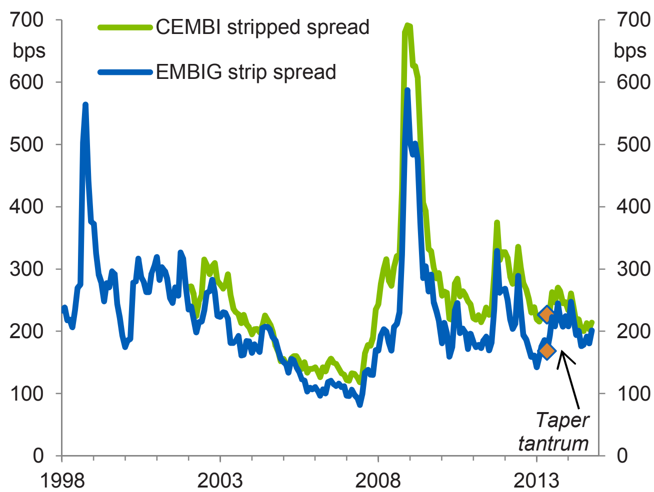
Figure 11: Relative emerging-market index returns and currency value vs. U.S.



Data as of 9/30/2014. Sources: MSCI, TIAA-CREF Asset Management.

In the short term, they are likely to continue to do so. Longer term, however, emerging-market equities still appear more attractive compared to developed-market equities (except Japan), as price-to-earnings (P/E) ratios suggest earnings are undervalued, while in developed markets P/Es are above average. Investors may need to be patient, however, as they wait to realize the potential returns that this gap in valuations represents.

Figure 12: Emerging-market debt spreads (USD, investment-grade)



Data as of 9/30/2014. Note: CEMBI represents corporate bonds, and the EMBIG represents sovereign bonds. Sources: J.P. Morgan, TIAA-CREF Asset Management.

Fixed Income

Spreads for U.S. dollar-denominated, investment-grade emerging-market debt are not too far off from where they were prior to the 2013 “taper tantrum.” Shock at the idea of rising interest rates sent spreads up by 50–75 basis points in a short period of time, leading to sharp losses for the indexes, though they have since recovered. There is still the potential for upsets ahead, but the prospect of rising rates has been largely absorbed by the markets, and we expect a more modest reaction to future Fed hikes (or discussion of hikes). With spreads averaging around 200 basis points over Treasuries, sovereign and corporate emerging-market debt still appear to offer good value relative to their developed-market counterparts, and they do not face the same currency risk as emerging-market equities or local-currency debt.

Conclusion

The long-anticipated transition to a post-QE world may have finally begun. As a result, many of the trades that benefited from the Fed’s policies — high-yielding equities, fixed-income, gold, foreign currencies — are likely to see poorer returns over the next year. The transition, however, is unlikely to be smooth as investors reallocate portfolios. A steady U.S. recovery still argues for ongoing gains in equity markets, though relative performance may be better in Europe as the ECB tries yet again to stimulate the economy. Attractive valuations in Japan also offer higher expected returns. Geopolitical events will occasionally provide support to core, investment-grade fixed-income assets as investors seek safe havens, but interest rates should march higher over the next year — with a risk that this happens more suddenly than markets currently anticipate.