Weekly Market Update

# Market roller coaster continues as fear and rationality compete for attention

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**Article Highlights**

- The S&P 500 enters correction territory, but we do not see this as the start of a bear market.
- U.S. Treasuries benefit from a flight to safety, then reverse on better economic releases.
- Concerns about economic weakness in Europe and China persist.
- While the threat of Ebola is real, investor fear may be disproportionate to the risk.
- Despite recent volatility and negative headlines, value is being created in the current market.

**October 17, 2014**

Repeating a familiar pattern, U.S. equities moved sharply lower for much of the past week before bouncing back on Friday. Fears of slowing global growth, plummeting oil prices, the imminent end of the Federal Reserve's quantitative easing (QE) program, and the arrival of the Ebola virus in the U.S. sent stock prices tumbling. At midweek, the S&P 500 Index was down almost 10% from its September 19 peak of 2,019—a drop that put the index in correction territory but does not, in our view, mark the beginning of a bear market.

Non-U.S. markets endured a similarly volatile ride during the week, with Japan's Nikkei 225 Index also experiencing a 10% correction from its recent peak. European equities lost about 2% for the week through October 16 before bouncing back the next day. In the emerging markets, recent results have varied widely. Some countries, such as India and the Philippines, have benefited from the collapse in commodity prices that has contributed to global growth concerns, while others, including Indonesia and Malaysia, have suffered. This has led to a very fragmented equity market that favors active portfolio management and stock picking.

Current updates are available here. For additional insights on emerging-market equities from Alex Muromcew, portfolio manager of the TIAA-CREF Emerging Markets Equity Fund, view our Weekly Market Perspective Video.

## Fixed income

U.S. Treasuries rallied as investors sought a safe haven amid the whirl of equity volatility. On October 15, the yield on the bellwether 10-year Treasury note, which

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moves in the opposite direction of its price, briefly fell below 2% and closed 16 basis points (0.16%) lower than its ending value from the previous week. High-yield corporate bonds, especially those from energy-related issuers, were hard hit early on but recovered somewhat later in the week.

Emerging-markets debt performed significantly better than U.S. high yield, buoyed partly by the decline in Treasury yields. In Europe, peripheral debt markets (such as Spain and Italy) suffered as investors sold bonds to take profits and offset equity losses. In addition, these markets sold off at midweek on the prospect of renewed Greek contagion, fueled by the government's political posturing to renegotiate Greece's bailout package. Markets later settled down as these fears eased.

## Despite growth concerns, the U.S. economy's trajectory has not changed

While U.S. economic data remains choppy from month to month, a broader perspective shows that the economy continues to ratchet slowly upward. The past week brought the usual mix of both positive and negative signals, with disappointing retail sales and a drop in homebuilder confidence balanced by improved industrial production, a surge in consumer sentiment, and a drop in first-time unemployment claims to their lowest level in more than 14 years.

We are not inclined to change our GDP growth forecast for the third quarter (currently in a range of 3.1% to 3.5%), but the latest readings suggest that the number may come in at the low end of the range, around 3.2%. We are less concerned about the minutia of the GDP report this quarter, and more focused on the trend, which remains intact.

A potential wild card is the arrival of the Ebola virus in the U.S. While we believe the most likely outcome is a successful attempt to control and suppress the outbreak, there is a risk that the government may not move decisively or swiftly enough to do so. In addition to reducing the obvious health and safety risks, successful containment would avoid a severe hit to consumer confidence and a disruption of the normal course of commerce. That in turn should prevent any material change in overall economic growth, help preserve expected earnings expectations, and bolster the U.S. equity market.

## Europe remains the epicenter of deflation concerns

As the eurozone economy continues to slow, fears of deflation have worsened. Consumer inflation on the continent came in at just 0.3% (year-over-year) in September—softer than in the previous month and a five-year low. Germany has been the unlikely culprit in the latest cycle, burdened by the impact of Russian sanctions and slowing Chinese growth. Also a factor was a sharp slowdown in auto production during August, which drew down inventories. Auto production is now set to restart, which may well spur German data and calm markets. In addition, a recent uptick in auto sales is a positive sign. We continue to believe that Europe is poised to deliver strong equity returns, as valuations are now very low, while lower oil prices and a weaker euro are stimulative.

## Uncertainty over China continues to weigh

Chinese economic growth remains a mixed picture, with risks skewed to the downside. Although recent activity indicates good export demand, and Purchasing Managers Indexes (PMIs) have held steady just above the 50 level (signaling expansion), there is scant evidence that domestic demand is supporting the economy to any meaningful degree. Moreover, foreign direct investment in China fell 14% in August, and a weakening property sector could be a further drag on growth in 2015. The markets are anticipating further policy responses, despite government assurances that it will not embark on wholesale stimulus.

## Outlook

The past week was difficult for financial markets the world over, marked by increased uncertainty, a lack of confidence that central banks have a handle on economic growth and inflation, and too much attention to negative news. During periods when short-term volatility exerts undue influence, investors are well served by remembering that fundamentals will ultimately reassert themselves. So far, negative market sentiment has not yet bled into the real economy. For all of the fear-driven headlines, value is being created in today's market.

While we cannot declare with certainty that the stage has been set for a new advance in the U.S. equity market, the odds favor that outcome. In addition to support from steady (albeit slow) economic progress, contrarian indicators point to a market that has become oversold. This is evidenced in part by a rebound in small-cap stocks, which have been the victim of investor risk aversion since March.

In fixed-income markets, we believe a significant amount of risk has now been priced in. Treasury yields in particular appear richly valued, as the late-week reversal in the 10-year's slide suggests. That said, a sudden dramatic widening in spreads is not likely. On balance, we think current bond yields are attractive with enough spread cushion to help offset a very gradual rise in interest rates heading into year-end.