Weekly Market Update

Equity markets soar on surprise stimulus from Japan's central bank

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Article Highlights

- The Fed ends quantitative easing, while the Bank of Japan ramps it up.
- Equities surge and the yen plunges on Japan's surprise move.
- Positive earnings reports continue to lift the S&P 500.
- U.S. GDP growth is solid, and consumer confidence hits a seven-year high.
- Markets look to the ECB's next policy meeting for signs of imminent easing.

October 31, 2014

Equities

A surprise decision by the Bank of Japan (BOJ) to expand its monetary stimulus program drove equity markets higher on October 31, capping a week of broad gains. Japan's Nikkei 225 Index was the first beneficiary, surging 5% on October 31, and the ripple effects spread through U.S., European and other global markets. The yen, meanwhile, slumped to a near seven-year low of ¥112 to the dollar.

The S&P 500 Index had already moved 1.6% higher for the week through Thursday, buoyed by favorable corporate earnings. Of the S&P 500 Index companies that have reported third-quarter results so far, 80% have beaten expectations versus a long-term average of 60%.

The week was not without some volatility, however. On October 29, U.S. markets initially appeared to read too much hawkish intent into the Federal Reserve's meeting minutes, which included the official end to quantitative easing (QE). In emerging markets, Brazilian stocks plunged 6% on a market-unfriendly election result to start the week, then rebounded to recoup those losses and more the next day.

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Fixed Income

U.S. Treasury performance was modestly negative through October 30, as markets perceived a less dovish tone to the Fed's language. Treasuries added to losses in the wake of the BOJ news. Shorter- and intermediate-term yields (two-to-seven years) rose more than yields on longer-term Treasuries (10-to-30 years), resulting in a "flatter" yield curve. This flattening reflects the market's view that rates at the short end are increasingly likely to rise in the coming year.

Through October 30, most non-Treasury sectors also posted small losses, although high-yield corporate bonds performed marginally better than their investment-grade counterparts. We expect significant new issuance of investment-grade corporate debt in November, which could cause corporate spreads to widen on a temporary basis.

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

Third-quarter GDP growth shows U.S. economy remains on track

U.S. economic data has been mixed, but the overall trend remains positive. The past week's highlight was the government's advance estimate of third-quarter gross domestic product (GDP) growth, which showed the economy expanding 3.5% at a seasonally adjusted annual rate. This headline number was generally in line with our expectations, although business investment grew more slowly than we expected. We think this component of the report is likely to be revised upward. U.S. GDP growth has now exceeded 3% in four of the past five quarters.

Among the week's other releases:

- **Pending home sales** edged 0.3% higher in September, while **home price appreciation** in August continued to slow, based on the S&P/Case Shiller 20-City composite index.
- **Weekly first-time unemployment claims** remained below the 300,000 level for the seventh consecutive week.
- **Durable goods orders** declined in September for the second month in a row, largely attributable to the always-volatile aircraft sector.
- **Consumer confidence** surged in October to a seven-year high, potentially boding well for holiday retail sales.

In Europe, markets hope the ECB will follow the BOJ's lead

Economic conditions look somewhat better since European stocks tumbled in the first half of October. Bank loans may be bottoming, the money supply has increased, and Spanish GDP and unemployment have improved. The Citi Economic Surprise Index for Europe, a gauge of the extent to which recent economic data readings for the region have diverged from consensus forecasts, has turned sharply higher.

Our near-term focus is on the European Central Bank's (ECB's) meeting on November 6. Markets expect further monetary stimulus in response to still-feeble inflation data, or at least a signal that a move will be made in December. Japan's surprise monetary easing may have increased the odds of this happening. Absent such a signal, European equity markets may again be vulnerable. That said, even if the ECB disappoints, Europe might still be poised for better returns, provided it can skirt a recession and some green shoots of growth take hold. In that case, the upside potential for equities could be substantially better in Europe than in the U.S.

Outlook

On balance, we think the 10-year Treasury yield is close to fair value, and that it could rise to 2.5% by the end of this year. Meanwhile, our economic forecast calls for U.S. growth to accelerate marginally through next year, averaging close to 3.25%. If that occurs, we would expect the 10-year yield to climb a bit higher, to about 2.75% by the end of 2015.

Despite the past week's euphoria, Japan still faces challenges, including the need for substantive reforms and uncertainty over the economic impact of a second consumption tax increase scheduled to take effect in October 2015. The first tax hike in April 2014 hurt retail sales, which are only now recovering. Elsewhere in Asia, worries remain about China's slowing economy, although the data is not collapsing. Chinese equity markets have performed well, apparently discounting the current status quo to focus instead on expectations for more government stimulus and beneficial reforms.

With U.S. equity benchmarks at or near new record highs on the last day of October, the markets' mid-month swoon seemed far from investors' minds. Encouragingly, small-cap stocks have continued to lead the broader market's recovery. We expect the S&P 500 to move beyond its previous record close of 2,019, perhaps reaching higher targets before year-end.

In fixed-income markets, we reiterate our view that the Fed will not begin to hike short-term interest rates before June 2015, and that the increases will be slow and modest against a backdrop of low core inflation. The implication for "spread" products (higher-yielding, non-Treasury securities) is largely positive, as cheap financing will remain available for an extended period. In the meantime, the end of its QE program will likely result in increased short-term volatility as markets adjust to changing levels of Fed liquidity.

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Foreign stock market returns are stated in U.S. dollars unless noted otherwise.

Please note that equity and fixed income investing involve risk.