Market & Investment Insights

2014 Third Quarter Equity Market Review

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA-CREF ASSET MANAGEMENT

Article Highlights

- U.S. equities extended their year-to-date gains in the third quarter, but returns were modest and share prices were volatile.
- The S&P 500's strong performance in August, which saw the index rise above the 2,000 level for the first time, was bracketed by declines in July and September.
- Foreign developed-market and emerging-market equity benchmarks posted modest declines in U.S. dollar terms, in part due to a stronger dollar.
- While equity market volatility has increased since the quarter ended, we believe there is room for further gains heading into year-end.

November 25, 2014

Global equity markets posted mixed results in the third quarter of 2014, as weakening growth in Europe and Japan offset stronger economic conditions in the United States. Mounting strength in the U.S. labor market, along with expanding manufacturing activity and improved consumer sentiment, helped boost U.S. stocks while also raising the prospect of higher interest rates. At the same time, weak growth abroad put downward pressure on yields for European and Japanese government bonds. This divergence in economies and interest rates helped drive up the U.S. dollar to a four-year high against other major currencies.

The S&P 500 Index delivered a 1.13% total return in the third quarter, bringing its year-to-date gain to 8.34%. Foreign developed-market equities lagged slightly, with a 0.93% return in local currency terms based on the MSCI EAFE Index. Among various markets, equity returns ranged from a 0.24% decline in Europe to a nearly 6% rise in Japan in local currencies. For U.S. investors, however, the dollar's rise versus the euro and yen during the quarter turned positive results negative or magnified losses when translated into dollar terms. European and Japanese stocks, for example, returned -7% and -2.3%, respectively, in U.S. dollars, while the EAFE Index returned -5.88%. The same held true for emerging markets, where stocks posted a 0.56% return in local currencies and a -3.5% return in U.S. dollars.

Financial Services

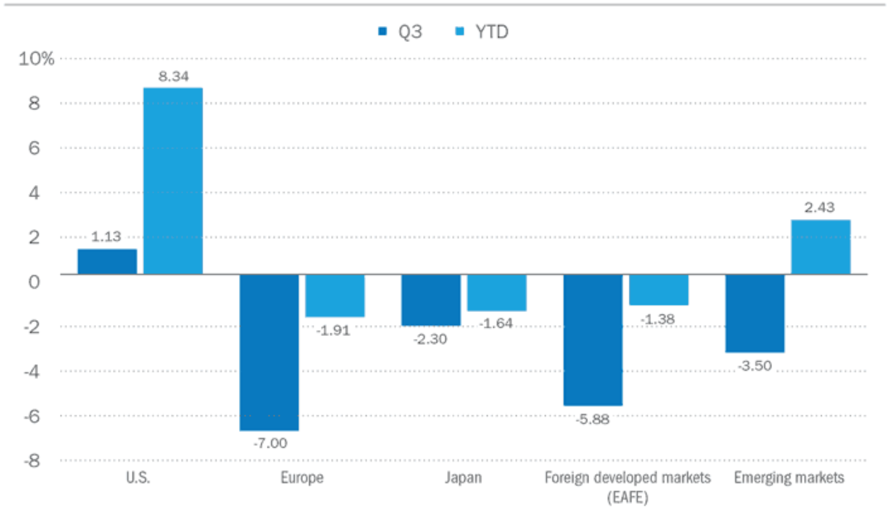
U.S. stocks gain as labor market improves

The quarter got off to an inauspicious start for U.S. equities, with the S&P 500 falling 1.38% in July to end a string of five straight monthly gains. In August, however, the index surged 4% and closed above the 2,000 level for the first time. The tide turned again in September, which generally lived up to its reputation as a seasonally poor month for stocks, as the S&P 500 finished with a -1.40% return for the month.

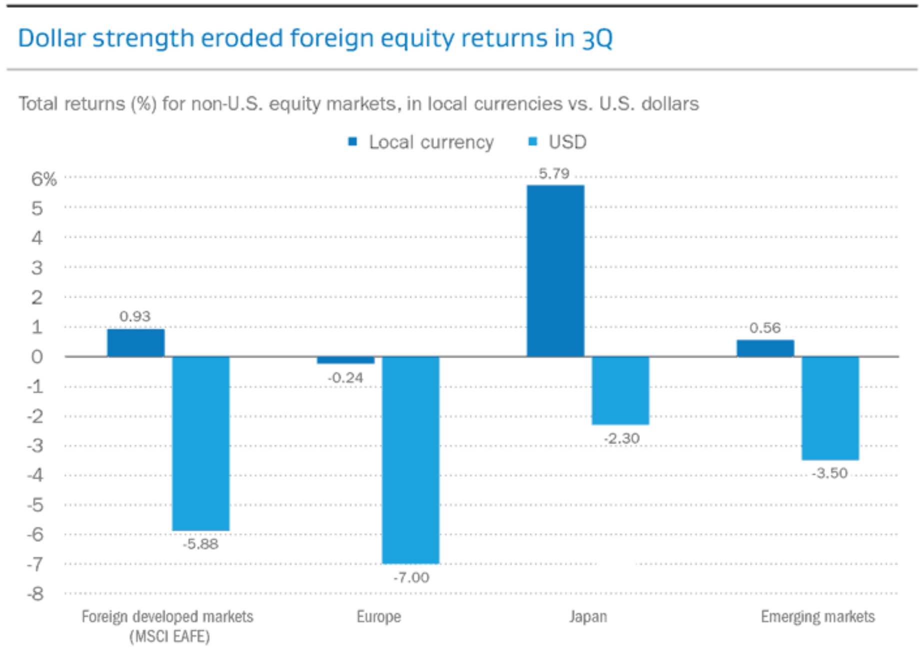
Returns among the S&P 500's 10 sectors varied widely. Healthcare (+5.33%), information technology (+4.64%) and telecommunications services (+2.69%) led the way, while energy (-8.78%) and utilities (-4.23%) lagged. Based on respective Russell market-cap and style indexes, large caps (+0.65%) outpaced mid caps (-1.66%) and small caps (-7.36%), while growth stocks (+0.88%) outperformed value shares (-0.87%).

Three key forces acted on the market during the quarter. First, strong employment numbers helped underpin demand for U.S. stocks and pointed to a slowly accelerating economic expansion. Reported job growth surpassed 200,000 in each month except for August, although August payrolls were subsequently revised upward to 203,000. Second, weaker growth in the eurozone, Japan, China, Brazil and Russia served to offset some of the optimism over the U.S. economy and helped push the dollar higher. Third, the impending conclusion of the Federal Reserve's quantitative easing program and fear of an accelerated timetable for Fed interest-rate hikes resulted in heightened volatility.

U.S. and international equity returns as of 9/30/14



Source: Factset. The U.S. market is represented by the S&P 500 Index. International markets represented by their respective MSCI indexes and expressed in U.S. dollars.



Source: MSCI

Europe

Eurozone equities came under pressure in July from lackluster economic growth rates. While they managed to rebound somewhat in August, stocks fell again in September as growth faltered. Throughout the quarter, economic data showed the eurozone was not on the path to a stronger recovery as many investors had hoped, and instead was in danger of slipping back into recession. Overall, eurozone growth came in at zero for the second quarter, with the German and Italian economies contracting, France stagnating and Spain growing less than 1%. Corporate earnings fell short of expectations, measures of inflation moved closer to deflation, and fears of a return to the region's debt crisis were revived briefly when Portugal's Banco Espirito Santo of Portugal missed a loan payment.

While the European Central Bank's surprise rate cut in September gave the market some temporary support, it was not enough to halt the slide in stocks, as subsequent economic data showed manufacturing activity in Germany slowing and business sentiment falling for the fifth straight month.

Japanese stocks gain as the yen weakens

After rebounding in the second quarter from a decline during the first three months of the year, Japanese equities rallied again in the third quarter, posting a 5.79% return in local currency terms. Much of that gain was fueled by the rapid depreciation of the yen, which began the quarter at about 101.5 to the dollar and weakened to 109.7 by quarter-end, the lowest level since August 2008. Driving the yen's decline has been the Bank of Japan's (BOJ's) massive stimulus program. The BOJ has been buying Japanese government bonds at the rate of as much as ¥70 trillion annually since the first half of 2013 in an effort to weaken the yen, reverse the country's cycle of deflation, and stimulate the domestic economy. A weaker yen benefits Japanese exporters by making their products more competitive and raising the value of foreign currency earnings.

Emerging markets

The stronger U.S. dollar affected emerging-market equity returns as well, with the MSCI Emerging Markets Index posting a modest gain in local currency terms (+0.56%) but declining in U.S. dollars (-3.5%). Among the so-called BRIC countries (Brazil, Russia, India, and China), Russia had a -4.72% return for the quarter in local currencies, extending a decline from the first half of the year, as the conflict with Ukraine brought economic sanctions from Europe and the U.S. Also, falling oil prices undercut Russian energy stocks and hurt the country's trade balance. Based on MSCI indexes, Brazil (+1.55%), India (+5.09%), and China (+1.61%) posted gains in local currency terms. In U.S. dollar terms, however, stocks in Brazil and Russia fell by 8.62% and 15.41% respectively, while China and India managed to post m gains of 1.42% and 2.34%.

Outlook

In U.S. equity markets, further gains are possible in 2015, but the advance will likely prove more difficult and far more volatile than we have seen in 2014. The market's challenges may stem from the Federal Reserve's tightening schedule and/or increases at the short end of the U.S. yield curve. The two-year Treasury yield is currently up by more than 20 basis points (0.20 percentage points) from its mid-October low. Typically, equities begin to waver as that rate increase approaches 50 basis points.

For European equities, price-to-book and price-to-earnings ratios—key valuation metrics—have declined almost to levels last seen during 2009 market lows. Along with tentative signs that economic conditions in Europe may be starting to improve, these valuations make the region a more attractive investment destination, in our view, than the U.S.

China is still suffering from weaker-than-expected growth and the potential for a property price collapse. Moreover, there is a risk that the falling value of the Japanese yen will prompt China to devalue its own currency in an attempt to support export growth. That in turn, could export deflation to Europe (especially Germany) and the U.S.

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