Weekly Market Update

A reprieve in oil and a “patient” Fed spur a global equity rally

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

Article Highlights

- Equity markets welcome the Fed’s reassurance that there’s no rush to raise interest rates.
- Amid fixed-income volatility, U.S. Treasury prices dip, while high-yield corporate bonds rally.
- Oil prices stabilize, bringing a measure of calm to the markets.
- Russia’s central bank hikes interest rates to 17% to shore up the plummeting rouble.
- Both equity and fixed-income markets may see further gains, but with greater volatility.

December 19, 2014

Equities

In a highly volatile environment, U.S. equities rebounded from a seven-day, 5% correction to finish the week up more than 3%. Markets were initially driven lower by collapsing oil prices that some investors fear reflect a slowdown in global growth, and by news that the Russian central bank had hiked its overnight interest rate from 10.5% to 17% to defend the rouble, which has been plunging along with oil prices. The S&P 500 Index then surged on December 17 and 18, buoyed in part by stabilizing oil prices, generally positive economic data, and a Federal Reserve statement that reassured markets the Fed “can be patient” about raising interest rates.

These catalysts spilled over into European markets, which also posted a gain of about 3% for the week. In Japan, the Nikkei 225 Index rose about 1.5% for the week in the wake of Prime Minister Shinzo Abe’s decisive electoral win on December 14. In our view, it is now essential that Abe implement the major structural reforms necessary to combat deflation and jumpstart the economy. As always, the devil will be in the details. Chinese equities also moved higher, underpinned by market expectations of further stimulus. Economic activity in China appears to be bottoming, potentially leading to further gains in what remains a very cheap market.

Financial Services

For additional insights about Russia and oil prices, read this new analysis by TIAA-CREF Global Investment Strategist Dan Morris.

Fixed Income

Fixed-income markets were also highly volatile, as the confluence of Russian rouble depreciation and plummeting oil prices spurred demand for safe-haven Treasuries early in the week, while end-of-the year illiquidity exacerbated daily price moves. As the week wore on, stabilizing oil prices, the equity market rally, and the Fed’s press release eventually drove the 10-year U.S. Treasury yield slightly higher, to close the week at 2.17%.

High-yield corporate bonds moved in sympathy with equities, recouping recent losses. We don’t believe there will be as many defaults as the market seems to expect, given the opportunities for many energy-related high-yield firms to avoid them by adjusting capital expenditures or merging.

Current updates are available here.

The week’s data reports, while mixed, show the economy remains on track

Although some of the week’s economic releases were disappointing, particularly in housing and manufacturing, the economy’s trajectory has not materially changed. If GDP growth in the current quarter comes in at 3.0% or better, as we forecast, it will be the fifth quarter out of the last six in which the economy has grown at or above that level.

- **U.S. housing starts and building permits** fell 1.6% and 1.2%, respectively, in November. Homebuilder confidence ticked lower but remained near a nine-year high. In our view, these readings do not portend a slowdown in the housing market, as this is a seasonally soft time of year. In addition, mortgage rates are falling, pointing to a pickup in spring sales.
- **Regional manufacturing indicators** slipped in December. The Empire State Index declined, as did the Philly Fed survey index (albeit from its highest level in almost 21 years).
- **National manufacturing activity** slowed to 53.7, based on the “flash” (preliminary) reading of the Markit Purchasing Managers Index, but remained above the 50 reading that separates expansion from contraction.
- **Leading economic indicators** climbed in November, according to The Conference Board, a sign of further expansion in the next few months.
- **First-time unemployment claims** fell by 6,000 to 289,000, in keeping with stronger hiring trends.

Greece and Russia add uncertainty to European equity markets

While we view European stocks favorably overall, we are mindful of two potential risks. First, if the Greek parliament fails to elect a new president, general elections

will be required next year. That could lead to further equity market volatility, although we believe any downside risks are already reflected in the country’s stock prices.

Russia remains a bigger concern. Belligerent responses by President Vladimir Putin to stronger sanctions by the West could spill over into a broader European or NATO conflict and destabilize markets. The Russian economy, heavily dependent on energy exports, has already been hit hard by falling oil prices and a tumbling currency.

Outlook

In the U.S., we forecast annual GDP growth of 3.1% in 2015, although lower oil prices—a boon to both consumers and businesses—could provide an upside surprise. Elsewhere, China’s GDP growth may fall shy of 7%, while in Japan, the central bank is likely to deploy additional monetary stimulus. The ECB, similarly determined to skirt a recession in the Eurozone, is all but certain to launch QE in the first quarter of 2015.

While the S&P 500 Index has reached the intermediate target level of 2,050-2,100 that we have been anticipating, we think a move to 2,150 next year is possible. However, volatility will become an increasingly prominent factor to contend with as we get closer to the Fed’s rate hikes.

In fixed-income markets, we expect the 10-year Treasury yield to reach 2.75% by the end of 2015, with demand from foreign investors and falling U.S. inflation expectations possibly capping the increase. Emerging-market and high-yield corporate bonds should to recover in the new year, but, as with equities, volatility is likely to remain elevated. This will present opportunities for active fixed-income managers.

Financial Services

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Please note that equity and fixed income investing involve risk.

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