Weekly Market Update

Volatility greets global equity markets

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Article Highlights

- U.S. and European equities end on a down note in a volatile week.
- The eurozone's negative inflation rate in December makes ECB quantitative easing a near certainty.
- Despite skeptical consensus views, we view European equity markets favorably.
- U.S. job creation remains healthy, but wage growth disappoints.
- Fed tightening this year, along with global macro factors, will likely spur market volatility.

January 9 2015

Equities

Following five straight losing sessions that saw the S&P 500 Index fall sharply from its December 29 record high, U.S. equities bounced back strongly at midweek but struggled to sustain that momentum as the week drew to a close. Oil prices, which had shown some signs of stabilizing, resumed their slump on January 9, settling below $49 per barrel, a nearly six-year low.

In Europe, equities registered a bigger drop. They initially tumbled on fears that upcoming elections in Greece may lead to the country's exit from the eurozone, as well as preliminary data showing the region had slipped into deflation for the first time since 2009. That deflationary pressure then sparked a rally, as markets seemed convinced that the European Central Bank (ECB) will finally announce a program of quantitative easing (QE) when it meets on January 22. Against this backdrop of potentially aggressive ECB monetary stimulus, the euro continued to move lower versus the dollar.

Fixed Income

In contrast to equities, U.S. Treasuries and "spread products" (higher-yielding, lower-rated non-Treasury securities) rallied despite the volatility brought on by the week's market events. The yield on the bellwether 10-year U.S Treasury, which moves in the opposite direction of its price, closed as low as 1.96% during the week and was trading below 2% on January 9.

Financial Services

In overseas markets, concerns about continued economic weakness, the growing risk of deflation, political uncertainty in Greece, and the potential for QE fueled demand for sovereign bonds, resulting in German bond yields reaching new lows during the week.

Current updates are available here. For additional insights from TIAA-CREF Global Investment Strategist Dan Morris, view our Weekly Market Perspective Video.

December's employment report is solid, but there are caveats

The U.S. economy added 252,000 jobs in December, slightly above forecasts. Moreover, employment gains for October and November were revised upward, to 261,000 and 353,000, respectively. For the year, the economy generated nearly three million jobs, the biggest payrolls increase since 1999. However, the labor-force participation rate, which measures the share of the working-age population that is either employed or seeking a job, dropped to 62.7%, matching a post-recession low and a level last seen in 1978.

Additionally, wage growth fell 0.2% after rising in November. In the face of falling wages, the Federal Reserve may find it more difficult to proceed with an interest-rate hike in June, although we are not yet convinced that the Fed will wait.

Among the week's other economic releases:

- **Weekly first-time unemployment** claims declined by 4,000 to 294,000, and the four-week moving average inched down to 290,500—levels consistent with healthy job creation and GDP growth.
- **Non-manufacturing activity** slowed to 56.2, based on the Institute for Supply Management's non-manufacturing index. Despite the drop, the index remains firmly above the 50 level indicating expansion.
- **The trade deficit** fell, in large part due to the lowest level of crude oil imports since 1994.
- **Automobile sales** in December remained strong, at a seasonally adjusted annual rate of 16.8 million.

We see value in European equity markets

While many equity investors have shunned the eurozone, we believe there are opportunities among the region's "unloved," undervalued stocks. Supporting our belief are signs of economic improvement, including:

- Better leading economic indicators
- Substantial consumer demand underpinned by a high savings rate
- Growing consumer confidence
- An expanding money supply

Moreover, banks appear to be less reluctant to extend credit, and GDP growth should be helped by falling oil prices and a weakening euro, which helps exports. In

fact, we would not be surprised if the region's economy accelerates to 2% growth in 2015—well above consensus expectations. Risks remain, however, including the uncertainty surrounding Greece's January 25 election and a January 14 ruling on the legality of the ECB's asset purchases.

Outlook

The stimulative effect of lower oil prices could, by some estimates, add an incremental 0.5% to U.S. GDP growth, although that gain may be partially offset by the stronger dollar. Overall, we anticipate that the U.S. economy will expand by 3% or more (at least in the first half of 2015), supporting equity prices.

In equity markets, we believe the past week's correction was a temporary pullback that neutralized overly optimistic investor sentiment. Longer-term sentiment has now become more bearish. This contrarian indicator often presages a market advance, in line with our outlook for the S&P 500 to move to, and perhaps past, the 2,150 level in 2015.

This rise is likely to be accompanied by even greater levels of volatility, brought on by a variety of global macroeconomic and geopolitical factors such as the possibility of aggressive acts by Russia, a slowdown in the Chinese economy, Greece's potential exit from the eurozone, and the threat of deflation. In the U.S., Fed tightening, a historical source of market turbulence, may also exacerbate stock-price swings. Another risk is that the Fed seems poised to raise rates sooner than markets expect. Reconciling those views could create additional turmoil.

For fixed-income markets, U.S. Treasuries continue to attract capital, thanks to their relatively higher yields. This rising demand has reduced yields even as the job market continues to improve and the Fed comes closer to raising rates.

In terms of identifying fixed-income opportunities, we believe value exists in non-oil-related high-yield securities, whose spreads have widened in sympathy with energy-related high-yield bonds. Even oil-related companies appear attractive, given that the market has priced in default rates approaching 50%. In our view, defaults at that level are unlikely, as many companies can reduce costs in the face of sub-$50 oil. Lastly, we believe most credit markets, specifically investment-grade corporate bonds, higher-quality high yield, and structured securities, should perform well in 2015.

Financial Services

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