Weekly Market Update

Global markets cheer the ECB's quantitative easing plan

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Article Highlights

- The ECB's long-anticipated QE announcement exceeds markets' expectations.
- Global equity markets surge, while European bond yields and the euro plunge.
- QE aside, structural reforms are key to the Eurozone's long-term health.
- U.S. housing indicators are mostly encouraging and should add to GDP growth.
- Election results in Greece will lead to protracted debt negotiations and continued uncertainty.

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After months of debate and speculation, the European Central Bank (ECB) finally announced an open-ended, large-scale quantitative easing (QE) program on January 22. The program is designed to provide much-needed stimulus to the weak Eurozone economy by driving interest rates lower and increasing inflation until it approaches the central bank's target of close to 2%. Beginning in March, the ECB will purchase €60 billion (US $68 billion) worth of Eurozone sovereign bonds every month for at least 18 months.

Equities

Global equity markets surged during the past week, buoyed by anticipation of the ECB's move and then pleasantly surprised by the scope of the QE program when announced. European stocks gained roughly 5% for the week. Through January 22, the S&P 500 Index was up 3.6% in a U.S. trading week shortened by the Martin Luther King holiday. U.S. equities gave back some of their gains on January 23, however. Meanwhile, the euro plunged to another multi-year low against the dollar, ending the week near the $1.13 level.

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

Fixed income

European fixed-income markets also rallied strongly, with yields on 10-year government bonds in Germany, France, Italy, Spain, Ireland, Portugal, Belgium,

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and Denmark hitting record lows in the wake of the ECB announcement. (Yields and prices move in opposite directions.) At mid-day on January 23, for example, the German 10-year yield stood at 0.32%.

The 10-year U.S. Treasury yield experienced some volatility during the week, falling as low as 1.77% and as high as 1.95% in intraday trading before settling in the low 1.8% range. Meanwhile, spread products (higher-yielding, non-Treasury securities), which have benefited so far this year from the global search for yield, generally posted flat to slightly negative returns for the week through January 22.

U.S. housing indicators are generally favorable

In a relatively light week for U.S. data releases, housing starts and permit data suggest that construction activity is picking up, a welcome development that we think will ultimately add to future GDP growth.

- **Housing starts** rose 4.4% in December to an annual rate of 1.09 million, ahead of forecasts and the highest level in seven years. For single-family homes, starts increased 7.2%.
- **U.S. home prices** rose 5.3% on a year-over-year basis in November, according to the Federal Housing Finance Agency (FHFA) index. The pace of appreciation has remained fairly consistent over the past several months.
- **Homebuilder confidence** levels ticked lower in January but hovered near a nine-year high, according to the NAHB/Wells Fargo index.
- **Building permits**, a forward-looking indicator, climbed 4.5% in December for single-family homes, the biggest increase in more than two years.
- **Mortgage rates** fell to a 20-month low of 3.63%, continuing to spur demand for home loans.
- **Existing home sales** rose slightly (+2.4%) in December.

Among other releases, the Labor Department reported that first-time jobless claims dropped by 10,000, to 307,000, while leading economic indicators increased, according to The Conference Board.

In Europe, some hopeful indicators emerge, but reforms remain key

In addition to benefiting from the ECB's announcement, European equities may have received a lift from signs of improvement in the region's economic landscape. Manufacturing and service-sector activity for the Eurozone, as measured by Markit's "flash" (preliminary) composite Purchasing Managers' Index (PMI), rose to a five-month high of 52.2 in January, slightly ahead of expectations. (Readings above 50 indicate expansion.) Moreover, bank credit is expanding, and earnings revisions have turned positive.

As for the impact of quantitative easing, the question remains whether strength in European financial markets will "transmit" to the real economy. As we have stated previously, QE alone will not solve the region's woes; structural reforms are also essential. Encouragingly, France and Italy, the Eurozone's second- and third- largest economies, respectively, appear to be making progress in this area.

Outlook

For the Eurozone, the most immediate benefit of QE is likely to come via a weaker currency, which will increase the cost of imports while making exports cheaper. The euro has already fallen by nearly 20% versus the U.S. dollar since May 2014, and we forecast it could decline a further 4%-5% this year, approaching parity (i.e., the point at which the exchange rate between the two currencies is 1:1).

We see Europe's equity markets as among the most compelling in the world. Even as the euro continues to weaken, thereby reducing the returns of European holdings for U.S. investors, stocks in Europe will likely outperform U.S. shares. Key risks in the region remain, however, including uncertainties resulting from Greece's January 25 election. Regardless of the eventual coalition government that takes shape, a prominent role for anti-austerity party Syriza will mean difficult negotiations ahead regarding the country's debt load and payments. In our view, however, the prospect of a Greek exit from the Eurozone is remote.

In the U.S., we believe equities will look more attractive than bonds for the remainder of this year. Throughout 2015, fund flows should remain positive for investment-grade corporate bonds, but we expect greater volatility of flows for both emerging-market and high-yield debt. Additionally, while European fixed-income assets will continue to benefit from QE, further euro weakness will erode their returns in U.S. dollar terms.