Weekly Market Update

U.S. equities continue to feel the pain of volatility

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

Article Highlights

- A Friday plunge in U.S. stock prices erases the week's earlier gains.
- Investors fret over a surging dollar, tumbling oil prices and the Fed's next move.
- U.S. economic data is muted, confirming a relatively weak trend so far this year.
- Treasuries rally as European QE sends global investors in search of higher yield.
- The Fed's March meeting should provide further clarity on the timing and pace of coming rate hikes.

March 13, 2015

Equities

U.S. equities started the week by bouncing back from the previous week's sharp decline, but conditions turned more volatile, resulting in wide daily price swings. As of midday trading on March 13, the S&P 500 Index appeared headed for its third consecutive week of losses. The recent market turbulence has not been surprising, given stretched valuation levels and overly optimistic near-term sentiment. Investors have also been unnerved by the prospect of an earlier Fed rate hike and a steadily rising dollar, bolstered by February's surge in U.S. job growth.

European and broad-market international equities generally fared better, at least in local currency terms. For U.S. investors, however, the continued precipitous slide in the value of the euro magnified small losses, eroded gains, or turned positive returns negative when translated into dollars. The MSCI Euro Index, for example, returned 0.82% in euros for the week through March 12 but -1.45% in dollars. Oil prices, which tumbled about 9% for the week and slipped below $45 per barrel, were also hit by the dollar's strength, along with growing worry over excess supplies.

Financial Services

U.S. equities continue to feel the pain of volatility

Current updates are available here. For additional insights from TIAA-CREF Head of Global Active Equity Portfolio Management Saira Malik, view our Weekly Market Perspective Video.

Fixed income

U.S. Treasuries recovered from the previous week's selloff, when the bellwether 10-year yield spiked to 2.24% on the heels of the monthly U.S. payrolls report (yields and prices move in opposite directions). Economic releases since then have been rather muted, and the 10-year yield was trading at 2.10% on March 13. In addition, Treasuries benefited from the launch of quantitative easing (QE) in Europe, which drove European yields lower and fueled demand for the higher yields available in the U.S.

Performance varied among non-Treasury categories, including high yield, where new issuance had to be absorbed. Mortgage-backed securities underperformed Treasuries and the broader Barclays U.S. Aggregate Index on concerns about prepayment risk, while emerging-markets debt saw yield spreads widen as the dollar strengthened.

U.S. economic data is subdued after the previous week's release of February payrolls

Overall, recent data releases confirm that February was a fairly weak month for the U.S. economy, although slightly stronger than January. Among the past week's reports:

- **Retail sales** fell 0.6% in February, falling short of consensus forecasts for a 0.3% gain and marking the third monthly drop in a row. We believe this weak showing is partly due to harsh winter weather across much of the country and the impact of a port slowdown on the West Coast.
- **Consumer sentiment** dipped to its lowest level since last November, based on the Thomson Reuters/University of Michigan index.
- **First-time unemployment claims** fell by 36,000 to 289,000, having reached a multi-month high the week before. Improving labor market conditions remain on track.
- **Wholesale inventories** rose in January, while **sales** slipped. Meanwhile, **wholesale inflation,** as measured by the Producer Price Index, decreased 0.5% in February and was down 0.6% year-over-year (the first 12-month decline on record).

Negative inflation numbers have been driven primarily by the steep fall in oil prices over the past year. We think inflation is likely to stabilize and resume its upward trend, perhaps as early as this fall.

The euro plummets to our year-end forecast as QE begins

The European Central Bank (ECB) began its QE asset purchases on March 9, and the impact has already been felt, with yields on 10-year German government bonds falling to 0.20% early in the week before turning slightly higher by week's end.

Meanwhile, the euro has already depreciated to 1.05 against the dollar, our forecasted level for year-end 2015. We still believe the euro can recover some of its value this year, but the prospect of parity with the dollar is certainly closer than we previously expected.

Outlook

U.S. equity market action is tending to conform with the path we are expecting, which is a move on the S&P 500 to and through the 2,150 level or higher before we might have to contend with a 5% to 10% correction. This view is supported by a healthy correction in near-term sentiment. Hedge fund net exposures have moved back down toward 50%, and short-term trading sentiment has also headed lower. That said, while our base-case scenario remains cautiously optimistic, we recognize that the market remains somewhat extended, valuations are not cheap, and a stronger dollar is a significant headwind for U.S. corporations.

A key from here will be the Fed's meeting on March 17 and 18, at which the word "patient" is likely to be dropped from the language about the timetable for raising short-term interest rates. In addition, the new "dot plots" of Fed rate forecasts should provide further clarity about both the likely rate increase and the subsequent pace of tightening. Both of those variables have been lowered but remain above what equity markets are pricing in. We expect equity markets to remain volatile around March's meeting and between then and the June meeting—still the most likely timing for the first rate hike.

In fixed-income markets, we believe that bond spreads currently represent reasonable but not exceptional value compared to equities. We find investment-grade corporate bonds particularly attractive, as their buyer base is largely institutional and stands to benefit directly or indirectly from European QE. While absolute yields in high-yield bonds and loans are attractive, trading in these assets tends to be more volatile, as buyers include higher concentrations of hedge funds and retail investors.