Weekly Market Update

U.S. equity and Treasury markets cheer the Fed's surprisingly dovish tone

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

- Despite dropping its pledge to be "patient," the Fed signals a later rate hike and a slower pace of increases.
- U.S. equity and bond prices rise on the Fed's dovish message.
- European stocks rally for the seventh consecutive week.
- Economic reports in the U.S. are mixed, while those in the eurozone are generally encouraging.
- We expect markets to remain volatile, especially around Fed policy meetings.

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After holding the federal funds rate near zero since December 2008, the Federal Reserve had been widely expected to open the door to a June 2015 increase. While the language in the Fed's March 18 policy statement did remove a commitment to remain "patient" in timing its first rate hike since 2006, the overall message actually makes it more likely that the rate increase will occur in September rather than in June.

Moreover, the Fed also signaled a slower pace of subsequent rate increases, affirming that it will set policy at each meeting based on the latest economic data. Tightening will begin when the central bank "has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term." Reflecting this view, Fed officials cut their estimate for the federal funds rate to 0.6% at the end of 2015, down from 1.1% in their December 2014 outlook.

Equities

The prospect of a slower pace of rate increases sent U.S. stocks higher and the dollar lower. The S&P 500 Index snapped a three-week losing streak by surging nearly 3% for the week.

European stocks also gained, recording their seventh straight week of positive returns on optimism driven by the European Central Bank's quantitative easing

Financial Services

program and a weaker euro. Cyclical, export-oriented sectors such as autos and industrials outperformed.

Japan continued to lead global markets higher, as the softening yen versus the dollar helped the Nikkei 225 Index notch a fresh 15-year high. The advance has been supported by effective government-induced corporate reforms and shareholder-friendly actions (e.g., increased dividend payouts and share buybacks) by several high-profile companies. A market pause, though, is possible after the country's fiscal year ends on March 31.

Fixed income

Fixed-income markets broadly benefited from the Fed's "dovish" commentary. Treasury prices rose sharply across nearly all maturities, pushing yields down. (Prices and yields move in opposite directions.) The yield on the bellwether 10-year note plunged 13 basis points (0.13%) on March 18 alone and closed at 1.93% on March 20. "Spread products" (higher-yielding, lower-rated, non-U.S. Treasuries) were helped by the market's perception that riskier assets could benefit in this lower-rate environment.

Limited supply of qualifying debt in the tighter markets of the Eurozone helped the region's fixed-income markets, while in the wake of the dollar's decline immediately following the Fed's announcement, emerging-markets debt rallied modestly.

Current updates are available here. For additional insights from TIAA-CREF professionals, view our Weekly Market Perspective Video.

Another batch of mixed reports for the U.S. economy

The past week's economic releases contained a number of disappointing data reports, some of which could very well reflect the severe winter. Among the releases:

- **Home builder confidence** fell in March for the third month in a row, according to the NAHB/Wells Fargo index.
- **Housing starts** slumped 17% in February to an annual rate of 897,000, well below estimates.
- **Building permits**, a forward-looking indicator, edged higher.
- **Leading economic indicators** rose in February, according to The Conference Board, a sign the economy should expand at a moderate rate in the months ahead.

- **First-time unemployment claims** ticked up by 1,000 to 291,000, as did the less-volatile four-week moving average, to 304,750.
- **Regional manufacturing indexes** slipped in March, as both the Empire State manufacturing index and Philly Fed survey declined.

The Eurozone takes a few more steps toward recovery, but potential stumbling blocks remain

Data releases from Germany continue to improve. On the heels of reports revealing a drop in unemployment and surging consumer confidence, investor sentiment in the Eurozone's largest economy rose for the fifth month in a row in March, and business sentiment in February jumped**.** For the Eurozone as a whole, the threat of deflation eased modestly in February. Consumer prices fell 0.3%, slower than January's rate, while core inflation, which excludes food and energy costs, picked up slightly (+0.7%).

There are a few caution flags, however. Limited progress has been made to ease the conflict in Ukraine and to resolve the debt crisis in Greece. Moreover, reforms are still needed to make European labor markets more flexible and economies more productive.

Outlook

Markets welcomed Chair Janet Yellen's unexpectedly more dovish tone compared with her language over the preceding weeks, perceiving that the Fed is now concerned about raising rates too quickly and worried about a market shock associated with rapid tightening. In our view, the Fed's retreat from recent guidance will contribute to increased market volatility, especially around Fed policy meetings, as officials appear to have moved to a "wait and see," data-dependent stance without any accompanying interpretation of that data.

In terms of U.S. equities, we remain cautiously optimistic. Although continued low oil prices are good for consumers, a later-rather-than-sooner Fed rate hike may indicate that the economy's recent weakness and the impact of dollar strength are signs of a broader slowdown.

We would not be surprised to see a pullback in European equity markets given the speed of their advance and sentiment indicators suggesting the market may be overbought. That said, stocks in Europe remain more attractively valued than their U.S. counterparts, assuming the eurozone economy and corporate profitability continue to improve.

For fixed-income markets, we believe wage inflation, which the Fed would like to see materialize before considering a rate hike, is still many months away. This provides a potential window of investment opportunity in U.S. and European fixed-income assets, as bond markets would stand to benefit from a very gradual rise in wages. One key question is how the number of people working, as represented by the labor participation rate, will affect wage increases and, ultimately, fixed-income returns.