Weekly Market Update

Equity markets retreat in an unsettled week

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

- A surge in Middle East hostilities and rising interest rates contribute to a drop in the S&P 500.
- U.S. Treasury performance also wavers amid mixed economic data.
- The Eurozone recovery grows stronger, but the Greek bailout saga continues.
- Despite the U.S. economy's sluggish start to the year, we see signs of strengthening ahead.
- We expect ongoing volatility in equity and fixed-income markets as Fed tightening approaches.

March 27, 2015

Equities

U.S. equities failed to extend their recent Fed-inspired rally, when markets rose on the assumption that short-term interest rates will not be hiked until later this year. For the past week, the S&P 500 Index fell more than 2% amid a bump up in oil prices driven by escalating hostilities in Yemen, coupled with higher interest rates.

European stocks also lost ground, snapping a seven-week winning streak. A rebound in the euro, combined with a bout of risk aversion given Middle East tensions, contributed to the pause. We believe the region's brightening economic prospects continue to offer the opportunity for favorable returns.

Japan's manufacturing sector slowed in February, while activity in China's factories contracted. Investors may take this weak economic news as a sign that more central bank stimulus is forthcoming, providing future support for equity markets. In local currencies through March 26, Japan's Nikkei 225 Index and Shanghai's "A Share" index were up about 12% and 14%, respectively, trailing Europe (+17% in local currencies).

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Fixed income

In a reversal from the prior week, Treasury prices fell across almost all maturities, driving up yields. (Price and yield move in opposite directions.) Through afternoon trading on March 27, the yield on the bellwether 10-year note was 1.96%, up 4 basis points (0.04%) for the week. Returns for "spread products" (higher-yielding, lower-rated non-U.S. Treasury assets) were broadly negative, although high-yield bond performance bucked the trend, supported by positive fund flows.

In Europe, concerns about the future of Greece's bailout package and a possible Greek exit from the eurozone have not spread to fixed-income markets. Eurozone sovereign debt continues to rally, with the decline in yields most pronounced among longer-dated bonds.

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

While not stellar, February's U.S. economic data offers signs of optimism

February's economic releases, although on the weak side, were slightly better than January's, and we see some hints of acceleration. This bodes well for economic growth in the second quarter and second half of the year.

Among the past week's reports:

- **Existing home sales** ticked up (+1.2%) in February, reversing January's drop.
- **New home sales** surged to a seven-year high in February (+7.8%) from an upwardly revised level in January.
- **First-time unemployment claims** fell by 9,000 to 282,000, and the less-volatile four-week moving average also declined, to 304,750.
- **Consumer prices** climbed 0.2% in February, the first increase in four months, but remained flat compared to a year ago.
- **U.S. manufacturing activity** rose in March to 55.3, well above the 50 mark separating expansion from contraction, as measured by the Markit "flash" (preliminary) Purchasing Managers Index (PMI).
- **Durable goods orders** (aircraft, machinery, computer equipment, and other big-ticket items) fell 1.2% in February, lagging expectations for a small increase, while January's rise was revised downward.
- **Consumer sentiment** dipped in March, according to the Thomson Reuters-University of Michigan Index, although the final reading for the month was higher than the preliminary figure.

Meanwhile, the government's third and final estimate of fourth-quarter GDP growth (+2.2%) was unchanged from the previous estimate.

The eurozone recovery continues apace, but Greece may have hit a tipping point

The week brought further evidence of Europe's economic strengthening. Business activity grew at the fastest rate in almost four years, with Markit's "Flash" Eurozone PMI reaching 54.1 in March, and business confidence in Germany increasing for the fifth straight month. Moreover, the Euro Area Citi Economic Surprise Index, which measures economic releases relative to forecasts, turned higher (meaning data has been coming in better than expected). And in a sign that the European Central Bank's quantitative easing program may be taking hold, lending to companies and households is rising.

Against this positive backdrop are the ongoing problems plaguing Greece. The new government is scheduled to deliver a detailed package of economic reforms to Eurozone officials on March 30 in the hope of unlocking financial aid and avoiding bankruptcy. Greece's previous list of planned reforms was criticized for being too vague. Therefore, creditors will demand greater detail before agreeing to release any funds. To address the potential for a run on Greek bank deposits, Athens may be forced to consider imposing capital controls over the next few weeks.

Outlook

Since the beginning of the U.S. economic recovery, the first quarter of each year has been soft. That pattern has continued in 2015: Weakness in January and February will significantly dampen first-quarter GDP growth, and improved activity in March—while providing momentum heading into the second quarter—will not offset the year's slow start. Consequently, we are revising our first-quarter GDP growth forecast downward, from 2.4% to 1.5%.

In the near term, the path of the S&P 500 Index may well be determined by results of the upcoming first-quarter earnings season. Recent revisions have been negative, although the market has previously attributed lower-than-expected earnings to the stronger dollar and, in some cases, bad weather. Additional volatility is to be expected, as markets have historically exhibited wide price swings in anticipation of Fed interest-rate hikes.

In fixed-income markets, fundamentals remain stable to positive. High-yield bond default expectations remain low (outside of energy companies), and mergers and acquisitions activity in the investment-grade corporate bond space is still modest compared to long-term averages. However, any number of upside economic surprises could trigger a rise in yields, as markets fear that better economic news could hasten the Fed's tightening timetable. We believe the odds of the initial rate hike happening either in June or in the third quarter are evenly split. In the meantime, we continue to monitor movements in 2- and 5-year Treasury yields, which tend to rise significantly between one and three months prior to the Fed's first hike in a new rate cycle.