Weekly Market Update

U.S. equities retreat on Greek concerns, uneven economic data

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Article Highlights

- Mixed U.S. data releases and the Greek debt drama send U.S. and European stocks lower.
- U.S. Treasuries benefit from heightened demand for safe-haven assets.
- GDP growth is revised downward into slightly negative territory, as expected.
- We have lowered our GDP growth forecasts for both Q2 and 2015 as a whole but do not believe the economy is faltering.
- While an agreement will likely be reached in Greece, the greater risk may be the Russia-Ukraine conflict.
- At current levels, bonds appear reasonably priced, but equities offer better value.

Equities

U.S. equity markets turned volatile in a week shortened by the Memorial Day holiday. Amid mixed economic data and conflicting messages about a possible breakthrough in the Greek debt negotiations, the S&P 500 Index was down about 0.5% for the week as of mid-day trading on May 29. Stocks also fell in Europe. Year to date through May 28, European equities are up 20.8% in local currency terms, although the dollar's sharp appreciation versus the euro trimmed that advance to 9% for U.S.-based investors. In contrast, the S&P 500 has gained just 3.9% so far this year.

In Asia, Japan's Nikkei 225 Index notched a series of 15-year highs and 11 straight days of gains, supported by a weaker yen and strong retail sales. Year to date through May 28, the Nikkei is up 18.4% in local terms and 14.3% in dollar terms. The recent run-up in Chinese equities, fueled by stimulus measures and expectations of future monetary easing, reversed course sharply during the week. Despite the correction, shares in China remain in a firm uptrend.

Financial Services

Fixed income

Following a recent rise in yields, Treasury markets shifted gears. The Greek saga spurred demand for safe-haven assets, pushing up prices (and driving down yields) for both U.S. Treasuries and German government debt. The decline in U.S. stocks, along with some subdued data releases, also boosted Treasury prices, with the yield on the bellwether 10-year note falling steadily through the week, from 2.21% on the morning of May 26 to around 2.10% as of afternoon trading on May 29.

Returns for Treasuries and “spread products” (higher-yielding, non-U.S. Treasury securities) alike were broadly positive for the week through May 28, led by investment-grade corporate bonds, which continued to benefit from strong issuance and demand.

Current updates are available here. For additional investment insights from TIAA-CREF high-yield fixed-income portfolio manager Kevin Lorenz, view our Weekly Market Perspective Video.

The U.S. economy contracts in Q1, but we expect a second-quarter pickup

As we expected, first-quarter U.S. GDP growth was revised downward, from +0.2% to -0.7%. Lower inventory spending and an expanding trade deficit—the result of weaker exports and stronger imports—were the main reasons for the adjustment.

Among the week’s other data releases:

- **Housing prices** rose 0.9% in March and 5.0% compared to a year ago, based on the S&P/Case-Shiller 20-City Composite Index.
- After a surprising fall in March**, new home sales** topped forecasts with a 6.8% gain in April.
- **Pending home sales** increased for the fourth consecutive month, rising 3.4% in April to their highest level in nine years, and 14% compared to a year ago.
- Following April’s sharp decline, The Conference Board’s index of **consumer confidence** edged higher, buoyed by an improved view of the labor market.
- **Consumer sentiment** beat expectations by ticking up, according to the University of Michigan-Thomson Reuters index’s final May reading.

- **First-time unemployment claims** and the less-volatile four-week moving average edged up to 282,000 and 271,500, respectively, but remained near 15-year lows. These figures support monthly job growth of about 225,000 and a modest drop in the unemployment rate.
- Although the headline figure for **durable goods orders** (aircraft, machinery, computer equipment, and other big-ticket items) fell 0.5% in April, orders rose 0.5% excluding the volatile transportation sector. Business investment rebounded, as orders for core capital goods climbed 1%.

Greek talks dominate headlines while the Russia-Ukraine conflict looms

With key loan payment deadlines approaching, Athens repeatedly claimed that a deal was close, even as its international creditors insisted the two sides remained far apart. Despite these mixed messages, we believe a compromise will ultimately be reached. While Eurozone bank officials would prefer not to offer concessions, the alternative is a “Grexit,” meaning not only the loss of Greece in the monetary union but also all possibility of its creditors recovering any portion of what they are owed.

Of more immediate concern is Russia’s reported buildup of troops and military equipment along Ukraine's border. Heightened hostilities could spark renewed market volatility, depending on the sanctions levied by the West.

Outlook

We had been expecting a bigger bounce in the U.S. economy for the second quarter. Instead, April was a slow to down month, and May has seen evidence of bottoming. As a result, we are lowering our GDP growth forecast for the second quarter, from 3.2% to 2.0%. For 2015 as a whole, we expect GDP growth of 2.3%, down from our previous forecast of 2.5%. In our view, this doesn’t mean the U.S. economy is faltering, but rather that it is stuck in slow-growth mode.

In terms of a Fed rate hike, September remains the likely liftoff point, but the odds of a later start have risen because the economy hasn’t strengthened sufficiently. That said, some Fed officials have suggested that further improvement in labor markets between now and September might lead to a rate hike even if economic growth remains subdued.

For U.S. stocks, the risk premium is at average levels, investor sentiment remains muted, and equity flows have been negative (in favor of bonds)—three indicators that often signal a rise in stock prices. Against this backdrop, we could see the S&P 500 move to perhaps 2,150 to 2,175 and possibly to 2,200 amid rising volatility. From those levels, a correction of 5% to 10% is possible. We still believe the U.S. equity market will end higher for the year.

Such a correction could be triggered by a rise in longer-dated U.S. Treasury yields. This would likely occur if German rates lift, making U.S. debt relatively less attractive. For now, Treasuries will likely trade in a narrow range until the Fed announces a rate hike or we see a sustained increase in wage growth. Broadly speaking, bonds are reasonably priced, but equities offer greater value.

Financial Services

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