Weekly Market Update

Equity and fixed-income markets feel the pain of volatility

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Article Highlights:

- Anxiety over Greece and bond market volatility send U.S. and European stocks lower.
- Global bond yields spike amid tight liquidity and the prospect of higher rates.
- May's better-than-expected jobs report means the economy is likely performing better than GDP figures suggest.
- We forecast 2% U.S. GDP growth in the second quarter, with some improvement in the second half of 2015.
- The odds of a Fed rate hike in September have increased.
- In our view, volatility will continue in both equity and fixed-income markets.

June 5, 2015

Equities

Global equity markets fell during most of the week as uncertainty over the next phase of the Greek debt crisis and ongoing volatility in global government bond markets took their toll. Stocks were choppy following the release of May's robust jobs report on June 5, which sparked investor fears of a sooner-rather-than-later rate hike by the Federal Reserve. We think the employment data increases the likelihood of a September liftoff. The S&P 500 Index finished 0.7% lower for the week.

Stocks also declined in Europe. Japan edged lower but remains the best-performing equity market year to date. In China, equities marched higher despite some troubling economic fundamentals.

Fixed income

Volatility in German government bonds continued to spill over into U.S. Treasury markets. Rising expectations for Eurozone economic growth and inflation, coupled with tight liquidity, fueled the largest two-day spike in 10-year German bond yields since 1998. For the week, the German 10-year yield rose by roughly 30 basis points (0.30%), ending at about 0.85%. Similarly, the yield on the bellwether 10-

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year U.S. Treasury jumped from 2.12% on the morning of June 1 to close at 2.41% on June 5.

Rising yields also hurt returns for “spread products” (higher-yielding, non-U.S. Treasury securities), which were broadly negative for the week through June 4. Investment-grade corporate bonds were hit especially hard, while high-yield bonds demonstrated some resilience.

Current updates are available here.

For additional investment insights from TIAA-CREF Portfolio Manager Chris Semenuk on the effects of the potential exits of Greece and the U.K. from the European Union, view our Weekly Market Perspective Video.

May payroll report support our view that the economy is turning

The U.S. economy generated 280,000 new jobs in May, well ahead of most forecasts, including our own. The unemployment rate edged up to 5.5% from 5.4%, mainly because more people entered the labor force. More importantly, payrolls for April and March were revised upward by a combined 32,000.

Meanwhile, wages ticked up 0.3% in May and 2.3% versus a year ago. While not stellar, these figures suggest we may see stronger wage growth during the second half of the year, as labor markets continue to tighten. This, in turn, may bolster consumer spending.

The payroll report, along with the week’s other releases, confirms our view that April was soft, May saw signs of improvement, and June will be even better. Among the week’s other data highlights:

- **First-time unemployment claims** fell 8,000, to 276,000, and the less-volatile four-week moving average edged up to 274,750. Both figures remained near 15-year lows.
- The **U.S. trade deficit** shrank 19.2% (nearly $10 billion) in April, as imports fell and exports rose modestly, while March’s deficit was revised downward. With the West Coast ports fully operational, we believe the trade deficit will continue to shrink, driving the economy toward 2% GDP growth in the second quarter.
- **U.S. manufacturing activity** softened to 54.0 in May, according to Markit’s Purchasing Managers Index (PMI), but remained well above the 50 level separating expansion from contraction. A similar index from the Institute for Supply Management (ISM) rose to 52.8, ahead of forecasts.
- **U.S. service-sector growth** slowed in May, with the ISM index dipping to 55.7.
- After slowing in April, **auto sales** bounced back in May with their highest total in nearly 10 years.

Outlook

While equity market volatility will continue and a correction on the S&P 500 is possible at levels of 2,150 to 2,200, we still believe U.S. stocks remain on an upward trajectory. Contributing to this view is a closely watched technical indicator showing that Wall Street strategists are underweighting U.S. stocks—a contrarian signal historically associated with a subsequent rise in stock prices.

In Europe, we have already seen the expected correction in equity markets, and investor sentiment there is also negative—two factors that could set the stage for a move higher. Moreover, recent economic releases have been encouraging: retail sales, employment, and manufacturing production have improved, while Eurozone inflation rose by 0.3% in May, helping to ease deflation concerns. As for Greece, the end game is approaching, but in our view the odds still favor a compromise, most likely in the form of an eleventh-hour agreement later this month. Such an outcome could provide additional support for Eurozone stocks.

We have been surprised by the strong performance of Japanese stocks this year. The Nikkei 225 Index has gained 18% (in yen terms) and 15.1% (in dollar terms) year to date through June 4. Prime Minister Shinzo Abe has finally begun to introduce corporate-governance reforms, which should further unlock shareholder value. However, Japanese stocks are no longer inexpensive and may be hard pressed to produce additional gains this year.

In fixed-income markets, heightened volatility reflects concerns about the direction of rates, exacerbated by poor market liquidity. In spite of these conditions, non-Treasury sectors such as emerging-market debt, high-yield bonds, and agency mortgage-backed securities have been surprisingly resilient compared to their performance during the rise in rates that marked the May 2013 “taper tantrum.” We think this bodes well for fixed-income markets going forward.