Weekly Market Update

Greek worries take a toll on equity markets

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Article Highlights:

- U.S. and European equity markets weather late-week Greek debt drama to finish essentially flat.
- Treasuries benefit from heightened demand for safe-haven assets.
- Despite the discouraging headlines, we believe a “Grexit” will be averted.
- We expect an upward revision to Q1 GDP growth, while Q2 GDP may top our 2% forecast.
- Bond market volatility is likely to rise as the Fed prepares to tighten, most likely in September.

June 12, 2015

Equities

Following two straight weeks of losses, U.S. equities rallied midweek, buoyed by a stream of strong economic data and hopes for an agreement in Greece. However, stocks retreated after the International Monetary Fund (IMF) walked away from the Greek negotiations on June 11. The S&P 500 Index was up a scant 0.1% for the week. Stocks in Europe also inched 0.1% higher, while Japanese equity indexes edged lower.

Fixed income

In spite of several solid U.S. data releases, yields on 10- and 30-year U.S. Treasuries declined slightly, as escalating fears of a “Grexit” boosted demand for safe-haven assets. After beginning the week at 2.41%, the bellwether 10-year Treasury hit a high of 2.50% on June 10 before dipping to 2.39% on June 12.

Treasuries and nearly all “spread products” (higher-yielding, non-U.S. Treasury securities) posted small gains for the week through June 11. Significant outflows hurt high-yield bonds, while demand for investment-grade debt kept up with robust supply.

Current updates are available here.

Financial Services

For additional investment insights from TIAA-CREF Portfolio Manager Joseph Higgins on bond market liquidity and future actions by the Federal Reserve, view our Weekly Market Perspective Video.

A good week for the U.S. economy

The past week's economic releases showed continued vigor in the job market following May's better-than-expected payrolls report, increased willingness of consumers to open their wallets, and a housing market that is picking up some steam as we head into summer. Among the week's reports:

- **First-time unemployment claims** and the less-volatile four-week moving average each edged up to 279,000 but remained near 15-year lows. Moreover, job openings (as reported by the JOLTS report) hit a record high in April, a sign that March and April payrolls may be revised upward.
- **Mortgage applications** surged, which bodes well for both the housing market and the government's third and final estimate of first-quarter GDP growth, scheduled for June 30 release.
- **Retail sales** rose 1.2% in May (+1.0% ex-autos), their third straight monthly advance, and were 2.7% higher than a year ago. Nearly all retail categories posted gains for the month, offering evidence that the economy has regained momentum after contracting in the first quarter. In addition, sales for March and April were revised upward.
- **Small business sentiment** hit its highest level of the year in May, according to the NFIB's small-business optimism index.
- **Consumer sentiment** topped forecasts by a wide margin, based on the preliminary June reading of the University of Michigan-Thomson Reuters index.
- The **Citi Economic Surprise Index** moved higher from its May low. This index is a gauge of the extent to which economic data releases have diverged from consensus forecasts.

Amid broader economic improvement in Europe, all eyes are on Greece

European economic activity has continued to improve, while markets in the region remain focused on the ongoing Greek debt negotiations. Despite the past week's developments, we still believe that Greece and its international creditors are heavily invested in signing an agreement, although the process could drag on until early next year. The possibility of capital controls looms in order to stanch a run on Greek banks, but in our view a "Grexit" from the Eurozone remains unlikely.

Outlook

The final estimate of first-quarter GDP data will likely show that the U.S. economy contracted at a 0.2% pace instead of the 0.7% reported last month. Meanwhile, the recent batch of encouraging reports suggests that second-quarter GDP growth may top our 2% forecast.

Greek worries take a toll on equity markets

Following two weeks of declining stock prices, short-term investor sentiment has soured and hedge funds' net exposure to equities has fallen—two technical indicators that often presage a market upturn. Therefore, we weren't surprised by the S&P 500's mid-week rebound even in the face of rising long U.S. bond rates driven by higher European yields, more robust U.S. inflation expectations in the wake of better economic releases, and higher oil prices. Longer term, we expect the S&P 500 to break through the 2,300 level by year-end, with a correction likely once the index hits the 2,150 to 2,250 range.

In terms of a Fed rate hike, the odds are high for a September liftoff. We expect an initial 25 basis point (0.25%) hike followed by a waiting period to assess market reaction. If markets take this move in stride and economic data continues to strengthen, we anticipate a similar increase at the Fed's December meeting. This slow and careful approach should help keep markets calm.

That said, until Fed policy actually changes, bond market volatility is likely to increase. Tight liquidity, which exacerbates price moves, will continue to be a factor, especially as markets price in higher rates. This condition stands in stark contrast to the extremely liquid, low-volatility environment of the past several years. Against this backdrop, we expect the 10-year U.S. Treasury yield to reach 2.75% by year-end, up from a previous forecast of 2.5%, with the possibility of temporary spikes to about 3%.

In China, the housing market has shown some signs of stabilizing even as the broader economy continues to weaken. This has prompted the government to apply additional targeted stimulus programs and investment-driven spending. So far, authorities have made progress on balancing decelerating growth with reforms, although the risk of an economic "hard landing" remains.

Meanwhile, Japan's virtuous cycle of a weaker yen and higher stock prices may be nearing an end, as Bank of Japan Governor Haruhiko Kuroda told a group of legislators that the yen is unlikely to depreciate further.

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