Weekly Market Update

With Greece receding from view, markets focus on fundamentals

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- U.S. and European stocks lose ground following Greek “relief rally.”
- Concerns about China’s weak economy help drive Treasury prices higher.
- Housing remains a standout in a week of mostly positive U.S. economic data.
- The Chinese government’s focus on economic growth could undermine reform efforts.
- We remain optimistic about U.S. equity and fixed-income performance, despite an expected increase in Fed-induced volatility.

July 24, 2015

Equities

Not surprisingly, U.S. equities declined from overbought levels reached as the Greek debt crisis faded from the headlines. The S&P 500 Index fell about 2.2% for the week through afternoon trading on July 24. Some disappointing corporate earnings releases weighed on the market as well, even as earnings from S&P 500 companies who have reported so far have topped estimates by 5%. Results for U.S. multinationals have been better than expected, despite headwinds from a strong dollar.

In Europe, manufacturing and service-sector growth slowed slightly in July, although the rate of expansion remained one of the strongest in four years. The STOXX 600 Index ended a nine-session winning streak on July 21 and finished down 2.7% for the week.

In contrast, Chinese stocks extended their rebound following June’s descent into near bear-market territory. While there have been some mildly encouraging signs for China’s economy, its manufacturing sector contracted sharply in June, and the ongoing fall in global commodity prices may indicate further significant economic weakness, as China is the world’s largest purchaser of most commodities. A worsening slowdown would be harmful for other emerging-markets nations as well, who have depended on exports of commodities to China to prop up their economies.

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Fixed income

Yields on longer-term U.S. Treasuries declined steadily despite a number of positive U.S. data points, including a sharp drop in weekly unemployment claims to a four-decade low. (Yield and price move in opposite directions.) After beginning the week at 2.34%, the bellwether 10-year Treasury yield slid to 2.26% on July 24—a rally driven largely by concerns over the health of China's economy.

Returns for most spread sectors (higher-yielding, non-U.S. Treasury securities) were broadly positive for the week through July 23. Fund flows were mixed, offering only modest support: Outflows from both high-yield and emerging-market debt funds continued, but the pace of withdrawals moderated. Meanwhile, leveraged loan funds saw the highest level of inflows in two months.

Current updates are available here. For additional insights from TIAA-CREF Global Investment Strategist Dan Morris, view our Weekly Market Perspective Video.

Housing releases claim the spotlight

The most important data releases came from the housing sector, a source of continued strength for the U.S. economy. Among the week's reports:

- **Existing home sales** surged 3.2% in June, their fastest pace in more than eight years. Combined with other June releases showing multi-year highs in homebuilder confidence and building permits, along with robust gains in housing construction, we believe the housing sector will continue to strengthen moderately this year and provide a modest boost to overall economic growth.

- **Home prices** rose 0.4% in May and 5.7% compared to a year ago, according to the FHFA.

- **New home sales** fell 6.8% in June, bucking the recent positive trend. Although this report was below expectations, June has historically been a soft month for new home sales, and we expect a July rebound. Sales are still up 18% compared to last year and 21% year to date.

- **First-time unemployment claims** plummeted by 26,000, to 255,000, the lowest total since 1973. While this marked a significant improvement from the spike earlier in the month, claims for July, December, and January tend to be the most volatile and thus, potentially less reliable.

- Driven in part by strong building permits, the index of **leading economic indicators** published by The Conference Board climbed 0.6% in June, suggesting the economy will accelerate in the third quarter.

- The pace of manufacturing activity climbed in July to 53.8, according to Markit's "flash" (preliminary) Purchasing Managers' Index (PMI). (Readings over 50 indicate expansion).

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Outlook

Despite a strengthening job market and a pickup in real wages, the U.S. economy remains on a modest growth trajectory amid subdued consumer activity and low levels of capital expenditures. At the same time, the housing market's improvement and favorable leading economic indicators reinforce our view that the U.S. will gain momentum heading into 2016.

This economic backdrop presents a "good news/bad news" scenario. On the positive side, an accelerating U.S. economy would be welcomed not only at home but also throughout the world—especially if China slows and is unable to act as a global growth engine. On the down side, such an improvement could prompt the Fed to speed up its timetable for raising rates, sparking volatility in equity and bond markets.

We are cautiously optimistic that U.S. stocks can maintain their upward trend through these volatile patches. Supporting our view are two closely watched contrarian indicators that historically have been associated with a subsequent rise in stock prices: Short-term investor sentiment remains overwhelmingly bearish, and Wall Street strategists are currently underweighting stocks. We also believe bonds will be able to weather any Fed-induced volatility.

In Europe, the economy is still on track but vulnerable—even with the Greek debt crisis no longer a front-page story. While European shares are not cheap, we still believe they offer better upside potential than U.S. stocks, as profit margins in the region are some 20% to 25% below normal.

As for China, we are relatively sanguine about the country's short-term prospects but cautious over the longer term. The announcement of 7% second-quarter GDP—precisely the government's growth target—raises concerns over the integrity of Beijing's calculations along with the possibility that the government's ambitious reform agenda is being sidelined by a focus on stimulus to meet aggressive GDP goals. Moreover, recent measures to prop up domestic equities undermine the reforms that have already taken place in China's financial markets. Overall, the country's transition to a more consumer-led base from an export model remains a key barometer of global growth trends.