Weekly Market Update

U.S. equities gain but begin to feel the pressure of an upcoming Fed rate hike

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- Positive earnings and economic data boost U.S. stocks.
- Disappointing wage growth sends the 10-year U.S. Treasury yield lower.
- Stocks in Europe overcome a China-induced selloff to finish up for the week.
- The U.S. economy expands 2.3% in Q2, while Q1 growth is revised upward.
- Absent Fed clues for an earlier rate rise, we still believe the odds favor a December move.

July 31, 2015

Equities

U.S. stocks started to display the volatility that usually precedes the first interest-rate hike in a Fed tightening cycle. After falling on July 27, the S&P 500 Index meandered higher to return about 1.2% for the week through afternoon trading on July 31. Some better-than-expected corporate earnings releases underpinned the advance, as earnings from S&P 500 companies who have reported so far have topped estimates by more than 5%. Some solid economic reports also supported the market. Cyclical stocks, strong performers during economic upswings, have begun to outpace growth shares, which tend to lag as interest rates rise.

Chinese stocks suffered their sharpest one-day decline in eight years on July 27 and finished with their worst month since August 2009 even as Shanghai stepped up efforts to stem the decline in domestic share prices. While some have equated China's equity weakness with a slowdown in its economy, we see signs of economic firming—a decidedly minority position—amid an uptick in positive data surprises.

In Europe, the STOXX 600 Index weathered the China-led sell-off to gain 0.4% for the week, boosted by a slew of acquisition announcements and encouraging company earnings results. The index also rose 4% in July, its best month since February.

Financial Services

Fixed income

Long-dated U.S. Treasuries traded within a narrow range for most of the week. On July 31, however, the yield on the bellwether 10-year note dropped to 2.21% after the government reported the smallest quarterly gain in wages (+0.2%) since 1982. This is a clear sign that the diminishing slack in labor markets has yet to build wage pressure.

Returns for most "spread" products (higher-yielding, non-U.S. Treasury securities) were modest for the week through July 30. Meanwhile, flows were negative for emerging-market debt along with investment-grade and high-yield bonds, which continue to feel the pain from commodity weakness.

Current updates are available here. For additional insights from TIAA-CREF Head of Global Active Equity Portfolio Management Saira Malik, view our Weekly Market Perspective Video.

The U.S. economy rebounds in the second quarter

Second-quarter GDP grew at a 2.3% annual pace, according to the government's advance estimate—precisely in line with our forecast. Consumer and business spending were a bit soft, but exports perked up as expected, reflecting the end of the West Coast port shutdown. Additionally, first-quarter GDP was revised upward to 0.6% from a 0.2% contraction, as the government has taken steps to refine seasonal adjustments for some components of GDP. Other releases were mixed but leaned positive, including:

- **First-time unemployment claims** rose to 267,000 but remained near their lowest level in decades, and the less-volatile four-week moving average fell to 274,750.
- **Durable goods orders** (aircraft, machinery, computer equipment, and other big-ticket items) jumped 3.4% in June.
- **Housing prices** increased 1.1% in May and 4.9% compared to a year ago, slightly lagging April's 5% annual growth, based on the S&P/Case-Shiller 20-City Composite Index.
- **U.S. manufacturing** edged up to 53.8 in July, based on Markit's "flash" (preliminary) Purchasing Managers' Index (PMI). (Readings above 50 indicate expansion.)
- **U.S. service-sector activity** also improved in July, with the "flash" PMI rising to 55.2.
- **Pending home sales** dropped 1.8% in June—not a surprise after June's dip in new home sales.

- **Consumer confidence**, as measured by The Conference Board index, fell sharply in July. Although the index remained at levels consistent with an expanding economy, a less optimistic view of the labor market and perhaps the financial market volatility prompted by uncertainty over Greece and China appear to have weakened consumers' confidence. Likewise, according to the final reading of the University of Michigan's index, consumer sentiment pulled back in July.

Outlook

Although the second-quarter GDP report was solid, the lack of consumer and business spending growth revealed some weakness. That said, with the upward revision to first-quarter growth, the U.S. economy is on slightly stronger footing and poised to accelerate modestly in the second half of the year. This suggests steady momentum that brings us closer to a Fed rate hike.

In terms of the Fed, we still believe that the odds favor a December rate "liftoff." A comparison of June's and July's policy statements shows that the Fed's overall view of the economy hasn't changed, which we believe is a sign that the central bank isn't ready to pull the trigger. Moreover, the Fed failed to suggest that a change of policy is in the works. Given the Fed's desire for transparency in order to avoid surprising markets, we would expect Chair Yellen to clearly signal an intention to raise rates before actually doing so.

Beneath the S&P 500's move toward recent highs is a sharp rotation across sectors and individual equities. A majority of stocks have fallen more than 10% from their recent peaks, and as of mid-week, only 36% of the index was above its 200-day moving average. This occurred last in October 2014, just prior to a sharp market rally.

Continued negative investor sentiment, a contrarian indicator that often precedes rising stock prices, also supports our view that stocks could move higher through year-end. While a correction of 5% to 10% is still possible, we may instead see wide price swings, as past Fed tightening has introduced heightened volatility. In fixed-income markets, credit-sector spreads may widen further until the first rate hike occurs.

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