Weekly Market Update

Calm returns to markets following surprise Chinese currency devaluation

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- U.S. stocks recover from a year-to-date dip into negative territory while European stocks decline.
- Treasuries are also volatile amid shifting investor sentiment and new supply.
- We expect Q2 GDP to be revised up to 2.8%, with Q3 to grow at about the same pace.
- In our view, the broad market volatility brought on by China's move will subside quickly.
- We are cautiously optimistic that stocks can move higher through year end.

August 14, 2015

In an otherwise quiet week, China caught investors off guard on August 11 by devaluing its tightly controlled currency, the yuan, sparking volatility in equity, Treasury, oil, and currency markets. China's central bank allowed the yuan, whose value is pegged to a basket of currencies including the U.S. dollar, to drift 1.9% lower—the largest one-day change in two decades. A fresh fall on August 12 further rattled investors. Markets then relaxed after Beijing intervened to prop up its currency, temporarily defusing fears of a destabilizing currency war.

Equities

After descending into negative territory for the year to date on August 13 in the wake of China's action, the S&P 500 Index rebounded to finish with a gain of about 0.4% for the week.

Although European stocks got a boost from encouraging news out of Greece, including a recovery in second-quarter GDP and an agreement with international creditors over a three-year fiscal and structural reform program, the STOXX 600 Index suffered its worst day of the year on August 12 and fell 1.05% for the week in U.S. dollar terms. In contrast, Chinese stocks rallied, as lackluster economic data increased the likelihood of further stimulus from Beijing.

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Fixed income

During the week, U.S. Treasuries adjusted to new supply, shifting risk appetites, and some positive U.S. economic news. The bellwether 10-year U.S. Treasury yield was volatile during the week, hitting a high of 2.24% and falling as low as 2.05% and hovering around 2.18% as of afternoon trading on August 14 (Price and yield move in opposite direction.)

Returns for "spread" sectors (higher-yielding, non-U.S. Treasury securities) were broadly negative. In particular, high-yield bonds were again hurt by depressed energy prices, while their investment-grade counterparts fell amid increasing supply. Emerging-market debt faced continued headwinds from a rising dollar and the anticipation of higher U.S. interest rates, which make lower-risk fixed-income sectors more attractive.

Current updates are available here. For additional insights from TIAA-CREF professionals, view our Weekly Market Perspective Video.

U.S. data releases help clarify the economic picture

This week's reports support the status quo of improving labor markets, a softening of the economy's supply side (which we think will continue), a marginal pickup in demand, and stable business sentiment. Among the highlights:

- **First-time unemployment claims** increased to 274,000, and the less-volatile four-week moving average dipped to 266,250, suggesting tighter labor markets.
- **Retail sales** ticked up 0.6% in July (along with a relatively strong +0.4% ex-autos), while May's and June's results were revised upward. These are signs that U.S. consumers may be starting to spend some of their savings from lower gas prices, perhaps an indication of better activity in the second half of the year.
- **Small business sentiment** improved in July after two months of declines, according to the NFIB.
- **U.S. business inventories** rose 0.8% in June, the largest gain since January 2013. Business sales, though, were up just 0.2%. This suggests that inventory spending should support an upward revision to second-quarter GDP, while third-quarter growth will likely face a headwind, as businesses do not add to supplies because of lagging sales.
- **Consumer sentiment** edged slightly lower in August, based on the preliminary reading of the University of Michigan index.

Outlook

Although there was some market trepidation concerning China's devaluation, including the possibility that the Chinese economy was weaker than Beijing was letting on, we believe the government was more likely trying to de-link the yuan from the dollar as the U.S. currency rose, since a stronger dollar puts pressure on Chinese exports. Another strong possibility is that China wants the yuan to be included in the International Monetary Fund's reserve assets, known as Special Drawing Rights (SDR). Inclusion in this basket of currencies would dramatically increase yuan demand and usage across the world.

In our view, the market volatility brought on by these events will subside quickly. The week's devaluation of about 3% may have little additional impact on capital markets or trade in the near term. In the long run, we expect the Chinese currency to depreciate further from its overvalued level but not by the 10% to 20% that some are forecasting.

For the U.S. economy, as June's final data trickles in, we expect second-quarter GDP to be revised upward by about 0.5%, to 2.8%. Meanwhile, the third quarter has started off slowly. As we have long stated, the U.S. economy needs more robust spending by both consumers and businesses in order to fire on all cylinders. Instead, a lack of business spending may act as a counterweight to better consumer activity, leading to third-quarter growth of 2.8%, down slightly from our earlier 3.0% forecast. Fourth-quarter GDP could soften somewhat from our 3.3% forecast if supply-side measures continue to disappoint.

In equity markets, we are cautiously optimistic that the S&P 500 Index can move higher through year end. Investor sentiment has plunged while market technicals remain positive, two factors that tend to point to a future rise in stock prices. At the same time, mixed economic data gives us pause, with weak third-party company surveys and a drop in the leading index published by the Economic Cycle Research Institute (ECRI) at odds with better consumer data and an increasing number of economic releases topping forecasts. European equities are also poised to rise, bolstered by improving economic data and earnings reports, and an easing of the Chinese currency issues.

Regarding fixed income, sentiment has also soured, as investors brace for the spike in volatility that has accompanied previous Fed tightening cycles. The mood should improve if, as we expect, the Fed begins with a modest rate "liftoff" (of perhaps 0.25%-0.50%), with the timing and pace of subsequent hikes remaining data dependent.