Weekly Market Update (Special Edition)

Current turmoil sparks concern but is not likely the start of a bear market

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA-CREF ASSET MANAGEMENT

- Despite the recent sharp drop in stock prices, we do not believe this is the start of another bear market.
- Economic fundamentals in the U.S. and Europe remain on track, a long-term positive for stocks.
- In our view, U.S. equities are fairly valued, while technical measures of volatility and sentiment are at levels often associated with a market upturn.
- China and the emerging markets remain a key focus for global markets; we think a potential bottoming process may be underway.

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Our perspective on the recent market downturn

This week began with a continuation of the market turmoil that we covered in our August 21 update, with global equity markets selling off on fears of a slowing Chinese economy, weakening commodity prices, and ongoing uncertainty over the timing of the Fed's anticipated interest-rate hike. On the margins, market sentiment has also been hurt by the announcement of snap elections in Greece, potential conflict in Korea, and a decline in Japanese GDP.

Despite the recent sharp drop in stock prices, we do not believe we are witnessing the start of another bear market. Economic fundamentals in the U.S. and Europe remain positive, and China appears poised to shift its immediate focus from reform to urgent stimulus. Meanwhile, technical market indicators are also providing some support. The VIX (or so-called "fear" index), which measures implied volatility in the S&P 500 Index, spiked to almost 50 today, a level that typically indicates an intermediate bottom, and short-term investor sentiment is extremely negative, which often precedes a market upswing.

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Also encouraging was the rebound in U.S. stock prices through early afternoon today, with the major indexes stabilizing and then clawing back after declines of roughly 5% at the opening bell. The S&P 500 Index, for example, temporarily slid below 1,900 but held firm within the 1,860-1,870 range, at which point investors began to step in and begin buying. As of midday, the S&P 500 was trading above its October 2014 low, reinforcing that this pullback—while a painful correction—does not indicate a broader earnings problem. In our view, the market is currently fairly valued at 16 times earnings.

U.S. and European economies continue to provide a favorable backdrop

While the U.S. economy has not been especially robust, it has remained in expansionary mode. We expect further improvements, particularly in the consumer sector, given expanding job creation and income gains, as well as lower gasoline prices. A key question is the extent to which the recent market decline may affect industrial and consumer sentiment. The potential risk is that fearful markets could trigger economic weakness in a self-reinforcing cycle, although that is not our base case scenario.

Like U.S. markets, European equities have given back their year-to-date gains and are now at levels below where they stood before the onset of the European Central Bank's quantitative easing program. On a fundamental basis, however, Purchasing Manager's Indexes (PMIs) in Europe are holding steady, and earnings revisions have improved. We remain confident that European stock returns will outpace those of the U.S. market.

China and the emerging markets remain in focus

Emerging markets have been a focal point of concern, with peak-to-trough declines of 30%—a scope of loss similar to the 33% drop in 2008—which technically may also serve as the basis for a market bottom. Unlike the turmoil seen in 1997-1998, this year's decline in emerging markets looks more like a scare than a collapse driven by a current account crisis, as foreign-exchange reserves for China and the rest of the Pacific Rim are too large for that to be the case. A hopeful sign is that some of the worst-hit emerging-market currencies came off their lows today, which could mean a bottoming process is potentially underway.

The state of China's economy in particular remains a key worry for global markets. Chinese growth has been much weaker than the official statistics would imply, though we expect further stimulus to help offset that. Importantly, third-party surveys of Chinese company activity improved last week, which aligns with better housing data and other real-time surveys that we track.

Fear that China's central bank will trigger further devaluations of the yuan has also weighed on markets, although to date the currency has weakened by a modest and controlled 3%. This supports the view that moving toward a controlled float is designed to decouple the yuan from the U.S. dollar and make the case for including the Chinese currency in the IMF's reserve currency program. However, if China acted to sharply devalue the yuan, it would be a negative signal that there is greater weakness to come in the emerging-markets space.

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