Weekly Market Update

Relative calm returns to equity markets as a turbulent week concludes

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

- A late-week rally erases a decline in the U.S. and trims losses in Europe.
- U.S. Treasury prices retreat as demand for safe-haven assets wanes.
- Revised Q2 GDP growth easily tops expectations, but we forecast a slowdown in Q3.
- On balance, we think the odds favor a Fed rate hike in December.
- U.S. equities may move higher, but there are caution flags ahead.

August 28, 2015

Equities

Global equities concluded a week filled with wide intra-day price swings amid ongoing concerns over a slowdown in China and weakening commodity prices. However, investors also took heart from improving U.S. economic data and fading expectations for a September rate hike by the Fed.

After slipping into correction territory following a major decline on Monday, August 24, the S&P 500 bounced back at midweek with its best one-day return (+3.9%) in nearly four years. For the week, the index posted a gain of roughly 0.9%.

Positive economic news out of Germany and a rise in Eurozone economic sentiment to a four-year high provided fresh evidence of the region's continuing recovery. The STOXX 600 Index, like the S&P 500, endured large swings, ranging from -5.3% (its worst day in nearly seven years) to +4.2% in local currency terms, finishing the week up 0.6%. The euro and the British pound lost value against the dollar, however, converting that gain to a 2.8% loss for U.S.-based investors.

TIAA CREF Financial Services

Relative calm returns to equity markets

In an effort to boost slowing economic growth and help stem a slide in domestic equity prices, China's central bank cut interest rates, reduced bank reserve requirements, and injected 140 billion yuan ($21.8 billion) of liquidity into the country's financial system. There were also signs of unexpected stock purchases by the government. While these aggressive moves contributed to a late-week rally, major Chinese indexes were still down sharply for the week.

Fixed income

U.S. Treasury yields moved in tandem with sharply shifting market sentiment. On August 24, demand for safe-haven assets amid the broad global equity sell-off drove down the yield on the bellwether 10-year to just under 2% for the first time in four months. (Price and yield move in opposite directions.) As the "risk-off" mood receded, bolstered by a partial recovery in equity markets and largely favorable U.S. economic reports, the 10-year yield rose to 2.18% on August 28.

Results for non-Treasury assets were mostly negative, although high-yield bonds eked out a small positive return. Relative to Treasuries, spreads for investment-grade, high-yield, and emerging-markets debt are at or near their widest levels in years. Poor investment flows for higher-yielding asset classes have been a headwind against spread narrowing.

Current updates are available here. For additional fixed-income insights from Lisa Black, CIO of TIAA-CREF Global Public Markets, view our Weekly Market Perspective Video.

A better-than-expected GDP report highlights a solid week for the U.S. economy

According to the government's second estimate, U.S. GDP grew at a 3.7% annual pace in the second quarter, well above the previous estimate of 2.3%. Fixed investment (business spending and spending on new homes), inventory spending, and consumer spending accounted for two-thirds of the upward revision. Overall, the U.S. economy remains on a moderate 2.5% annual growth trajectory.

Among the week's reports:

- **First-time unemployment claims** fell to 271,000, the first decline after four straight weekly gains, an indication that the labor market is still healthy, while the less-volatile four-week moving average edged higher, to 272,500.
- **Housing prices** rose 1% in June and 5% compared to a year ago, based on the S&P/Case Shiller 20-City Composite Index. Given the steady pace of price increase that we have already seen, we don't expect significant further gains for the rest of the year.
- After a sharp decline in June, **new home sales** jumped 5.4% in July and were up 25.8% compared to last year.

- Following July's steep fall, The Conference Board's index of **consumer confidence** soared in August to its highest level since January, buoyed by an improved view of the labor market.

- Orders for **durable goods** (aircraft, machinery, computer equipment, and other big-ticket items) climbed by a better-than-expected 4.1% in July, and June's advance was revised upward. We are particularly encouraged by these figures, which are closely tied to rising incomes and consumer sentiment.

- **Consumer spending** rose 0.3% in July and was revised upward for June, in line with a modest acceleration trend, a good sign. Meanwhile, July's increase in wages and salaries (+0.5%) marked their biggest gain since last November.

Outlook

While we were encouraged by the GDP revision, we expect the U.S. economy to slow in the third quarter, with the likely culprit being a decline in inventory accumulation, which surged in the first half of the year. This reduction alone could trim up to 1% from GDP growth, partially offset by modest gains in consumer and business spending. We now forecast third-quarter GDP growth of around 2%, compared to our earlier forecast of 2.8%. The possibility of decelerating U.S. growth may well have contributed to the market's surprisingly sharp decline early in the week.

Despite the disappointing pullback, we believe that the U.S. equity market, may have found its footing. Several technical indicators during the past week pointed to an intermediate market bottom, including a spike in the VIX (or so-called "fear" index), which measures implied volatility in the S&P 500 Index, to levels not seen since 2008. In addition, while past performance does not guarantee future results, the S&P 500 has lost more than 10% within a one-week period only five times in history, and in each case this was followed by an average gain of 16%. Lastly, investors have liquidated equity and fixed-income mutual funds in order to hoard cash, a sign of negative investor sentiment that often precedes a market upturn.

In spite of that upbeat view, we do caution that selling pressure from options-related hedging could hinder market gains. This was a factor in a sharp afternoon reversal of what had been a healthy bounce in the S&P 500 on August 25. While we still expect the S&P 500 to finish the year at new highs, the index may well be vulnerable to a retest of the recent correction levels.

Relative calm returns to equity markets

In terms of China, we believe the government was surprised by the market turmoil caused by its move to a controlled float of the yuan, as it triggered an emerging-markets downdraft that spread to the U.S., Europe, and Japan. Fortunately, we have seen a more stable yuan this week. If this stability persists, it will help support other emerging-markets currencies and help heal the region's equity markets.

A delay in Fed tightening, which could help weaken the U.S. dollar, might provide another source of short-term strength for developing world currencies. Although a September rate hike is still on the table despite the recent market volatility, on balance the odds have shifted to a December move.