Weekly Market Update

Reassuring words from the Fed fail to prevent a down week for equities

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- U.S. and European stocks pare losses but still end down for the week.
- Treasury yields edge higher in wake of clearer Fed guidance on timing of rate "liftoff."
- Revised Q2 GDP growth tops expectations, capping a week of mixed data releases.
- Inflation should pick up in 4Q, providing the backdrop for a Fed rate hike in December.
- We see opportunities in fixed-income markets, underpinned by signs of strength in the U.S. economy and the possibility of an accelerating recovery in Europe.

September 25, 2015

Equities

U.S. equities declined for the week through September 24, with the S&P 500 Index retesting its August lows. The market's move was not surprising, given continued uncertainty over the strength of the U.S. economy, concerns over China's slowing growth, and apprehension over the threat of another U.S. government shutdown.

Stocks responded favorably to a speech delivered by Fed Chair Janet Yellen after markets closed on September 24 but gave back gains on September 25. Yellen indicated that the U.S. economy appears to be on sound footing and that signs of weak growth overseas won't be large enough to significantly affect Fed policy. This more hawkish tone was in contrast to the prior week's Fed statement that cited global economic and market developments as a potential risk to U.S. growth and a consideration in not raising interest rates in September. By stating that an initial rate hike is likely this year, Yellen removed some of the uncertainty around the timing of rate "liftoff," which had added to market volatility over the past few months.

In Europe, the STOXX 600 Index finished the week down 1.6% in local currency terms (-3.3% in U.S. dollars), near an eight-month low. Despite the market's sluggish performance, Eurozone economic data has offered encouraging signs that the slowdown in China, a major trading partner, has not undercut the region's recovery. Manufacturing and service-sector activity enjoyed its best quarter in four

Financial Services

years, credit demand is increasing, financing costs are lower, and Europe's money supply is expanding strongly—often a leading indicator of economic growth.

Fixed income

U.S. Treasuries traded within a relatively narrow range during the past week. Concerns over softer global growth fueled investor appetite for safe-haven assets, with the yield on the bellwether 10-year Treasury note dipping to 2.13% amid this "risk-off" environment. (Yield and price move in opposite directions.) The 10-year yield then reversed course in the wake of Yellen's speech, hovering around 2.18% on September 25.

Returns for most "spread" products (higher-yielding, non-U.S. Treasury securities) ranged between modest gains and losses, although high-yield bonds realized sharp losses. Credit spreads continued to drift wider on a combination of developments, including Brazil's continued economic woes, the effects of upcoming quarter-end illiquidity, and a number of high-profile corporate bond credit downgrades.

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

An upward GDP revision is the highlight of a mixed week for U.S. economic releases

According to the government's third and final estimate, U.S. GDP expanded at an annual rate of 3.9% in the second quarter, higher than the previous estimate of 3.7% and well above the 0.6% first-quarter figure. The better-than-expected outcome was driven by higher consumer spending and somewhat stronger business investment than previously reported.

Among the week's other data releases.

- **First-time unemployment claims** inched up to 267,000, and the less-volatile four-week moving average declined to 271,750, subdued levels offering further evidence of a healthy jobs market.
- **New home sales** increased 5.7% in August to their highest level in more than seven years and surged 21.6% compared to a year ago. July's sales were revised upward**.**
- **Existing home sales** fell 4.8% in August, their first decline in four months, but climbed 6.2% compared to last year.
- **Home prices** rose 0.6% in July, according to the FHFA. For the 12 months ending in July, prices were up 5.8%, to near an eight-year high.
- **Consumer sentiment** dropped, according to the final September reading of the University of Michigan index. Although most consumers believe he U.S. economy is largely insulated from outside forces, they now expect slower jobs and wage growth.
- **U.S manufacturing continued to grow,** registering 53.0 in September, based on the "flash" (preliminary) Purchasing Managers' Index (PMI)

published by Markit. While any PMI reading over 50 indicates expansion, September's figure was unchanged from August's, a 22-month low.

Outlook

Looking back on the Fed's September meeting, our view is that soft inflation—-and not international weakness—drove the decision to hold firm on interest rates. The Fed still believes that low inflation readings are transitory but is looking for some evidence of price increases before tightening. Along those lines, we expect inflation to pick up during the fourth quarter as oil prices begin to move higher compared to a year ago, with December the most likely month for the first rate hike.

For U.S. equity markets, investors are more bearish today than at any time since 2000. This pessimism, a contrarian indicator that often presages a market advance, is in line with our view that the S&P 500 will advance during the fourth quarter. Compared to U.S. shares, European stocks offer better upside potential, with attractive valuations based on normalized profit margins and stable earnings estimates. In addition, European equity markets appear to be adjusting to softer data out of China.

Meanwhile, in China, the risk remains that Beijing will once again devalue its currency, potentially triggering a destabilizing trade war. Countering that possibility is the realization by government officials that little would be gained by such a move, as they are wary of competitive devaluations by their neighbors and recognize that demand for Chinese products is probably not sufficiently robust to boost the country's exports.

A possible upside to China's economic deceleration may be further government stimulus, perhaps leading to improved economic activity and a rally in "unloved," beaten-down emerging-markets (EM) equities. Investors' below-average allocations to EM stocks and extremely negative investor sentiment support the case for better future returns in these markets.

Lastly, we see opportunities in fixed-income markets, underpinned by signs of strength in the U.S. economy and the possibility of an accelerating recovery in Europe, even as the extent to which China has slowed remains unclear. Overall, U.S. debt appears reasonably valued, with the potential for spreads to rally following the Fed's first rate increase and a corresponding reset of market expectations.

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