Weekly Market Update

Equity markets conclude a strong October with a mixed week

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- U.S. equities gain for the fifth straight week, while European stocks post a modest loss.
- Hawkish Fed commentary sends U.S. Treasury yields higher.
- Despite their recent rally, high-yield bonds still offer reasonable value.
- Third-quarter U.S. GDP growth disappoints, but consumer spending remains a bright spot.
- Higher inflation will be key to a potential Fed rate hike in December.

October 30, 2015

Equities

U.S. and European equity markets sought to extend their four-week winning streaks in the face of a possible December rate hike by the Federal Reserve. In the U.S., the S&P 500 Index rose about 0.2% for the week though afternoon trading on October 30, extending its October surge to 8.5%. Despite returning -0.60% in local currency terms for the week (-0.36% in U.S. dollars) the STOXX 600 Index was on pace for its first positive month since June.

Meanwhile, economic news continued to show that the Eurozone's recovery remains on track. Unemployment fell to its lowest level in almost three years in October, and measures of business and consumer confidence reached a more than four-year high. While headline inflation came in flat for the year through October, "core" inflation, which strips out volatile food and energy costs, rose a better-than-expected 1% over the past 12 months.

Chinese equities declined for the week, but their solid advance in October ended a string of four straight down months. The recovery in China seems to be taking hold, as evidenced by rising property prices, and stronger retail and vehicle sales.

Fixed income

In its latest policy statement, the Fed dropped previous references to the risks that global economic and market weakness pose to the U.S. economy. This change in language was perceived by the market as "hawkish," helping to drive the yield of the bellwether 10-year U.S. Treasury from 2.09% at the start of the week to 2.19% following the conclusion of the Fed's meeting on October 28, before moving

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slightly lower on October 30. (Yield and price move in opposite directions.) The yield on the two-year Treasury note, which is highly sensitive to changes in the Fed's rate policy outlook, jumped from 0.66% to 0.73% during the week.

Returns for spread sectors (higher-yielding, non-Treasury securities) were broadly negative, although high-yield corporate bonds posted only a modest loss. For the month through October 29, high-yield debt, which tends to perform in sympathy with equities, returned 2.75%.

Current updates are available here. For additional insights on fixed-income markets from TIAA-CREF portfolio manager Joseph Higgins, view our Weekly Market Perspective Video.

U.S. GDP growth disappoints, but under the headline we see some bright spots

Third-quarter GDP grew at a 1.5% annual rate, according to the government's advance estimate—slightly below forecasts, including our own. There were bright spots heading into the fourth quarter, though: Consumers and businesses largely maintained their robust pace of spending from the second quarter, when the U.S. economy grew at a healthy 3.9% clip.

Other U.S. economic releases were mixed. Among the mostly positive reports:

- **First-time unemployment claims,** inched up to 260,000, while the less-volatile four-week moving average decreased to 259,250, a fresh 42-year low.
- **Housing prices** rose 0.4% in August and 5.1% compared to last year.
- **Consumer sentiment** improved in October, according to the final October reading of the University of Michigan index. Consumers viewed their future financial prospects more favorably than any time since 2007.
- The **Citi Economic Surprise Index** turned higher. This index is a gauge of the extent to which economic data readings have diverged from consensus forecasts.

Among the weaker releases:

- **New home sales** slumped 11.5% in September from August's downwardly revised level but remain 2% higher compared to a year ago.
- **Pending home sales** fell 2.4%, although they're up 3% from last September.
- U.S. **service-sector activity** dipped to 54.4 in October, a nine-month low, based on Markit's "flash" (preliminary) Purchasing Managers' Index (PMI). (Readings over 50 indicate expansion.)
- **Consumer confidence** declined in October after September's modest rise, reflecting a less-optimistic view of the jobs market.

- Orders for **durable goods** (aircraft, machinery, computer equipment, and other big-ticket items) fell 1.2% in September but still exceeded expectations, following an even sharper drop in August.

Outlook

For the U.S. economy, it is clear that consumption and business spending have increased, both of which are signals of ongoing strengthening in labor markets and wages. Meanwhile, overall economic growth continues at about the same restrained pace of 2%-2.5%. Looking ahead, wages should improve in the near term, underpinning further gains in consumption over the next few quarters and driving a modest acceleration in GDP in the fourth quarter and 2016.

In terms of the Fed, we still believe that it is waiting for inflation to pick up—even marginally—before raising rates for the first time since 2006. In our view, the Fed believes signs of pricing pressures may soon appear, paving the way for tightening to begin in December. Once rate "liftoff" begins, future hikes should be slow and measured, limiting their effect on longer maturity bonds.

Regarding U.S. equities, the market's mood has improved amid dissipating fears over a so-called "hard landing" in China, hints of further quantitative easing by the European Central Bank, and the anticipation of better U.S. economic growth. Against this backdrop, investors rotated into value and economically sensitive sectors, which were supported by steadily improving regional manufacturing indexes and a better-than-expected third-quarter earnings season that saw the majority of companies top forecasts. These cyclical and value stocks have begun to outperform, a trend we think may continue into 2016.

In U.S. fixed-income markets, we believe high-yield bonds offer reasonable value even after their recent rally, as default risks remain low. For investment-grade corporate debt, mergers & acquisition risks are still elevated, emphasizing the importance of prudent security selection.