Weekly Market Update

Global equities surge from recent lows

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

Article Highlights

- U.S. and European stocks snap two-week losing streak.
- High-yield bonds easily outperform other fixed-income assets.
- Inflationary pressures appear to be building, raising the odds of a Fed rate hike later this year.
- Increased U.S. demand for oil, coupled with a slowdown in domestic production, should lead to higher oil prices.
- While we remain cautiously optimistic about equity markets, uncertainty will likely continue.
- Despite fixed-income volatility, there is value to be found in non-Treasury sectors.

February 19, 2016

Equities

Global equity markets advanced during the past week, as some U.S. economic releases improved at the margin and China's currency (the yuan) stabilized after the country's central bank ended weeks of silence by downplaying the need for further yuan weakening. Also supporting the week's gains was a midweek rebound in commodity prices following an agreement between Russia, Saudi Arabia, and other major oil exporters to freeze output at January's levels. Oil later retreated to end the week with a modest gain.

In the U.S., the S&P 500 Index reclaimed positive territory in February by rising about 2.9% for the holiday-shortened week, underpinned by its biggest three-day gain since last August. Europe's STOXX 600 Index was in even better form, surging 4.5% (in local terms), its best week in over a year. In Japan, the Nikkei Index rose 8% (in local terms), erasing much of the previous week's 11% slide, while stocks in China also rallied.

Current updates to the week's market results are available here.

Financial Services

Fixed income

U.S. Treasuries traded within a relatively narrow range. After beginning the week at 1.74%, the bellwether 10-year Treasury yield rose to 1.81% by midweek amid lessening demand for safe-haven assets before falling to 1.76% on February 19 as investors' risk appetite faded.

Based on Barclays indexes, returns for most U.S. "spread sectors" (non-Treasury fixed-income assets that include agency, corporate, mortgage-backed, and other types of securities) ranged from mildly positive to slightly negative amid ongoing negative fund flows. High-yield bonds gained almost 2% for the week through February 18, moving in sympathy with higher equity and oil prices.

U.S. employment data continues to improve

In a mixed week for U.S. economic data, the job market was once again a highlight, and inflation showed signs of strengthening. Among the week's releases:

- **First-time unemployment claims** dropped to 262,000, a three-month low, and the less-volatile four-week moving average also fell, by 8,000, to 273,250.
- **Housing starts** unexpectedly declined 3.8% in January, while **building permits**, a forward-looking indicator, dipped 0.2% but were up 13.5% compared to a year ago.
- **Homebuilder confidence** slipped in February from January's upwardly revised reading, according to the National Association of Home Builders/Wells Fargo Housing Market Index. Although builders reflected consumers' concerns about recent negative economic trends, fundamentals are in place for sustained growth in the housing market.
- The index of **leading economic indicators** published by The Conference Board dipped 0.2% in January but still suggests that the U.S. economy is on track for moderate expansion.
- **Regional manufacturing** improved slightly but stayed weak, according to the Philly Fed and Empire State manufacturing indexes. In contrast, **industrial output** topped forecasts by climbing 0.9% in January, the first increase since last July.
- **U.S. consumer prices** were unchanged in January but rose 1.4% compared to a year ago. Stripping out volatile food and energy costs, so-called "core" inflation increased 0.3%, the biggest one-month gain since August 2011, and 2.2% over the past 12 months. This reading, in addition to January's stronger-than-forecast producer price index gains and the overall increase in wages, supports our view that inflationary pressures are building, raising the odds of a Fed rate hike later this year.

Outlook

The market's rebound during the past week could be viewed as an indication that U.S. economic conditions are normalizing. At the same time, while we remain optimistic, it's too early to proclaim an end to the market volatility that has driven the S&P 500 Index down by almost 15% since its May 2015 high. Investors must still grapple with the possibility of further rate hikes by the Federal Reserve and an uncertain U.S. corporate earnings outlook. However, recent declines in market rates have triggered a weaker dollar, which supports both export activity and bolsters S&P earnings.

On another positive note, manufacturing—while still struggling—is showing "green shoots" of recovery, bank loans are rising, and the U.S. labor market continues to be a bright spot. Retail sales data has also shown signs of vigor, although a recent third-party survey of retailers fell sharply, possibly in connection with the sharp stock market sell-off. This again underscores the importance of sentiment to the health of the economy.

In fixed-income markets, volatility has created potential buying opportunities. Our fundamental analysis has identified value on a selective basis in emerging-market debt, high-yield corporate and investment-grade bonds, and structured products such as asset-backed and commercial mortgage-backed securities. Moreover, the environment for finding attractive yield is among the best we've seen in recent years, supporting our ability to find compelling returns even if volatility persists and bond spreads don't tighten.

As for China, we expect that Beijing 's attempt to engineer the country's transition to a consumer-based economy will continue through targeted monetary easing and infrastructure spending, along with programs designed to support the housing market. Policymakers face the added challenge of stemming capital flight, which puts pressure on the yuan and forces the government to spend its reserves. Losing control of outflows and the yuan would put further pressure on both the Chinese and global economy. Europe, one of China's leading trading partners, would be especially vulnerable.