February 26, 2016

TIAA GLOBAL ASSET MANAGEMENT

A bounce in oil helps equities extend recent gains

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA ASSET MANAGEMENT

Article Highlights

- U.S. and European stocks add to the previous week's gains.
- High-yield corporate bonds benefit from positive inflows and improved investor sentiment.
- Revised Q4 GDP growth tops expectations but doesn't change our outlook for the U.S. economy.
- While we are encouraged by the S&P 500's recent activity and believe the index could move higher from current levels, China remains a potential source of market stress.
- In fixed income, we are assuming a "credit-based" focus by targeting select high-yield and emerging-markets bonds.

February 26, 2016

Equities

Oil remained the dominant driver of market activity during the past week. Despite sharp day-to-day volatility, the price per barrel rose about 3% for the week as a whole, supporting major equity indexes.

In the U.S., the S&P 500 Index rose about 1.6% for the week. Value, energy, and consumer cyclical shares continued to rebound, providing evidence of the economy's resilience after its slowdown in the second half of last year.

The U.S. rally was mirrored by overseas markets. Europe's STOXX 600 Index advanced 1.6%, and Japan's Nikkei 225 Index rose about 1%. However, Chinese equities could not overcome a 6.4% plunge on February 24 amid heightened worries about market liquidity. In China, the government is increasing deficit spending to stabilize growth, which may have contributed to recently higher commodity prices; iron ore, for example, has rallied 35% since hitting a bottom. At the same time, slowing jobs growth in China is eroding consumer confidence, and Beijing is still struggling to contain capital flight.

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

Fixed income

U.S. Treasury yields stayed mostly rangebound. The bellwether 10-year yield headed lower to 1.71% on February 25 before closing at 1.75% the next day—roughly where it began the week.

(Yield and price are inversely related.) Meanwhile, returns for non-Treasury “spread sectors” were broadly positive, benefiting from the fixed-income market’s generally more positive tone and net inflows. Outperformers included investment-grade and high-yield corporate bonds, which returned 0.84% and 0.61%, respectively, for the week through February 25.

Upside surprise in U.S. GDP doesn’t alter our view of the economy’s growth trajectory

According to the government’s second estimate, U.S. GDP grew at a 1% annual pace in the fourth quarter of 2015. While an improvement over the previous estimate of 0.7%, the revision offered few positive surprises, with little to cheer about in consumer or business spending. All told, we believe the U.S. economy will maintain its slow, steady pace, with GDP growth of about 2% in the first quarter of 2016.

Other U.S. economic releases were mixed:

- Although **first-time unemployment claims** rose by 10,000, to 272,000, the less-volatile four-week moving average dipped by 1,250, to 272,000, the lowest level since early December. This indicates that companies are sticking to current employment levels despite slower U.S. economic growth.
- **Home prices** increased 0.8% In December and 5.7% versus a year ago, according to the S&P/Case Shiller 20-City Composite Index.
- **Existing home sales** topped forecasts by rising 0.4% in January. Sales are now 11% higher than a year ago—the largest year-over-year gain since July 2013. In contrast, **new home sales** sank 9.2% in January and were 5.2% lower compared to a year ago.
- Orders for **durable goods** (aircraft, machinery, computer equipment, and other big-ticket items) jumped 4.9% in January following December’s sharp drop.
- **Consumers’ outlooks** dimmed in February, as both The Conference Board’s index and the University of Michigan’s consumer sentiment gauge ticked lower.
- **Manufacturing activity** unexpectedly slowed in February to 51.0, the lowest reading in more than three years and just above the 50 mark separating expansion from contraction, according to the “flash” (preliminary) reading of Markit’s Purchasing Managers’ Index (PMI). Manufacturers reported weaker business sentiment and uncertainty about the general economic outlook.
- **Service-sector activity** slipped into contraction territory (+49.8) for the first time since October 2013, as measured by Markit’s non-manufacturing PMI.
- The **U.S. trade deficit** widened in January to $62.2 billion, the largest level since June, as exporters battled the familiar headwinds of a rising dollar and lackluster global economy.

Outlook

From a technical standpoint, the S&P 500's rebound above the 1,950 level after dropping below 1,900 earlier in the week was particularly encouraging. It appears as if the equity market is anticipating stronger economic news, which we saw in the part week's solid durable goods data, improving third-party company surveys, ongoing resilience in the jobs market, and higher oil prices. Once again, strong U.S. demand for gasoline underpinned oil's rise. On the down side, manufacturing is still weak and consumer confidence fell. We still think there is scope for the S&P 500 to advance through the 2,100 mark before pulling back again.

A chief concern is the prospect of a substantial currency devaluation by the Chinese government, as markets have often lost steam after such a move. Although Beijing has insisted that no more devaluations are on the horizon, officials have consistently been unable to deliver clear signals to the market. As a result, we take such assurances with a grain of salt. Also on our radar is China's ongoing battle with capital flight. Global equities may well retreat if the March 7 release of the country's currency reserves reveals outflows greater than last month's $100 billion.

In fixed income, markets remain wary of exogenous factors that could weigh on the U.S. economy, including China, oil supplies, and global growth. We are taking a more "credit- centric" approach, focusing on select high-yield bonds (especially those rated BB) and emerging-market debt issued by countries benefiting from lower oil prices. In contrast, neither U.S. Treasuries nor agency mortgage-backed securities offer significant value, in our view. Overall, fixed-income assets continue to take their cues from oil prices and macro events rather than from more U.S.-centric economic data.

TIAA Global Asset Management provides investment advice and portfolio management services through Teachers Insurance and Annuity Association and affiliated registered investment advisors, including Teachers Advisors, Inc., TIAA-CREF Alternatives Advisors, LLC and Nuveen Asset management, LLC.

© 2016 Teachers Insurance and Annuity Association of America (TIAA), 730 Third Avenue, New York, NY 10017

C29897