June 10, 2016

Global growth concerns weigh on equity markets

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA PUBLIC INVESTMENTS

Article Highlights

- The S&P 500 loses ground after nearing its all-time high, while European stocks fall for the second straight week.
- Fixed-income markets benefit from risk aversion and the demand for yield.
- The S&P 500's current pause is not surprising, and we still expect the index to reach new highs, although the advance is unlikely to be in a straight line.
- In our view, bonds are fully valued, with investment-grade corporate debt offering the best opportunities.

Equities

After tracking oil prices higher, global equities reversed course by midweek. Investors fretted about global economic health while becoming more cautious ahead of the Federal Reserve's June 14-15 meeting and the June 23 "Brexit" vote. In the U.S., the S&P 500 Index rose to within 1% of last year's all-time high of 2,131 before giving back gains, finishing the week down about 0.1%.

Overseas, stocks in Europe fell for the second straight week, with the broad STOXX 600 Index losing 2.5% in local currency terms. On the economic front, the Eurozone received a bit of good news, as first-quarter GDP was revised higher to 0.6% from an earlier estimate of 0.5%. This pushed the region's annual growth rate to 1.7%. Growth in the fourth quarter of 2015 was also revised higher, to 0.4% from 0.3%. Chinese equities ended a holiday-shortened week with a modest loss.

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

Fixed income

In light of May's disappointing payrolls data, the disruptive possibilities of a "Brexit" from the European Union, and concerns over China's growth trajectory, risk-averse, investors sought out Treasuries, driving up their prices and pushing down their yields. The yield on the bellwether 10-year U.S. Treasury note, which began the week at 1.71%, dropped to 1.64% on June 10, a multi-year low. Meanwhile, the yield on Germany's 10-year note edged closer to zero during the week, touching record lows along the way.

The search for yield also drove demand for non-Treasury “spread sectors.” For the week through June 9, high-yield corporate bonds surged 1.1% (+9.3% year to date), while their investment-grade counterparts, buoyed by positive fund flows, gained 0.4% (+6.6% year to date).

A light week for U.S. data

There were few major U.S. economic reports during the week, but two of the more closely watched indicators were positive:

- **First-time unemployment claims** declined by 4,000, to 264,000, a six-week low, and the less-volatile four-week moving average also fell, by 7,500, to 269,500. In addition, job openings increased in April according to the JOLTS report. This release closes the book on April, a strong month for U.S. economic data.

- **Consumer sentiment** improved, according to June’s preliminary reading of the University of Michigan index. Consumers were especially encouraged by the prospects for higher income in the year ahead.

Outlook

The past week’s pause in U.S. stocks did not surprise us, as the S&P 500 has rallied nearly without interruption since its mid-February lows. Over the next 12-18 months, we still believe the index can move to and through the 2,250 level. Advances are likely to occur in a slow, choppy “stair-step” fashion, with pullbacks perceived as buying opportunities. In our view, the “Brexit” vote will continue contributing to equity market volatility regardless of whether Britain stays in the European Union or not.

Several factors support our cautiously optimistic outlook. Long-term investor sentiment remains deeply pessimistic, and hedge funds’ net exposure to stocks has fallen. Moreover, a closely watched indicator shows that Wall Street strategists have reduced their allocations to equities. These technical signals have historically been associated with a subsequent rise in equity prices. Lastly, high-yield bond spreads are still contracting—usually a good sign for both the economy and stocks.

Although fixed-income markets performed well the past week, bonds are fully valued, in our view. Yields are very low, and we don't believe the U.S. is headed toward a recession or will fall into deflation, both of which could depress yields further. Overall, we think investment-grade corporate debt offers the best opportunities. The asset class is benefiting from a tailwind courtesy of European Central Bank purchases of European bonds issued by U.S. companies.

TIAA GLOBAL ASSET MANAGEMENT