June 24, 2016

TIAA GLOBAL ASSET MANAGEMENT

Markets turn volatile in wake of Brexit vote

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA PUBLIC INVESTMENTS

Article Highlights

- U.K. voters approve “Brexit,” capping a high-stakes, emotion-fueled campaign.
- Global equities end the week with large one-day declines, erasing earlier gains.
- Treasuries and other safe-haven assets rally amid the uncertainty.
- While near-term volatility was to be expected in the event of a “leave” victory, we believe the markets have overreacted.
- It will take several years for all of the necessary negotiations and agreements to be crafted and implemented before Brexit is realized. In our view, investors are best served by staying focused on the long-term.

On June 23, voters in favor of the U.K.’s exit from the European Union prevailed over those who advocated staying. Response to the 52% to 48% vote was swift and strong in global financial markets, which turned volatile at Friday’s opening and remained so throughout the day. Additional TIAA perspective on the Brexit vote is available here.

Equities

In defiance of “leave”-leaning polls early in the week, many investors had been betting that the Brexit vote would fail. This confidence helped the British pound, commodities, and equities rally for the first four days of the week. Europe’s broad STOXX 600 Index rose more than 6% (in local terms) during that span but ended the week losing 1.2%, its fourth consecutive one-week decline. Meanwhile, the British pound, which had touched a six-month high of 1.50 versus the dollar on June 23, fell the next day to its weakest level against the dollar in 30 years.

In the U.S., the S&P 500 Index climbed to within 1% of last May's all-time high of 2,131 before giving back gains, finishing the week down about 1.6%. The U.K's vote also reverberated through Japanese markets, with the Nikkei 225 Index plunging 7.9% (in local terms) on June 24, its steepest one-day loss in five years.

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

Fixed income

Fixed-income markets traded in orderly fashion throughout the week. Returns for most non-Treasury "spread sectors" were lower through June 23 amid light trading and modest new issuance. Supported by solid demand, high-yield corporate bonds bucked that negative trend, bringing their year-to-date return to 9.5%. As Brexit vote tallies began to come in, however, risk aversion clearly favored U.S. Treasuries and other safe-haven assets. The yield on the bellwether 10-year U.S. Treasury note, which traded above 1.75% ahead of the referendum, tumbled to 1.56% on June 24. (Yield and prices move in opposite directions.)

Mixed U.S. data releases are overshadowed by Brexit

Markets generally paid little heed to the latest batch of U.S. economic data, which offered a reassuring signal from the labor market, mixed results for housing, and weak durable goods orders. Among the week's reports:

- **First-time unemployment claims** tumbled by 18,000, to 259,000, while the less-volatile four-week moving average fell, by 2,250, to 267,000. Claims have stayed below the key 300,000 level for 68 straight weeks, the longest such streak in 43 years.

- **Existing home sales** rose 1.8% in May to their highest level since February 2007 and 4.5% compared to a year ago, while **new-home sales** declined 6% but remained 6.4% higher versus last year.

- After climbing in April, The Conference Board's index of **leading economic indicators** unexpectedly dipped 0.2% in May. Indicators suggesting that the economy will continue on its steady growth path were tempered by those focused on volatile financial markets and a moderating outlook for labor markets.

- **Consumer sentiment** weakened, according to June's final reading of the University of Michigan index, as consumers expressed concerns about the economy.

- **Durable goods orders** (aircraft, machinery, computer equipment, and other big-ticket items) fell by a more-than-forecast 2.2% in May, while orders in April were revised down slightly.

Outlook

It is too early to speculate on how the process of unwinding the 43-year relationship between the U.K. and the EU will unfold. Neither the EU, the U.K., nor any central bank had a formal backup plan for a "leave" vote. What we do know is that changes will not occur overnight. The government must invoke Article 50 of the Lisbon Treaty before the exit process can begin, and the timing of that step has yet to be determined. From there the withdrawal process will take at least two years to complete.

Despite the anxiety and "doomsday scenarios" portrayed in the press, it's essential to focus on the long run. The U.K. is still Europe's second-largest economy (after Germany) and also its most competitive, while London remains the region's financial capital. These advantages mean the U.K. holds a strong bargaining position in its negotiations with the EU.

The risk that the U.K.'s successful leave campaign could inspire other defectors is real but should not be overstated. While there are factions within Scotland and Northern Ireland that may seek a referendum to leave the U.K. in order to remain in the EU or to join with Ireland, the feasibility of any such move remains to be seen. Within other EU nations, including Spain, Italy, and Austria, there are movements with varying motivations and degrees of anti-EU sentiment. The political fortunes of these movements are unknown but will be tested as early as this weekend in Spain's national election.

On balance, the current volatility, though painful, could represent select buying opportunities for patient investors. We still may see the S&P 500 reach new highs by year-end, underpinned by resurgent consumers, a cautious Fed, and bearish long-term sentiment at levels often associated with higher stock prices. In our view, the Brexit sell-off does not mark the beginning of a correction, as such a pullback will likely come from higher levels for the S&P 500.

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

Foreign stock market returns are stated in U.S. dollars unless noted otherwise.

Please note that equity and fixed income investing involve risk.

© 2016 Teachers Insurance and Annuity Association of America-College Retirement Equities Fund, 730 Third Avenue, New York, NY 100177

C32418