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TIAA GLOBAL ASSET MANAGEMENT

Markets stabilize after Brexit vote swoon

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Article Highlights

- Global equities end a volatile June by recouping much of their Brexit-related losses.
- U.S. Treasuries continue to rally, while the search for yield benefits non-Treasury fixed-income assets.
- We have upwardly revised our Q2 GDP forecast for the U.S., with continued strong consumption the key to a potential upside surprise.
- Although ongoing market volatility is likely, we expect further gains this year for both U.S. and European stocks.

Equities

After falling sharply for a second straight day on June 27 in the wake of the U.K.'s vote to leave the European Union (EU), global stocks rallied over the next three days and were headed higher on July 1, the first day of the new quarter.

One trigger for the retracement has been the market's realization that the U.K. still has options at its disposal to engineer an "exit from Brexit," even though the odds still favor a full departure. These possibilities include the British Parliament overruling what is a legally non-binding result, holding a second referendum, or negotiating terms with the EU that largely preserve the status quo. Stocks also got a boost from the Bank of England's hints of summer stimulus to offset the uncertainty and likely economic effects of the Brexit vote.

Europe's broad STOXX 600 Index rebounded from a four-month low to finish up 3.2% (in local currency terms) for the week. Eurozone economic data was positive as well, with manufacturing growth hitting a six-month high in June, inflation returning to positive territory for the first time in four months, and unemployment touching a five-year low.

In the U.S., the S&P 500 Index was on pace for a gain of about 3.3%, nearly erasing all of its post-Brexit vote loss. Japanese and Chinese equities also rose sharply.

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

Fixed income

Despite the "risk-on" rally in equity markets as the week progressed, fixed-income investors remained cautious, boosting demand for safe-haven assets such as U.S. Treasuries. After starting the week at 1.57%, the yield on the bellwether 10-year note

dipped to 1.46% as of early-afternoon trading on July 1. (Yield and price move in opposite directions.) With the world further awash in negative-yielding assets after the U.K'.s vote, Treasuries remain especially attractive.

Meanwhile, non-Treasury "spread" sectors broadly benefited from the ongoing search for yield. Investment-grade and high-yield corporate bonds outperformed for the week through June 30, elevating their year-to-date returns to 7.7% and 9.1%, respectively.

U.S. GDP growth is revised upward, and so is our Q2 forecast

According to the government's third and final estimate, U.S. GDP expanded at an annual rate of 1.1% in the first quarter, higher than the previous estimate of 0.8% and in line with our forecast. Stronger exports and business investment drove the upward revision, while personal consumption expenditures, disappointingly, were revised down to their slowest pace in two years. The good news is that consumption headed substantially higher in April and May, thanks to a pickup in first-quarter wages. As a result, we are raising our second-quarter GDP growth forecast from 2.5% to 3.1%. Continued consumption strength in June would further improve our outlook.

Among the week's other data releases:

- **Inflation**, as measured by the Fed's preferred inflation barometer (the PCE index), rose 0.2% in May and 0.9% over the past 12 months. The "core" PCE index, which excludes food and energy costs, increased 0.2% in May and 1.6% compared to a year ago.

- **Manufacturing activity** grew at its fastest pace in 15 months, with the index published by the Institute for Supply Management reaching 53.2. (Readings above 50 indicate expansion.)

- **Non-manufacturing activity** remained steady at in June, according to Markit's "flash" (preliminary) service-sector index.

- **U.S. home prices** jumped 1.1% in April and 5.4% compared to a year ago, according to the S&P/Case-Shiller 20-City Index, while **pending home sales** slid 3.7% in May.

- **Consumer spending** rose (+0.4%) in May, while April's surge, the biggest one-month gain in spending since August 2009, was revised higher. **Personal income** grew just 0.2% in May, the smallest increase in three months.

- After declining modestly for two consecutive months, the Conference Board's index of **consumer confidence** rebounded in May. Overall, consumers were

more upbeat about business and labor conditions and still cautiously optimistic about short-term economic growth.

- **First-time unemployment claims** climbed by 10,000, to 268,000, while the less-volatile four-week moving average was unchanged, at 266,750.

Outlook

While it's a relief to see markets calm down following the extreme Brexit-related volatility, we are still facing and will continue to face heightened political uncertainty. This, along with damaged investor confidence, could trigger more bouts of market unrest. Nonetheless, we remain optimistic that with the U.S. economy on an upward trajectory, the S&P 500 will reach new highs by year-end. We believe European stocks should also rise, supported by ongoing European Central Bank monetary stimulus that will restrain bond yields. Meanwhile, fixed-income markets await June's U.S. jobs report, scheduled for release on July 8. In terms of individual fixed-income market sectors, we continue to prefer emerging-market, investment-grade corporate, and short-term structured securities.

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