Fall 2016

Economic and Investment Outlook

2016 Fourth Quarter

Timothy Hopper, Ph.D.
Managing Director
Chief Economist
TIAA

Brian Nick, CAIA
Managing Director
Chief Investment Strategist
TIAA Investments

Executive summary

- The U.S. economy appears to have accelerated in the third quarter, helped by a more balanced mix of growth than the second quarter's consumption-driven pickup and steep inventory decline.
- With growth picking up and the labor market tightening, we expect the Federal Reserve to raise interest rates at its December meeting, although this remains a close call.
- Globally, interest rates have begun a gentle climb, but central bank buying combined with sluggish economic activity should prevent them from rising significantly in the near term.
- While we believe both the S&P 500 Index and non-U.S. equity markets have room to move higher before year-end, their ascent will depend greatly on the pace of corporate earnings growth meeting already-high expectations.
- Policy uncertainty stemming from Fed indecision and the U.S. election in November could create enough volatility to dent returns on riskier assets, but we believe any such choppiness would be short-lived.

Asset class preferences

Equities	Fixed Income
United States	Government Debt
Large Cap	United States
Mid Cap	Non-U.S. Developed Markets
Small Cap	Emerging Markets
Growth	TIPS
Value	Munis
Non-U.S. Developed Markets	U.S. Corporate—Investment Grade
Emerging Markets	U.S. Corporate—High Yield

■ = Most preferred; ■ = Neutral; ■ = Least preferred. TIPS = Treasury Inflation-Protected Securities. Allocations based on an unhedged, U.S.-dollar-denominated portfolio. Please note the forecasts above concern asset classes only and do not reflect the experience of any product or service offered by TIAA. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, as well as political and economic developments. Past performance is not an indicator of future results.

Modest growth uptick and stable inflation, with December Fed hike likely

U.S. growth likely accelerated in the third quarter, following a disappointing Q2 in which a sharp inventory contraction offset a surge in consumer spending. Manufacturing and service-sector activity weakened in the July-September period but remains in expansion territory, while industrial production appears to be recovering. We continue to see little evidence that inflation is accelerating meaningfully, though there are faint signs that wages are growing faster than they have for several years.

Currently, the U.S. economic picture does not compel tighter monetary policy, but that may not deter the Federal Reserve from raising rates in the fourth quarter. Should payroll growth continue at its 2016 pace of around 170,000 jobs per month, the Fed could become convinced that inflation will soon follow. For now, the Fed's "dot plot" showing the path of anticipated interest-rate hikes calls for one increase before year-end and up to two in 2017, which is our expectation as well.

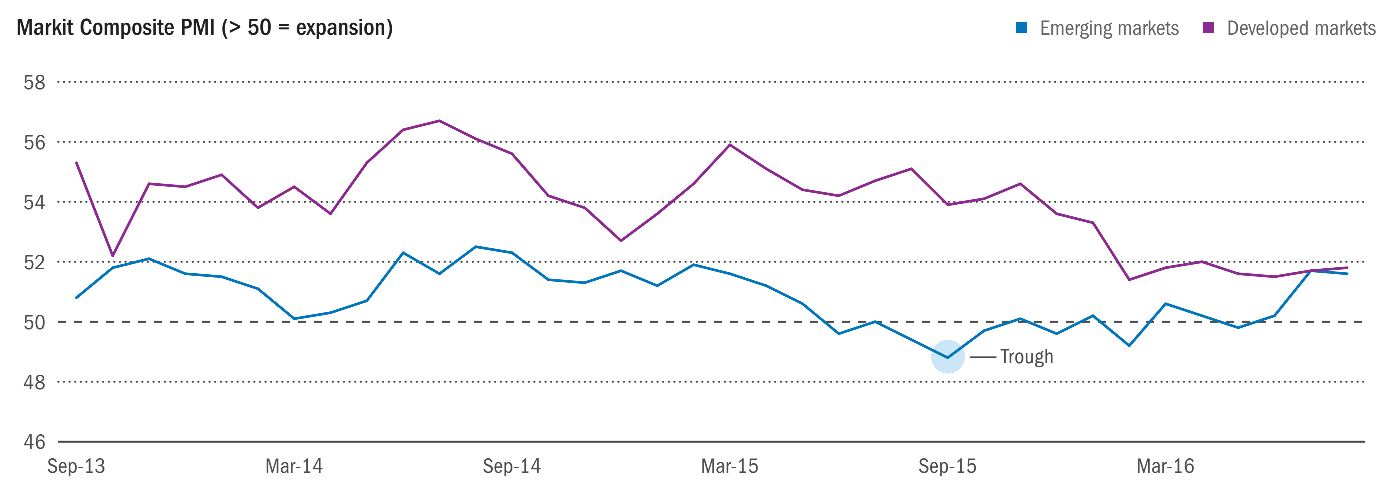
Eurozone resilient following 'Brexit' vote, emerging markets improving

Economic data out of the Eurozone and U.K. has been surprisingly resilient following the Brexit vote in June. U.K. business sentiment cratered initially but rebounded strongly the following month. While a good deal of uncertainty remains regarding the nature and economic impact of the U.K.'s exit from the European Union, the most dire predictions do not yet appear to be materializing. Along these lines, the European Central Bank in September provided no further guidance on extending its significant asset purchase program beyond March 2017 or taking further action on interest rates. With the banking sector still a concern and consumer spending still subdued, however, we do not expect Eurozone growth to surge higher in the near term.

The biggest news out of Japan was the central bank's decision to target a steeper yield curve by rearranging its long-standing asset purchase program. Until recently, negative long-term interest rates in Japan and elsewhere have been an accepted by-product of quantitative easing. But now policymakers may be reassessing the efficacy of these programs as they run low on available assets to purchase and gain a better understanding of the impact that flat yield curves and negative rates have on the health of banks' balance sheets.

Emerging-market (EM) economies are still struggling relative to developed markets. That said, there are some encouraging signs for the longer term. China's deceleration continues but appears better managed than it did earlier in the year. The cessation of U.S. dollar strength has helped in this regard. Although Brazil remains in recession, the change in political leadership has kindled hopes of an imminent turnaround. Meanwhile, as Figure 1 shows, business activity troughed in EMs nearly a year ago and has slowly caught up to developed markets. This is partially due to the stabilization in oil prices over this period. The excellent investment returns from EM assets year-to-date may attract more foreign investment, which should support the green shoots we already see in several countries after years of subpar growth.

Figure 1. Emerging-market expansion is catching up to the developed world's



Source: Bloomberg.

Equities

U.S. earnings recovery likely to benefit small caps

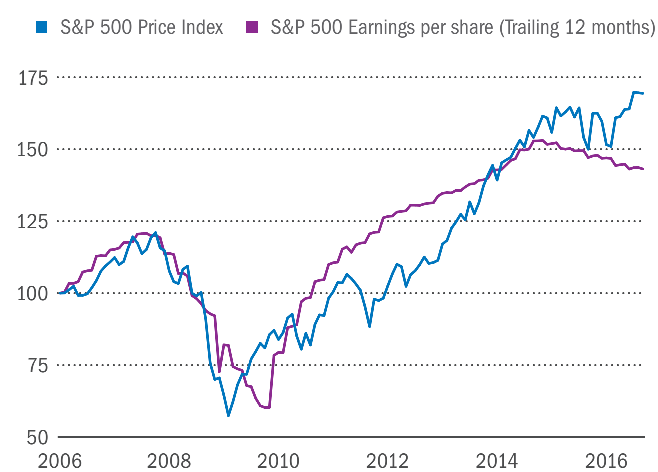
Global equity markets recovered strongly after the pronounced volatility stemming from the Brexit vote in late June. The S&P 500 Index hit its all-time closing high (2,190.15) on August 15 before losing steam due to cooler economic data and uncertainty about the path of Federal Reserve policy. The surge in equity prices in the absence of corporate earnings growth (for five quarters and counting) has left valuations somewhat stretched (see Figure 2), though not yet to levels that would cause us concern. As energy prices and the level of the dollar stabilize, we expect profits growth to turn positive, which should support stocks at their current levels. Moving forward, equity returns may lag corporate earnings growth as price-to-earnings multiples ease back to more comfortable levels. We continue to view 2,250 as an achievable S&P 500 target by year-end, reflecting a 3.8% rise from its September 30 level. We also believe that the broader recovery in earnings will benefit small-cap stocks, enabling them to maintain their recent momentum versus large- and mid-cap shares.

International markets attractively valued compared to U.S. stocks

After lagging badly during the first half of 2016, developed-market stocks outside the U.S. staged a strong third quarter (+6.4%) despite the hangover from Brexit. EM stocks (+9.0%) performed even better, boosted by stronger investor flows, positive inflection points in key economic data, and apparent political progress in countries such as Brazil and India. While international stocks outperformed the U.S. in the third quarter, they are still attractively valued relative to both the U.S. market and their own history. Figure 3 shows that a long-term measure of equity market valuation known as the "Shiller P/E" is above average in the U.S. but close to all-time lows in international markets. (Asset-class returns are based on respective MSCI indexes and stated in U.S. dollar terms.)

Additionally, the policy environment for equities remains friendlier outside the U.S. This, coupled with the recent positive momentum for international shares, leads us to prefer them to pricier U.S. stocks. Moreover, the very low yields on developed-market bonds outside the U.S., which we cover in the Fixed Income section of this outlook, implies that investors may want to consider allocating more of their

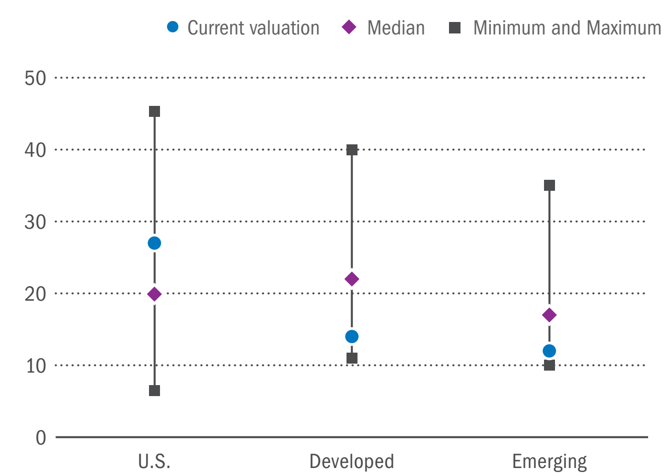
Figure 2. U.S. earnings stagnate while the S&P 500 Index climbs



Source: Bloomberg. Series indexed to 100 as of 1/1/2006.

Figure 3. Equities are cheaper outside the U.S.

"Shiller" valuation for major equity markets*



* Shiller P/E is the ratio of the current index level to real average earnings per share over the prior 10 years.

Source: Robert Shiller, Research Affiliates. U.S. and developed-market periods date back to 1975, emerging markets to 1994.

international assets to equities rather than to fixed income. The main risk to international stocks continues to be sluggish growth coupled with market dissatisfaction about the lack of new initiatives from central banks in Europe and Japan.

Fixed income

Credit no longer as cheap after spread tightening

Brexit sent global government bond prices soaring at the start of the third quarter, but only temporarily. As equity markets stabilized and recovered, yields on U.S. Treasuries rose gently back to their mid-June levels, leading to a modestly negative total return (-0.3%) for the asset class during the quarter. To a large extent, U.S. interest rates remain capped by the aggressively easy monetary policy that has been in place in Europe, Japan, and elsewhere over the past several years (see Figure 4). We do not see the 10-year U.S. Treasury yield rising much higher than 1.7% over the balance of the year.

A combination of factors pushed corporate credit spreads lower throughout the quarter (see Figure 5), a trend that benefited U.S. high-yield bonds (+5.6%) the most. The benign economic environment, investors' demand for income streams, and stable energy prices mean that corporate credit—including lower-rated debt—should continue to outperform U.S. Treasuries over the medium term. But we also expect that most of this outperformance will now come in the form of higher coupon payments, which compensate for higher risk, and not from significant additional spread tightening. As a result, for the fourth quarter we are no longer maintaining a preference for U.S. corporate credit over U.S. government debt.

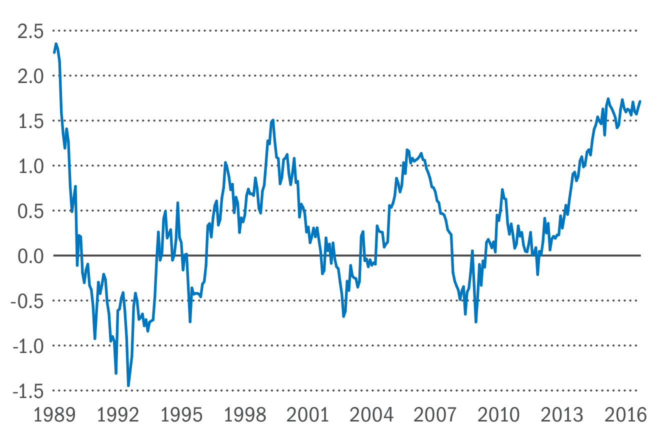
While the dollar's performance against other major currencies has been mixed, higher-yielding, EM local-currency debt achieved a positive return (+3.1%) for the quarter. Developed-market international bonds, on the other hand, carried much lower yields and, therefore, were more susceptible to even the gentle rise in global interest rates. For this reason, their return was lower (+1.0%) in the third quarter, although they have returned a healthy 13.1% for the year through September 30, thanks to the weaker dollar. With international yields still near all-time lows, we continue to prefer other areas of the global bond market, such as U.S. high-yield and EM debt. (Asset-class returns are based on respective Bloomberg Barclays indexes.)

U.S. election: A source of uncertainty, but not a big factor for markets

The most-watched event in the fourth quarter will almost certainly be the U.S. presidential election. But that doesn't mean it will be the biggest market mover. The topics covered above, ranging from Federal Reserve policy to corporate earnings data, tend to carry greater weight with investors than political campaigns, even ones in which the result remains highly uncertain up to Election Day. We still don't know if the 2016 race will come down to the wire, but we are reasonably confident that the resulting balance of power in Washington, D.C., will not tip too far in either major party's direction. This should forestall any sweeping legislative changes in the coming term that could materially impact economic growth or corporate and investor behavior. For more on our views about the election, see our recent white paper, **"The 2016 U.S. Election: More bark than bite for markets."**

Figure 4. Eurozone monetary policy is capping U.S. rates

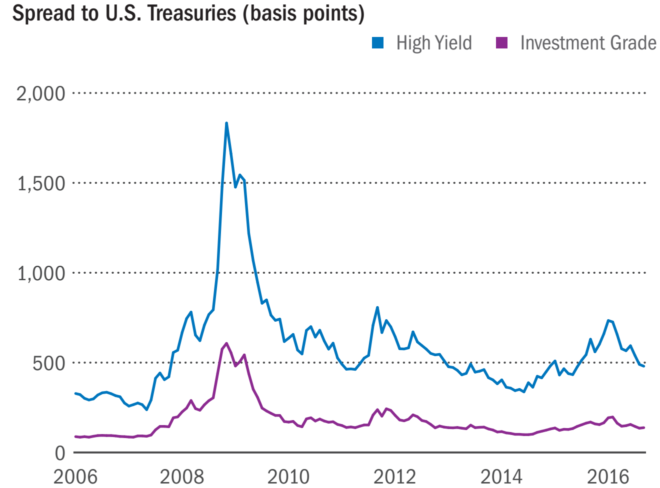
10-year yield spread (%) between U.S. Treasuries and German bunds



Source: Bloomberg.

Figure 5. U.S. corporate credit spreads have fallen closer to average levels

Spread to U.S. Treasuries (basis points)



Source: Bloomberg. Spreads based on Bloomberg Barclays Indexes.

Conclusion

Virtually all asset classes have delivered positive returns in 2016 so far, albeit with patches of volatility along the way. While the fourth quarter also promises its share of bumps, mainly due to policy and political concerns, we remain confident that solid U.S. economic growth, coupled with some early but promising signs of acceleration in the rest of the world, will provide a base of support for global equity and credit markets into 2017.

Figure 6. GDP growth forecasts (%)

	Real GDP growth		Forecasted real GDP growth*				
	2016	2017	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17
U.S.	1.4	2.2	1.1	1.4	2.0	1.8	2.5
China	6.6	6.4	6.7	6.7	6.6	6.6	6.4
Eurozone	1.5	1.2	1.7	1.6	1.4	1.2	1.2
Japan	0.6	0.8	2.1	0.7	1.2	2.0	0.9

* Quarterly GDP for China and the Eurozone are reported as year-over-year growth rates, while quarterly GDP for the U.S. and Japan are reported at seasonally adjusted annual rates (SAAR). Sources: Haver Analytics, TIAA.

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