2017 Second Quarter

TIAA

Economic and Investment Outlook—Nearing euphoria, but far from utopia

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Executive summary

- Equity markets delivered stellar first-quarter returns, buoyed by improving global economic and corporate earnings growth.
- Optimism about sweeping policy changes in the U.S. has shown up in confidence surveys and U.S. equity market valuations, but movement on major initiatives from the Trump administration has been slow.
- Growth outside the U.S. should accelerate further as central banks have more room to ease policy even as the Federal Reserve continues to tighten.
- U.S. equity markets are priced for a "near-perfect" political outcome at home, while valuations in Europe and elsewhere are held down by short-term election risk.
- Long-term interest rates have been slower to price in increased optimism about growth, leaving higher-yielding emerging-market (EM) bonds as the most attractive option for fixed-income investors.
- We prefer international equities given their earnings momentum and cheap valuations, and our expectation that perceived political risks will diminish in Europe as the year goes on.

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.

Introduction—Optimism with just a hint of trepidation

Investors approached 2017 with cautious optimism. While the caution is still present in global bond markets, optimism has clearly seized the reins in equity markets. Global economic data has, by and large, beaten expectations, and global equity markets have rallied on signs of broad-based earnings growth. Some of these markets appear to have overshot fundamentals, while others are seemingly just beginning to price in the improvements that have been taking place for some time. We think diversified portfolios will produce more modest returns over the balance of the year than they did in the first quarter. But an accelerating global economy should continue to present investors with attractive return opportunities…if they know where to look.

The economy

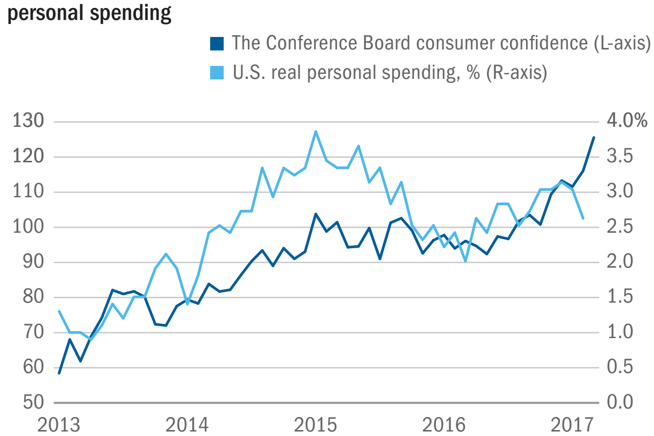
Last year's stunning U.S. presidential election led many economists to reevaluate their long-held views about the likely path of GDP growth over the next few years. The trifecta of comprehensive tax reform, fiscal stimulus, and deregulation now possible under a Republican president and Congress held—and still holds—the potential to drive growth higher than its 2% post-financial crisis average. In truth, the U.S. economy was already improving in the fall of 2016, with job openings more plentiful and manufacturing activity picking up. We continue to believe that U.S. growth will accelerate over the next few years.

What seems clear today—but was not in the immediate wake of the election—is that high hurdles exist to the passage of potentially stimulative policies, despite single-party control of the legislative process. The smoldering political fallout from the failure of the American Health Care Act could push back the timetable for corporate tax reform to later this year or, perhaps, 2018. Meanwhile, while survey-based economic readings on business and consumer confidence have reached impressive heights, they have not been matched by increases in real personal spending (Figure 1). Hiring is robust, but capital expenditures are muted. In short, while the U.S. economy should accelerate from its sluggish 2016 pace, the rate of improvement may be somewhat modest.

Meanwhile, the rest of the world has benefited from lower expectations. Two-percent growth in the Eurozone, for example, would be a significant achievement. We think that level is within reach as economic data has reliably beaten expectations and the European Central Bank (ECB) remains committed to easy monetary policy. Leading indicators have ticked up even in Japan, of all places, where growth has long failed to gain much traction. Stronger developed markets, coupled with a commodity price recovery, have also helped emerging-market (EM) economies, many of which struggled badly in recent years to balance stagnant growth with rising inflation as their currencies plunged. Recent indicators show faster-than-expected improvement in emerging economies ranging from China to India to Brazil (Figure 2).

Figure 1. Consumers have not yet put their money where their mouth is

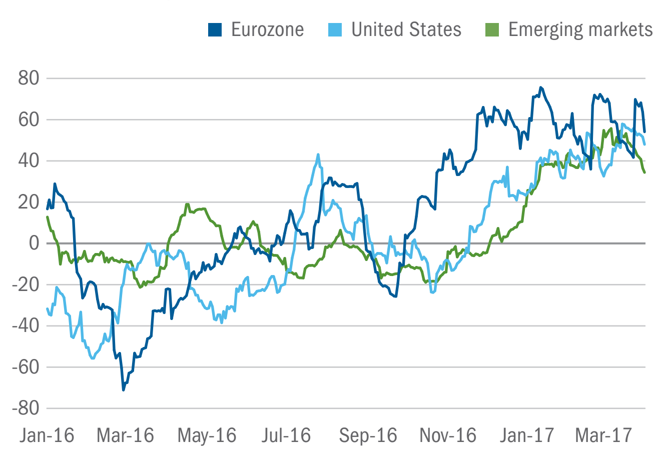
The Conference Board consumer confidence vs. % change in U.S. real personal spending



Source: Bloomberg.

Figure 2. Economic data is beating expectations in all regions

Citi Economic Surprise Indexes*



* These indexes gauge the extent to which worldwide economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises.

Sources: Citi, Bloomberg.

Having lagged the U.S. cycle for so many years, other economies still find themselves in the early stages of recovery, or in some cases, just crawling out of recession. This means the U.S. will likely also be the first economy in which growth slows as interest rates rise and profit margins are squeezed. It also means that many countries will boast an economic acceleration this year even greater than the one we expect to see in the U.S.

The markets

Financial markets seemed to be in general agreement about the macroeconomic outlook through thick and thin in 2016. In the latter part of the year, the dual promise of faster global growth and stimulative U.S. fiscal policy pushed up interest rates, the dollar, and U.S. equities. But so far in 2017, interest rates have been slow to rise, and the dollar has weakened against most currencies. Yet the U.S. equity market has rallied. The relatively low correlation between U.S. interest rates and equity prices of late (see Figure 3) hints at some measure of disagreement between the stock and bond markets about the direction of growth. We find a good deal of optimism baked into U.S. equity prices, while the Treasury market—as it often does—offers a more sober picture.

Three factors inform our asset class preferences moving forward: valuation, political risk, and cyclical strength. Thanks to the remarkable rise in domestic equity prices, the attractiveness of stock prices compared to bond prices is now back near its average in the U.S., but it remains high internationally. While markets factor in political risks everywhere, they seem to reflect a too-positive scenario in the U.S. and a too-negative one in Europe. Economic data complemented by relative shifts in central bank policy suggests 2017 will be a year in which U.S. risk assets relinquish their recent leadership to markets in the rest of the world.

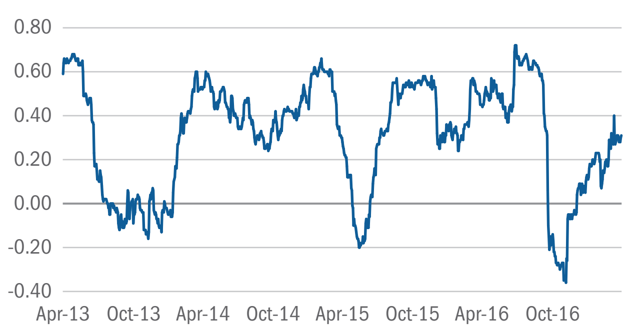
Equities

The S&P 500 Index hit an all-time high in July 2016 and has been making new highs ever since. Since the Brexit vote, U.S. equities have returned nearly 15%, the majority of which has come after the U.S. election, boosted in part by corporate earnings growth turning positive again following an oil-driven recession in profits. However, most of this recent stock market rally has been propelled by higher valuations, not a stronger earnings outlook. As a result, the U.S. equity market looks more expensive today by most measures than it has since the late 1990s, though not yet as pricey as it eventually became during the Technology bubble.

Warnings about expensive stocks should sound ominous only insofar as valuation—while not a good predictor of stock market corrections or bear markets—is a decent forecaster of long-term returns. When stocks are expensive, their returns tend to be below average over the next five to 10 years. Although we do not necessarily foresee a sharp market correction, we also do not believe U.S. stocks will sustain their current lofty valuations in perpetuity. A combination of mild disappointments on the policy front and stronger investor flows to destinations outside the U.S. will, we think, allow for only minimal upward price movement over the next several quarters, despite our expectations for a continued pickup in earnings. We maintain our year-end target of 2,400 for the S&P 500, less than 2% higher than the current level.

Figure 3. Stocks and bonds are "agreeing" about growth less often

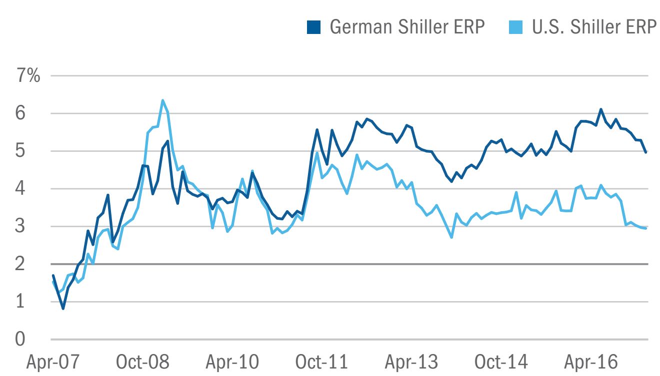
90-day rolling correlation:
S&P 500 Index vs. 10-year U.S. Treasury yield



Source: Bloomberg.

Figure 4. Stock versus bond attractiveness is more obvious in Europe than in the U.S.

"Shiller" equity risk premium (ERP) for Germany and U.S.



Shiller P/E is calculated using current index price divided by average annual earnings over previous decade. Shiller ERP is calculated using the inverse of the Shiller P/E less the real 10-year government interest rate. Sources: Robert Shiller, Bloomberg.

Fortunately, we see potential for better international market returns to offset our rather muted U.S. outlook. With the U.S. economic cycle several years ahead of those of other developed countries, investors have strongly preferred our market since 2011. But much of the rest of the world now finds itself at a similar point in its cycle as the U.S. was five years ago: profits are growing again, investor optimism is slowly on the rise, and valuations appear quite attractive, especially compared to the ultra-low bond yields prevailing in Europe (see Figure 4).

Still, investors are concerned about political risk in France and elsewhere as rising nationalist sentiment seems to threaten the fabric of the European project, including the euro. In our view, this risk appears to be overly priced into markets, keeping valuations low and making it a risk worth taking. We expect pro-European centrist candidates to win political victories in France and Germany this year, which could serve as a catalyst for heretofore nervous investors to get off the sidelines.

Meanwhile, EM equities have had a torrid start to the year. The panicked reaction in some quarters to the U.S. election results has given way to increased inflows as investors see opportunities in inexpensive, recovering markets with weak currencies. We remain optimistic that EM stocks can continue to outperform, given their inexpensive starting point, stable oil prices, and strong global growth. What's more, earnings estimates are on the rise and have further room to increase after a long period of no growth.

Fixed income

While equity markets have been keeping the party going so far this year, fixed-income markets have acted as a sort of designated driver. The strong upward trend in interest rates has flattened out despite the Federal Reserve's earlier-than-expected March rate hike, the first of three we expect to see this year. The federal funds target is still below 1% and may not even breach 3% in this cycle, which could explain why longer-term rates have been reluctant to rise. We have lowered our year-end forecast for the 10-year U.S. Treasury yield to 3%, based on a slightly slower growth outlook and only gradual tightening from the Fed.

Investors hoping that corporate bonds may help cushion their portfolios from further tightening—or at least provide higher return potential—may feel as though they are pedaling on a stationary bike. Credit spreads have tended to narrow when Treasury rates are rising but widen when those rates are falling. In either scenario, corporate bond yields remain more or less constant.

Last quarter, the real action in fixed-income markets took place overseas. Concerns about the upcoming election in France have driven up French bond yields to their highest levels, compared to their German counterparts, since the Greek crisis (see Figure 5). But more generally, the relatively low yields of European and Japanese debt continue to make international developed bonds one of our least-preferred asset classes.

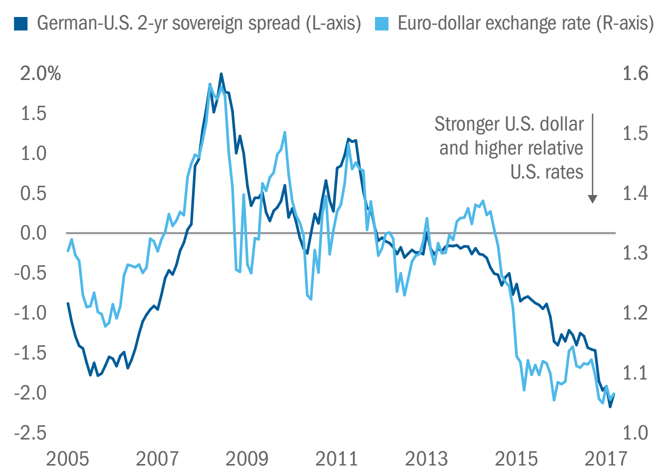
Figure 5. Election risk has seeped into France's bond market

Spread between French and German 10-year sovereign bonds (%)

Source: Bloomberg.

Figure 6. U.S. dollar strength is supported by relatively high interest rates

German-U.S. 2-year sovereign spread vs. euro-dollar exchange rate



Source: Bloomberg.

We believe portfolios that include significant allocations to international stocks and EM bonds should be well positioned for the remainder of the year and into 2018.

In contrast, EM credit has rallied impressively since swooning late last year, as spreads have compressed. Returns on local debt have been greatly bolstered by the 3%–10% appreciation in EM currencies against the U.S. dollar. Given the very EM-friendly mix of local disinflation and stronger global growth, we expect EM bonds to continue to outperform low-yield developed markets in the near- to medium term.

Currencies

While slightly off its recent highs, the U.S. dollar remains quite strong, largely because U.S. interest rates are still very high compared to the rest of the developed world (see Figure 6). Expectations for several more Fed rate hikes in advance of tightening by any other major central banks should prevent the dollar from weakening too much. But given its near-record strength and the fact that the market has largely priced in this likelihood of diverging monetary policy, we think the balance of risks clearly points to a somewhat weaker dollar by year-end, especially against EM currencies. The key here is not that the U.S. economy will weaken, but that the rest of the world is gaining strength.

Conclusion

First-quarter market returns have probably beaten most investors' expectations, but we foresee more dispersion along geographic lines moving forward. Meanwhile, the majority of fixed-income markets continue to provide relatively paltry return opportunities, with yields still far below normal. While U.S. economic growth appears likely to improve over last year, and some policy-related upside risk to equity markets remains, we believe portfolios that include significant allocations to international stocks and EM bonds are well-positioned for the last three quarters of the year and into 2018.

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