Weekly Market Update

Despite concerns, equity markets making record new highs

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ARTICLE HIGHLIGHTS

- Equity markets reaching new highs.
- Treasury yields increase, credit spreads continue to tighten, and bond fund flows remain broadly positive.
- U.S. unemployment rate down to 7.7%, positive surprise on non-farm payroll data

MARCH 8, 2013

Equity markets continue to focus on economic data points that suggest the U.S. economy is slowly grinding higher. The ISM manufacturing reading on Tuesday was above consensus as was Friday's employment data. Coupled with last week's improving housing data, and accommodative Fed commentary supporting loose monetary policy, the Dow Jones Industrial Average (DJIA) hit a new all-time high (reaching 14,372 intraday), and the S&P came within 51 points (less than 2%) of reaching the 2007 all-time high. Despite bullish investor sentiment, we would not be surprised by a mid-cycle correction based on macro concerns including the recently implemented U.S. budget sequestration, weakness in Eurozone economies, political infighting among EU members (including Italy's inability to form a government), and China's slowing GDP. In addition, market technicals are weaker globally.

Fixed-income markets were mixed on the positive economic data. Treasury prices declined (and the 10-year yield pushed above 2% from 1.9% last week), but corporate bonds rallied as the outlook for a sustainable economic recovery continued to improve. Fund flows continue nearly unabated into corporate bond funds, particularly investment grade corporates and leveraged-loan funds (funds that invest in adjustable-rate bank loans made to companies rated below investment-grade). The search for yield in fixed income is likely to continue, even with the strong economic releases this week, as it is our view that the Fed will not slow or stop purchases until they are fully assured that the economy is on a sustainable growth trajectory.

Financial Services

Positive economic data outweighs U.S. budget sequestration and higher tax fears

- **Non-farm payrolls** increased 226,000 in February, well above consensus estimates of 160,000–165,000. Construction-related employment hit a 5-year high, supporting last week's data on rising house prices and housing starts. February's employment readings follow a revised 119,000 gain in January that was smaller than first estimated.

- **Weekly jobless claims** fell to 340,000 below consensus of 357,000 and below the January level of 347,000. The unemployment rate fell slightly to 7.7%, within the range of consensus of 7.8%.

Other favorable economic readings included:

ISM non-manufacturing climbed to 56 in February, above consensus and previous readings of 55.2. Readings above 50 indicate more companies are expanding rather than contracting. The ISM non-manufacturing data complements last week's healthy manufacturing PMI readings, suggesting the U.S. service economy is improving as well.

Outlook

Equity sentiment is bullish and rising supported by ISM readings that suggest both manufacturing and service sectors are expanding, unemployment is moving lower, and employment is slowly rising. In addition, the Fed's bullish statement to keep rates at low levels serves as a positive support for equities. Although global PMI edged down as a result of slower Chinese and European activity to as low as a 50.9 reading, the global economy is still expanding.

Despite these positive indicators, we remain concerned that the market continues to be vulnerable to a correction. European economic growth, while stabilizing, is still near recession levels and political bickering between EU members threatens a fragile recovery. Furthermore, China remains a mystery—this week the government took steps to clamp down on real estate speculation which caused the Shanghai A market to sell off sharply, after having just peaked in February. There is some real debate on how serious the Chinese are about constraining growth. While food price inflation was elevated, it has now reversed and there remains a concern about the need to "reset" the direction of Chinese growth which has traditionally been driven by investment. Today many view that driver as no longer effective and arguably leading to an over-expansion of the Chinese economy. However, consumption-led growth has yet to become a true basis for sustainable economic growth in China and whether the government is willing to address that dynamic is an open question that is fueling debate.

Market technicals also concern us. While the U.S. markets are hitting all-time highs, non-U.S. markets have yet to recover from their February corrections. The MSCI All Country World Index (ACWI) is still 20% below its all-time high with two-thirds of the 45 countries in the ACWI index yet to recover to their January-February peaks. Ned Davis Research points out that globally, as a percentage of issues traded, the spread between advancing stocks less declining ones has reached low levels,

indicating “churning,” or market rotation. Historically this is a weak sign for equity markets as churning often indicates a point of inflection. That observation coupled with optimistic U.S. sentiment presents a red flag that we may face further market weakness.

Our fixed income outlook is positive. The ongoing strength in housing remains a very significant tailwind to markets and has the ability to help the economy eventually stabilize without the need for ongoing Fed asset purchases. While ongoing weakness in the Eurozone economy merits continual monitoring, the sentiment in U.S. markets is increasingly domestically focused. It’s not implausible that the U.S. returns to its more historical role (albeit, along with China) of serving as the central driver of global growth. All that said, slack in the economy remains considerable, it’s still a long road ahead. Underemployment above 14% remains a significant challenge.

In the credit markets, no major leveraged buyouts (acquisitions of companies using borrowed money, also known as LBOs) or re-leveraging transactions were announced this week. The investment-grade market remains exposed to an increase in LBO activity as the risks are not fully priced into current spreads. Credit metrics have deteriorated slightly quarter-to-quarter, however, this risk is small compared to that of an LBO itself.

The search for yield in fixed income is likely to continue as even with the strong economic releases of the week, it is our view the Fed will not slow or stop purchases until they are fully assured the economy is on a sustainable growth trajectory and that the requisite strength exists to shrug off the inevitable rise in Treasury yields that will accompany an eventual end to the quantitative easing programs.

Financial Services

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