Weekly Market Update

Disappointing data sparks a volatile week

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

ARTICLE HIGHLIGHTS

- China's weaker-than-forecast growth fuels global slowdown fears.
- Equity and commodity prices fall, adding to April weakness.
- Fixed-income markets remain relatively calm, with a modest flight to quality.
- Housing starts rise, a bright spot among generally weaker U.S. indicators.
- Second-quarter deceleration is evident but in our view not a signal of recession.

APRIL 19, 2013

As we have noted in recent updates, a pullback in equities has been a distinct possibility even as major U.S. stock indexes climbed to new record highs. The markets' resilience was certainly put to the test during the past week, as disappointing economic releases served as a trigger for sharp downside volatility. For the week to date through April 18, the S&P 500 Index was down nearly 3%, with the higher-risk, small-cap Russell 2000 Index falling further, close to 4.5%. Losses were slightly smaller in foreign developed and emerging markets during the same period, based on MSCI indexes. In early trading on April 19, the S&P 500 appeared to be trimming some of its earlier-week losses, in part due to some favorable earnings reports.

Bond markets traded within relatively tight ranges during the week. The Barclays U.S. Aggregate Bond Index, a broad measure of investment-grade fixed income performance, posted slightly positive total returns. Most "spread products" (higher-yielding, non-U.S. Treasury securities) underperformed, but not dramatically. Among these sectors, commercial mortgage-backed securities (CMBS) generally fared better, as investors focused on recovery in U.S. commercial property markets. Overall, during the first three weeks of April, we have seen a moderate flight to quality, with demand for Treasuries causing 10-year and 30-year yields to decline by 14 and 21 basis points (0.14% and 0.21%), respectively, as of April 18.

TIAA CREF Financial Services

Disappointing data sparks a volatile week

China’s slower growth sets the tone

The week got off to a rough start, with China’s first-quarter GDP growth coming in at 7.7%, below forecasts of about 8%. China’s economy, the world’s second-largest, has now slowed in eight of the past nine quarters. This deceleration rattled equity markets globally and sent commodity markets sharply lower as well. All key commodity sectors—energy, metals and agriculture, which are key drivers for many emerging-market economies and their equity markets—took a tumble.

Softer U.S. numbers add to market concerns

It is becoming increasingly evident that U.S. growth in March slowed from the more robust pace seen in January and February. Market expectations call for this relative weakening to carry into the second quarter, and we generally agree with this assessment. However, to be clear, we think the current and near-term deceleration represents another temporary “spring dip,” similar to those that occurred in 2011 and 2012, rather than a fundamental shift in the direction of the recovery.

U.S. economic data released during the week included some mixed headlines for the housing market:

- Housing starts rose more than forecast in March, exceeding an annualized rate of 1 million units for the first time since June 2008.
- Building permits fell 3.9%—a potential concern because permits are a forward-looking indicator and a sustained drop would signal diminishing future demand.
- Homebuilder confidence dipped in April for the third consecutive month and hit a six-month low, based on the National Association of Homebuilders (NAHB)/Wells Fargo Housing Market Index.

Various gauges of manufacturing and industrial activity were also mixed:

- Industrial production rose moderately in March, driven largely by higher utilities output in the face of extremely cold late-winter weather, and by increased automobile output.
- Capacity utilization, a measure of how much slack there is in the economy, barely budged, and manufacturing production was down slightly.
- Two regional manufacturing indicators, the Philly Fed Index and the Empire State Index, posted lackluster readings in March.

These muted results, along with a 0.1% drop in The Conference Board’s Index of Leading Economic Indicators for March, are consistent with a ratcheting down of economic momentum in the near term. The recent modest pace of growth has been accompanied by tame inflation, with consumer prices edging down 0.2% in March as gasoline prices fell. On a year-over-year basis, the Consumer Price Index was up a mild 1.9%.

Outlook

We expect continued growth in housing activity as the year progresses, as rebuilding from Hurricane Sandy moves forward in the Northeast, and as housing markets in general improve. Inventories of homes for sale remain low, which, along with a shortage of labor in housing construction crews, should translate into further home price appreciation. March's softer manufacturing trends align with our view of an economy transitioning into a period of slower growth in the second quarter, and we expect these trends to right themselves later in 2013. Moreover, lower commodity prices, particularly for gasoline, may support improved consumer spending in the second half of the year.

In the meantime, while economic releases look weaker and equity markets have turned lower, we have not seen a dramatic widening of spreads in the bond market—unlike the spring slowdowns of the past two years, when both investment-grade and high-yield corporate bonds saw their yields widen significantly versus U.S. Treasuries. Because the limited degree of spread narrowing of non-Treasury fixed-income sectors has not been in proportion to the substantial rise in equity markets this year, it is not surprising that spread widening has been more modest in the face of recent equity weakness.

There is little evidence of any exodus out of fixed income and into equities, as new money flows into stock funds appear to be coming primarily from investor cash holdings. However, fund flows into shorter-term investment-grade funds are outpacing those into longer-dated funds, an indication that fixed-income investors are aware of the risks of rising interest rates.

In equity markets, our base case scenario is that any correction will likely be limited to testing support levels (i.e., price levels below which stocks historically have tended not to fall) that currently look to be 2% to 5% lower in the U.S. A critical variable we are monitoring is short-term trading sentiment, which in in our view, has been overly bullish at times in 2013 but has begun to ebb somewhat. We see this lower level of optimism as a potentially positive sign to the extent that it may position U.S. equities for another advance after this current period of volatility. Outside of the U.S., European and Japanese equities appear to be reaching or have already reached key support points, suggesting the possibility of further downside movement in the near term. In China, however, the Shanghai "A" Share Stock Market Index jumped 2% on April 19, its best day in a month. If this move holds, it could potentially signal a rotation that favors commodities and emerging markets.

A final point of interest this week is the impact that the global downturn in commodities prices (reflecting both lower Chinese demand and increased supply) may be having on Consumer Staples stocks in the U.S. To date the effect has been positive, with the Consumer Staples sector leading the market since last February. This move is similar to a pattern we saw in the early 1980s, when commodities also broke lower, driving down key input costs for Consumer Staples stocks, as well as long-term interest rates. This is a trend that may have legs and bears watching.