Weekly Market Update

Markets temper gains as consumers scale back spending

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ARTICLE HIGHLIGHTS

- Equity markets turn volatile on lower retail sales and consumer sentiment.
- Drop in retail sales is consistent with recent softening of other economic releases.
- Treasury yields fluctuate on mixed economic signals and shifting demand for safe havens.
- With Europe's second-half outlook dimming, we now expect recession to last through year-end.
- Market sentiment, valuations and first-quarter earnings may hold clues to potential correction.

APRIL 12, 2013

Equities climbed higher for much of the past week, rebounding nicely from the previous Friday's dismal U.S. jobs report. For the second consecutive Friday, however, a weaker-than-expected economic release threatened to take the wind out of the market's sails. This time the culprit was a 0.4% drop in retail sales, the steepest decline in nine months. Consumer sentiment also hit a nine-month low. As of early trading on April 12, the S&P 500 Index was giving back some of the 2.6% it had gained earlier in the week. Foreign developed- and emerging-market equities were also wavering after a strong start to the week.

Fixed-income markets were in flux as well. U.S. Treasuries and other higher-quality investment-grade sectors posted negative returns for the week through April 11, after benefiting from the previous week's strong demand for safe-haven assets. The yield on the 10-year Treasury, which moves inversely to its price, was higher for the week at 1.82% as of April 11 but was back down to 1.75% in the wake of the retail sales report. Positive flows into fixed-income funds generally continued during the week, but at decreasing volumes, particularly for high-yield and investment-grade corporate debt.

Financial Services

U.S. economy is slowing in the near term

Although equity markets have so far defied bearish expectations for a correction in 2013, decelerating economic data may be taking a toll. Various indicators such as the Citigroup Economic Surprise Index, which trends higher when economic releases are exceeding consensus forecasts, have recently turned negative.

Specifically, the declines in retail sales and consumer sentiment unnerved markets because they fed growing concern that the consumer may be retrenching more than expected in light of higher payroll taxes and the effects of the federal budget sequester. However, a primary driver of the drop in retail sales was lower spending on gasoline due to falling prices at the pump—a plus for the consumer. Excluding gasoline, the sales report was not as dramatic as headlines might suggest. Moreover, as we have noted before, while first-quarter GDP growth will likely come in at or north of 3%, much of that strength occurred in January and February, with weaker economic performance in March. The latest retail sales figure is consistent with this expectation.

On a more positive note, first-time claims for unemployment fell by 42,000 in the most recent week, erasing the previous week's uptick and helping to calm anxiety over recent labor market softening. The four-week moving average of first-time jobless claims remains in its recent range, with the broader trend still moving lower over time.

Europe marks time

Concerns over Europe abated moderately during the past week, with Cyprus falling off the daily headline ticker—at least until Friday, when reports surfaced that the Cypriot government might request additional bailout funding. Attention has also begun to shift to Slovenia as potentially the next Cyprus, with the market waiting to see how the European Central Bank (ECB) will treat Slovenian bank depositors in the event a bailout there becomes necessary.

Otherwise, the economic story in Europe has remained one in which southern-tier countries (such as Italy and Spain) perform worse, while northern European economies move toward a semblance of stability. Industrial production across the southern tier deteriorated in February but improved somewhat in France, the U.K., and Germany. France presents a broader concern, however, with the government seemingly in paralysis when it comes to market-based reforms at a time when French debt levels are building.

In Italy, the good news is that politicians are at least talking about forming a coalition government. Another potential silver lining for the eurozone is that the weaker the economy becomes, the greater the pressure on the ECB to provide stimulus. If that occurs, it could well serve as a catalyst that drives European markets higher.

China is relatively quiet, Japan inspires differing outlooks

Economic news out of China was fairly light. Bank loan data improved in March—ahead of expectations but not much different on a year-over-year basis. Chinese inflation slowed, which reduced fears of tighter monetary policy. The Shanghai Stock

Exchange "A" Share Index, however, remained indifferent, signaling no real acceleration in economic growth. With China treading water, prices for many commodities have suffered, negatively affecting performance in emerging markets more broadly.

Aggressive monetary easing by the new Japanese government succeeded in driving the yen to a four-year low versus the U.S. dollar in the past week and triggered asset flows out of Japan. While these efforts have been well received so far, there is genuine debate among analysts as to whether this stimulus will work in the long run, as previous attempts to reinflate the Japanese economy have tended to fizzle. The concern is that without additional economic and labor market reforms, the recent stimulus-led surge in the Japanese stock market will stall after upcoming July elections.

Outlook: Still positive, but caution and vigilance are warranted

Our current expectation is that U.S. GDP will grow 3% in the first quarter, slowing to about 2% in the second quarter, with the potential to pick up again later in the year. We have revised our outlook for Europe and now see mildly negative growth for the entire year. Previously, we had expected the eurozone to remain in recession during the first half of 2013 and to stage a modest recovery in the second half, resulting in average growth of roughly 0% for the year.

The U.S. equity market remains in solidly positive territory year-to-date, despite indications of a slowing economy, above-average levels of absolute stock valuations, and elevated short-term sentiment that continues to point toward a possible market correction. U.S. equities have undoubtedly benefited from an influx of funds from Japan, as Japanese investors seek higher returns in dollar assets, given the weaker yen. Meanwhile, first-quarter earnings season has just gotten underway, and it is too early to draw any conclusions. Overall, despite predictions to the contrary, there is still no evidence of the market being supported by a "great rotation" out of fixed income and into equities.

In fixed-income markets, the search for yield continues in the persistently low interest-rate environment. Accordingly, high-yield bonds and U.S. dollar-denominated emerging-market bonds rallied during the past week. Following this rally, we believe many fixed-income asset classes are now fully valued. In our view, the opportunity for positive fixed-income returns for the remainder of the year will be driven by individual security selection, as opposed to broader sector allocation decisions.

While fixed-income sentiment remains generally subdued, we believe that the twin benefits of higher home prices and increased personal wealth (primarily in the form of higher equity prices) should continue to offer a counterbalance to the drag on consumer sentiment and spending caused by higher payroll taxes and the budget sequester. Additionally, given the recent softening of U.S. economic data, it appears less likely that the Federal Reserve will wind down its asset purchases any time soon.

The information provided herein is as of April 12, 2013.

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