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U.S. equities surge to a series of record highs

TIAA
GLOBAL ASSET MANAGEMENT

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Article Highlights

- The S&P 500 notches its third consecutive one-week advance, while stocks in Europe also move higher.
- Strong U.S. economic data lifts Treasury yields toward their pre-Brexit levels.
- Encouraging employment conditions, inflation figures, and consumer spending highlight the week's U.S. economic reports.
- While Brexit may have increased the odds of an eventual EU breakup, we view such an outcome as unlikely.
- Emerging-market equities are poised to continue outperforming, supported by the prospect of low U.S. interest rates, a weaker dollar, and firmer oil prices.

Equities

Following its solid performance on July 8 in the wake of June's robust U.S. nonfarm payroll report, the S&P 500 Index notched four consecutive record highs to begin the week. Although the rally ran out of gas on July 15, the index nonetheless gained about 1.5% for the week, its third consecutive one-week advance. Positive catalysts included a still-cautious Fed, higher oil prices, a surge in corporate stock buy-backs, and better-than-expected earnings releases from a number of large financial institutions.

European stocks took their cue from U.S. markets, with the broad STOXX 600 Index up 3.2% (in local terms) for the week. Equities in the region also benefited from greater political certainty, as a new prime minister took office in the U.K., and hopes for more monetary easing by global central banks. The week ended on a somber note, though, following an apparent terrorist attack in Nice, France.

In Asia, a steady welcome decline in the yen against the dollar fueled Japan's exporter-heavy Nikkei 225 Index to its best one-week performance (+9.2% in local terms) since December 2009. Investors also harbored hopes of an expansive fiscal-stimulus package from the Japanese government and more monetary easing by the Bank of Japan.

Meanwhile, the broad emerging markets (EM) continued to deliver, in part due to their ability to shrug off the potential effects of the Brexit vote. Year to date through July 14, EM stocks are up 10.7% (in U.S. dollar terms), based on the MSCI Index. With a gain of

about 2% for the week, Chinese equities are rebounding from their dismal first-half performance.

Current updates to the week's market results are available here.

Fixed income

Treasury yields rose amid strong U.S. economic data reports—retail sales in particular—and comments by Fed officials indicating that they believed the U.S. will largely be insulated from the effects of Brexit. The yield on the bellwether 10-year note, which began the week at 1.37%—a record low—briefly touched 1.60% before closing at 1.57% on July 15. (Yield and price move in opposite directions.)

Returns for non-Treasury "spread" sectors were broadly negative for the week through July 14. High-yield corporate bonds bucked the trend. Despite the pickup in Treasury yields during the week, demand from income-seeking domestic and overseas buyers bolstered high-yield bonds, which have now gained 12% year to date.

For the U.S. economy, it's "steady as she goes"

This week's data releases included positive takes on employment, inflation, and U.S. consumers, who are in a spending mood despite higher gas prices.

Among the week's reports:

- **First-time unemployment claims** held steady at 254,000, and the less-volatile four-week moving average slid, by 5,750, to 259,000, a 2 ½-month low. This data suggests that the economy continues to add jobs and, more importantly, labor demand has not softened.

- **U.S. consumer prices** increased 0.2% in June, their fourth straight one-month gain, and 1.0% compared to a year ago. Stripping out volatile food and energy costs, so-called "core" inflation rose 0.2% in June and a robust 2.3% over the past 12 months.

- **Retail sales** topped forecasts by jumping 0.6% in June, another indication that consumer spending picked up in the second quarter.

- **The Citi Economic Surprise Index** moved to its highest level since January 2015. This index gauges the extent to which economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises.

- **Small-business sentiment** rose in June for the third consecutive month, as measured by the NFIB Optimism Index. Confidence over the direction of the economy was tempered by pessimism about business conditions overall.

- **Consumer sentiment** weakened, according to July's preliminary reading of the University of Michigan index. High-income consumers in particular expressed concern over the effects of Brexit on the U.S. economy.

Outlook

For U.S. equities, technical indicators suggest that a near-term pullback (or pause) from the post-Brexit rally is possible, as more than 80% of the stocks in the S&P 500 are trading above their 50-day moving average. However, we view a correction as a buying opportunity and a springboard to new highs by year-end. Bearish long-term term investor sentiment, a contrarian indicator that has often presaged higher stock prices, supports our outlook.

European investors are also pessimistic. Brexit-fueled fears of slower growth and a breakup of the EU have accelerated outflows from European stock funds. Nevertheless, we believe the region remains a more attractive investment destination than the U.S.

First, while Brexit has increased the risk of an eventual EU dissolution, we view such an outcome as highly unlikely, as referendums are prohibited in a number of European countries, including Germany, the Netherlands, and Italy. Also, with Europe's economy growing at about a 1.5% annual rate, a slowdown triggered by a U.K. recession might trim up to 0.5% or so from GDP, still leaving the region in expansion mode. The pound's recent plunge in the wake of the vote should boost U.K. exports substantially, mitigating the downturn in economic growth. Lastly, European equity valuations are more attractive than those in the U.S., and the expected return from European stocks is higher than that of their U.S. counterparts.

Meanwhile, we believe stocks in the broad emerging markets are poised to move higher, bolstered by the prospect of "lower-for-longer" interest rates in the U.S., a weaker dollar, and firmer oil prices. Despite China's recent equity rally, we are concerned about the government's overuse of massive government stimulus to prop up the slowing Chinese economy. In our view, such policies create imbalances that cannot be sustained over the long term.

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Foreign stock market returns are stated in U.S. dollars unless noted otherwise.

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