Weekly Market Update

Markets turn lower in anticipation of Fed's policy statement

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA-CREF ASSET MANAGEMENT

Article Highlights

- U.S. equity and fixed-income markets fear a potential change in the Fed's rate-timing language.
- The 10-year U.S. Treasury yield continues its recent climb.
- Improving U.S. retail sales, consumer credit and consumer confidence bode well for 3Q growth.
- In Europe, markets remain focused on the September 18 vote on Scottish independence.
- Expected returns in some foreign equity markets are relatively higher than those in the U.S.

September 12, 2014

Equities

U.S. equities posted a loss for the first time in six weeks, as intensifying speculation about an accelerated Federal Reserve interest-rate hike outweighed improving retail sales and other positive economic data. The S&P 500 Index fell roughly 0.5% for the week through September 11 and was down another 0.6% on September 12.

Non-U.S. markets also declined, with the broad MSCI foreign developed and emerging-market indexes shedding 1.1% and 2.4%, respectively, in U.S. dollar terms through September 11. In Japan, the Nikkei 225 Index climbed 1.8% for the week, fueled by a steadily weakening yen, which benefits Japanese exporters and bolsters the prospects for a much-needed boost in domestic inflation.

Fixed income

U.S. Treasury yields continued their post-Labor Day rise. The yield on the bellwether 10-year note climbed as high as 2.60% in morning trading on September 12—up from its 2.46% close the week before and its highest level since late July. Solid economic data releases weighed on Treasury markets because of heightened concern that the Fed may change its language about the

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timing of an interest-rate hike (widely expected to occur in the second quarter of 2015).

Based on Barclays indexes, most "spread" products (higher-yielding, lower-rated non-Treasury securities) produced negative returns for the week through September 11. U.S. high-yield bonds underperformed the most, hindered in part by negative fund flows. Emerging-market debt was somewhat volatile, although new supply was absorbed by adequate investor demand.

Current market updates are available here.

For additional insights on market developments from TIAA-CREF's Head of Global Active Equity Portfolio Management Saira Malik, view the Weekly Market Perspective Video.

Retail sales rebound in August but remain well below where they should be

In a relatively light week for U.S. data releases, gauges of consumer attitudes and spending were the most revealing.

- **Consumer credit** growth moved sharply higher in July, posting a record monthly gain in dollar terms. Consumers have been taking on more debt to fund purchases since last December, a trend that reflects rising confidence and willingness to spend.
- **Retail sales** grew 0.6% in August, roughly in line with our forecast. Additionally, retail sales for June and July were revised upward. While welcome news, the latest readings remain below the 1% growth in sales that we would expect to see at this point in the business cycle.
- **Consumer sentiment** rose to its highest level in more than a year, as measured by the preliminary September reading for the University of Michigan-Thomson Reuters index.

Political uncertainty for the U.K. and glimmers of improving growth on the continent

On balance, European equity markets appear attractive for a number of reasons, including:

- Industrial production in the eurozone rose more than expected in July.
- Germany's trade surplus reflected robust export growth and marginally negative import growth. This points to stabilization on the continent and is a welcome reprieve from several weeks of weaker data.
- Economic activity appears to be bottoming at a point when the European Central Bank (ECB) is embarking on a program of renewed monetary stimulus.

- The euro has weakened dramatically (a primary goal of the ECB), benefiting exporters and bolstering inflation expectations and growth potential.

All of these are clear positives for Europe's economy and for an equity market that remains 25% below its 2007 peak.

A high-profile concern is the September 18 referendum on Scotland's potential decoupling from the United Kingdom. Early in the past week, one poll suggested that the pro-independence movement was gaining, which sent ripples of volatility through European markets. Subsequent polls brought a sense of relief, showing pro-union sentiment again in the lead. A vote in favor of Scottish independence would likely encourage other regions (such as Catalonia in Spain) to pursue a similar course, which would reignite volatility as concerns rise about sovereign risk.

Outlook

Overall, we believe Fed policy is likely to remain supportive of the markets, regardless of the specific wording used in the Fed's September 17 statement. Even if the language changes, we do not expect the first rate hike to occur before April of next year. Historically, the U.S. stock market corrects 4-to-6 months before the first rate increase in a cycle. The risk we see is not an accelerated timetable per se, but the potential for the Fed to raise rates at a substantially faster pace than what the markets are currently pricing in. If we see a reaction to either the Fed's communication or faster economic growth, the result could be a rapid jump in short-term rates that could destabilize markets. That said, we continue to expect the market to move higher from current levels, so setbacks will be viewed as buying opportunities.

Moreover, while we believe U.S. equities have room to rise, expected returns from some non-U.S. markets are relatively higher. In Japan, for example, equities look interesting due to positive earnings revisions that are among the highest of any region. Japanese companies are cutting costs and taking advantage of a weaker yen to raise prices. In China, the picture is less clear, as the beneficial effects of the past spring's "mini-stimulus" may be wearing off. This has implications for emerging markets collectively, which have rallied roughly 10% from springtime lows. We are becoming wary of the effect that higher U.S. interest rates, falling commodity prices and a strengthening dollar will have on these markets.

In our view, the value offered by equity and debt markets will be relatively balanced at current yield and valuation levels over the coming weeks. Longer term, equities are likely to provide higher returns as the long path to economic and monetary normalization in the U.S. continues to progress.