October 14, 2016

Equities try to find their footing in a volatile week

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Article Highlights

- A late-week rally in bank stocks helps European shares gain ground and pares losses in the U.S.
- Expectations for gradually tighter monetary policy helped push Treasury yields higher.
- Labor-market data remain firm, while business and consumer optimism softens.
- In our view, equity investors would be well-served by looking overseas, given international stocks' attractive relative valuations.
- With high-yield default levels near cyclical lows, we continue to find value in better-quality high-yield bonds and leveraged loans.

Equities

Global equities ended a choppy week on an upbeat note. Mixed economic news out of China, concerns over a December Fed rate hike, and sharp swings in oil prices combined to put investors on guard. However, some better-than-expected bank earnings on both sides of the Atlantic provided a late-week boost. Overall, financial stocks have shrugged off the negative headlines surrounding several global banks, benefiting instead from rising interest rates.

In the U.S., the S&P 500 Index lost about 1.0% for the week, its second consecutive one-week decline. European equities, meanwhile, eked out a 0.1% gain (in local currency terms), after falling to a two-month low on October 13.

In Asia, China's exports fell in September by 10% from a year earlier, following a 2.8% year-over-year contraction in August. Imports also declined in September, by 1.9%. In a bit of positive news, however, stronger-than-expected inflation data eased some concerns about the health of the world's second-largest economy. For the week, Chinese equity markets rose by about 1%, while Japan's Nikkei 225 Index was down slightly.

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

Fixed income

U.S. Treasury yields continued their rise this week amid ongoing expectations for a Fed rate hike by year end. After beginning the week at 1.73%, the yield on the bellwether 10-year note edged up to 1.79% on October 13, its highest level since early June, before closing at 1.80% on October 14. (Yield and price move in opposite directions.)

Returns for non-Treasury “spread sectors” ranged from slightly negative to modestly positive for the week through October 13, with investment-grade (IG) corporate bonds leading the way. The potential for higher yields is particularly valuable to banks and financial companies, which make up a significant portion of IG issuance. That is because rising rates tend to widen the gap between what banks charge on loans and what they pay for deposits.

More signs of strength from the U.S. labor market

In a light week for U.S. data releases, the job market remained a bright spot. The week’s other economic reports included some disappointing consumer and business sentiment results.

- **First-time unemployment claims** stayed at their lowest level (+246,000) since 1973, and the less-volatile four-week moving average dropped by 3,500, to 249,250, also a 43-year low.

- **Small business sentiment** dipped for the second consecutive month in September, as measured by the NFIB Index. Optimism over better business conditions was offset by weaker inventory levels and concerns over finding skilled job applicants.

- **Consumer sentiment** unexpectedly fell to a one-year low, according to the preliminary October reading of the University of Michigan index. Most of the loss was concentrated among households with incomes below $75,000. In contrast, upper-income households’ confidence was largely unchanged from the prior month.

- **Retail sales** rebounded 0.7% in September, confirming our view that U.S. consumers remain well supported by higher wages and job gains. August’s modest decline, the first drop in five months, was revised slightly upward. Although September’s headline figure was solid, we still believe that personal consumption expenditures will decline from 4.3% in the second quarter to below 3% in the third quarter.

Outlook

Currently, we think equity investors may be better served by looking outside the U.S. International stocks are attractively valued relative to both the U.S. market and their own history. Additionally, the policy environment for equities remains friendlier overseas.

Moreover, the very low yields on developed-market bonds outside the U.S. implies that investors may want to consider allocating more of their international assets to equities rather than to fixed income. The main risk to international stocks, in our view, continues to be sluggish growth coupled with the premature removal of accommodative policy by central banks in Europe and Japan. Markets will seek clarity from the European Central Bank (ECB) at its October 20 meeting. Rumors have surfaced that the ECB might begin tapering its bond purchases before next March, when its quantitative easing program is scheduled to end.

In fixed-income markets, overseas demand for IG bonds may subside somewhat as interest rates rise in Europe. At the same time, demand for these securities may hold up better than that for U.S. Treasuries; the higher yields available on IG debt help cover the costs of hedging dollars into local currencies. Meanwhile, with default levels near cyclical lows, we continue to find value in higher-quality high-yield bonds and leveraged loans.

As for the Fed, investors will remain in suspense until December, although we still expect a 25 basis point (0.25%) increase in the benchmark fed funds rate. If such a move is followed by a series of gradual rate hikes, markets should be able to adjust accordingly, absent exogenous shocks.

The U.S. economy appears to have accelerated in the third quarter, helped by a more balanced mix of growth than the second quarter's consumption-driven pickup and steep inventory decline. We still anticipate annual growth in the 2%-2.2% range as the U.S. enters a more mature phase of the economic cycle.

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