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TIAA GLOBAL ASSET MANAGEMENT

Global equities are mixed following Fed Chair’s latest comments

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA INVESTMENTS

Article Highlights

- The Fed suggests a rate hike has become more likely in the coming months.
- The S&P 500 tracks lower for the week, while European equities advance.
- U.S. Treasury yields rise in the wake of the “Fedspeak.”
- Although Q2 GDP is revised lower, robust consumer spending is still a bright spot.
- We expect two rate hikes next year, even as the Fed’s decision to tighten in 2016 remains a close call.

Equities

With few key earnings results or economic data reports to assess during the past week, markets were laser-focused on Federal Reserve Chair Janet Yellen’s August 26 address at the Fed’s annual Jackson Hole symposium, looking for clues about the Fed’s plan for raising interest rates.

Citing solid U.S. labor market performance and consumer spending, Yellen stated that the case for raising rates “has strengthened in recent months.” This language is consistent with recent public comments of her Fed colleagues, which generally had been interpreted as signaling at least one rate hike this year. Market expectations for a 2016 Fed move have now risen to 63%, from under 10% in early July.

The S&P 500 Index rallied in the immediate wake of Yellen’s speech before retreating later in the day, adding to the week’s earlier losses. For the month to date through August 26, the index is roughly flat. This sluggish performance doesn’t surprise us. The U.S. equity market has been digesting its gains from the post-Brexit rally, which lasted from late June through the end of July, and short-term trading optimism has been edging higher. (From a contrarian viewpoint, stocks often struggle during periods of rising investor confidence.)

In Europe, investors took Yellen’s remarks as a sign of confidence. The broad STOXX 600 Index returned 1.1% for the week (in local terms), with roughly half that gain coming on August 26. European markets don’t seem as worried as they once were about the U.K.’s decision to leave the EU, in part due to evidence that the Eurozone’s recovery

remains on track. The latest example was a preliminary reading of the region's manufacturing and services sector activity, which touched a seven-month high in August.

Meanwhile, U.K. economic data has been better than expected: consumer credit and retail sales jumped in July, consumer confidence rose in August at its fastest monthly rate in more than three years, and the Citi Surprise Index for the U.K. has moved sharply higher. (This index gauges the extent to which economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises). Lastly, a weaker British pound has boosted both exports and tourism. All told, better U.K. economic activity bodes well for the rest of Europe.

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

Fixed income

U.S. Treasury yields were volatile in the wake of Yellen's speech. After beginning the week at 1.58%, the bellwether 10-year note closed at 1.62% on August 26, its highest level since Brexit.

Returns for non-Treasury "spread" sectors were modestly positive. High-yield bonds benefited from their third consecutive week of inflows and have returned 14.3% year to date through August 25.

GDP revision confirms second-quarter weakness

According to the government's second estimate, U.S. GDP grew at 1.1% annual pace in the second quarter, down slightly from the previous estimate of 1.2% and in line with most forecasts. Although consumer spending and imports were revised higher, business investment was still soft, and government outlays fell more sharply compared to the previous estimate. Shrinking inventories alone sliced 1.3% from GDP growth.

Other economic releases were mostly positive, highlighted by sturdy employment data and a welcome pickup in durable goods.

- **First-time unemployment claims** dipped by 1,000, to 261,000, and the less-volatile four-week moving average also fell, by 1,250, to 264,000.
- Orders for **durable goods** (aircraft, machinery, computer equipment, and other big-ticket items) topped forecasts by jumping 4.4% in July, their biggest gain in nine months. Orders for **core capital goods**, often viewed as a proxy for business investment, increased a solid 1.6%.
- **New home sales** surged 12.4% in July, to their highest level in almost a decade, and 31.3% compared to a year ago. **Existing home sales,** however, declined 3.2%.

- **Consumer sentiment** eased, according to the final August reading of the University of Michigan index. Concerns over personal finances were tempered by positive views of the economy.

Outlook

Although markets may now believe the odds of a Fed move this year have increased greatly, our forecast has not changed. Whether Fed officials decide to tighten in 2016 remains a close call, but we still think it's more likely they will wait until next year to pull the trigger. Along those lines, we expect two rate hikes in 2017, with the hope that the economy will have picked up enough steam by then to require multiple, sequential rate rises.

In terms of the U.S. economy, the second-quarter's GDP revisions have little impact on our outlook for the rest of the year. Annual growth should return to trend (about 2%) in the second half of the year, with a more balanced mix of growth between consumption and investment. The drag from declining inventories will likely diminish in the third quarter as producers restock.

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