Weekly Market Update

U.S. equities move higher but lag foreign markets

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

- European and Japanese equities hit multi-year highs, outpacing the S&P 500's moderate gain.
- Treasury prices fall amid stronger U.S. economic data, while high-yield bonds benefit from strong inflows.
- The Eurozone economy continues to improve, although the Greek debt saga is likely to persist.
- With the cold weather behind us, we expect a second-quarter pickup in U.S. GDP and jobs growth.
- Given single-digit earnings growth, U.S. equity valuations are stretched.

April 10, 2015

Equities

U.S. equities edged higher during the past week, supported by signs of an improving economy and mergers and acquisitions (M&A) activity. Stocks also got a lift when minutes from the Federal Reserve's March meeting, published on April 8, revealed diverging viewpoints among Fed officials over when to begin raising interest rates. Markets now believe that "liftoff" will begin in September rather than in June.

European stocks, meanwhile, surged to a 15-year high during the week, also buoyed by indications of economic improvement and optimism over M&A deals. Adding to the positive mood was relief that Greece had met a deadline to repay €460 million to the International Monetary Fund. In Japan, the Nikkei 225 Index extended its rally, and on April 9 briefly surpassed the key 20,000 level for the first time since 2000. The Nikkei's gain for the year (almost 14%) has been underpinned by increased Japanese pension portfolio allocations and, more recently, by inflows from retail investors.

Fixed income

Treasury prices dipped in response to the week's solid economic reports. The yield on the bellwether 10-year note, which started the week at 1.85%, hovered around 1.95% in afternoon trading on April 10. (Price and yield move in opposite directions.)

Financial Services

Returns for “spread products” (higher-yielding, lower-rated non-U.S. Treasury securities) were flat to slightly negative, although high-yield bonds once again bucked the trend, supported by another week of strong inflows. Year to date through April 9, U.S. high yield (+3.30%) has handily outpaced both the broad investment-grade bond market (+1.63%) and the S&P 500 (+2.14%).

Current updates are available here. For additional insights from TIAA-CREF Chief Economist Tim Hopper, view our Weekly Market Perspective Video.

U.S. economic reports begin to reflect our expectations for a better second quarter

With the weather-depressed first quarter finally behind us, it appears that U.S. economic activity is normalizing, as we expected. Among the week’s reports:

- Although **first-time unemployment claims** rose 14,000, to 281,000, one week after matching a 15-year low, the less-volatile four-week moving average dropped by 3,000, to 282,250—its lowest total in 15 years.
- Bolstered by increased business activity and employment, U.S. **service-sector growth** increased in March to 59.2, well above the 50 mark separating expansion from contraction, according to Markit’s Purchasing Managers’ Index (PMI). A similar non-manufacturing index published by the Institute for Supply Management (ISM) ticked down to 56.5 but still exceeded forecasts.
- **Mortgage applications** picked up for the third week in a row, suggesting that housing activity may be regaining some traction following the first quarter’s mixed results.

More encouraging data from the Eurozone, though risks still loom for Greece

In the Eurozone, manufacturing and service-sector activity improved in March to an 11-month high, according to Markit’s Composite PMI for the region. In addition, a closely watched index of investor sentiment published by Sentix increased for the sixth straight month in April, to its highest level in almost eight years, reflecting greater confidence amid the European Central Bank’s quantitative easing program and the weak euro. Moreover, German exports rose in February after dipping in January.

There was positive news out of Greece, too, including better-than-expected industrial production and a €460 million ($494 million) debt payment to the International Monetary Fund on April 9. The nation’s precarious financial condition persists, however. Greek bank deposits continue to shrink, and there are some large upcoming debts over the next few months that the government may not be able to repay without further assistance from its international creditors.

Outlook

For U.S. equities, higher inflation expectations and better economic news are buttressing cyclical and small-cap shares. For example, after bottoming in October

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2014 and starting slowly in 2015, the small-cap Russell 2000 Index is up 4.86% year-to-date through April 9, more than double the 2.14% return for the S&P 500 Index. However, given single-digit earnings growth, U.S. equity valuations are stretched, while investor sentiment is creeping closer to overly optimistic levels. Therefore, we would not be surprised by a correction on the S&P 500. Likewise, the run-up in European equities makes them susceptible to a pullback as well.

Regarding the U.S. economy, the Job Openings and Labor Turnover Survey ("JOLTS") was positive, suggesting that the disappointing March employment report deserves a re-evaluation. We expect an upward revision to last month's payrolls and a quick recovery in jobs growth. Additionally, while we still believe the overall economy will begin to accelerate in the second quarter, we are feeling less confident about first-quarter GDP. Although our forecast for Q1 growth remains at 1.5%, the potential for a downside surprise has increased.

Outside of the U.S., China remains a primary concern, as economic activity continues to weaken. The government has been administering targeted stimulus, and recently the central bank cut its deposit and lending interest rates by 25 basis points (0.25%) to provide support for the cooling economy. Chinese equity markets have risen in response to these moves, but caution is warranted.

Financial Services

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