Weekly Market Update

Market volatility rises as European concerns resurface

WILLIAM RIEGEL, HEAD OF EQUITY INVESTMENTS

LISA BLACK, HEAD OF GLOBAL PUBLIC FIXED-INCOME MARKETS

Article Highlights

- Investors are more risk-averse in a week of high-profile global concerns.
- Equity markets post losses, while U.S. Treasuries benefit from safe-haven status.
- Fear of a potential banking crisis in Portugal may be overstated.
- Despite softness in recent data, Europe remains on track for modest economic growth.
- We believe the Fed will not raise short-term interest rates until the fourth quarter of 2015.

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Equities

After a strong start to the third quarter during the first week of July, U.S. equities turned volatile in the past week. Ongoing turmoil in Iraq and rekindled fears of a banking crisis in the eurozone contributed to the uneasy tone. The S&P 500 Index lost 1% for the week through July 10 and was trading essentially flat on July 11. Most non-U.S. equity markets also struggled, based on MSCI indexes, with Europe down more than 3% for the week.

A renewed bout of “de-risking,” in which investors sold off higher-growth technology, biotech and small-cap shares, fueled the U.S. decline. While resembling the sharp rotations that occurred in March and April, for now the pullbacks appear to be less severe—in the 5%-6% range instead of the 25%-35% drops that some categories of stocks experienced in the spring. To some extent, the current downturn for these groups is not surprising, as they led the market’s rally in May and June and were likely overdue for a correction, along with the broader market.

Fixed income

U.S. Treasuries performed well, supported by a modest flight to safety in the face of equity weakness and continuing geopolitical worries. Increased demand drove the price of the bellwether 10-year Treasury higher, and its yield lower—from

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2.63% at the beginning of the week to 2.51% at midday on June 11. Overall, U.S. investment-grade bond sectors had a good week, but high-yield corporate bonds were on track to post modest losses given the relatively risk-averse environment. In Europe, bond performance was less favorable than in the U.S., especially among peripheral markets (such as Portugal, Greece, Italy, and Spain), where yields jumped on news of a large Portuguese bank's financial woes.

Current market updates are available here.

With little new U.S. economic data, markets focus on Portugal's banking sector

Aside from another encouraging read on first-time unemployment claims, there were no major U.S. data releases for investors to digest. Instead, markets shifted their focus to Europe, and in particular, Portugal, where the parent company of Banco Espírito Santo (BES) missed a debt payment, prompting a halt in trading of the bank's shares. Fear that this might signal wider instability in Portugal's financial sector—and a potential return of the eurozone debt crisis—drove bond yields higher across the European periphery, rattled the region's equity markets, and strengthened the dollar and yen versus the euro.

Absent evidence of strain at other financial institutions, however, we are inclined to see the event less as the start of a new "contagion" in Europe and more as the culmination of issues specific to BES. According to Portugal's central bank, BES is "ring-fenced" (i.e., insulated) from the financial problems of its parent company, although some transparency issues remain. If this were to change, we believe the European Central Bank would step in to collateralize BES rather than risk a Europe-wide crisis.

Moreover, although Portuguese and other peripheral bond yields spiked on July 10, they reversed course the next day, as investors appeared more confident that a larger systemic crisis was not at hand. The outcome for the week may have been to create buying opportunities. Greece completed a bond offering on July 10 (admittedly raising less than it might have otherwise), and eurozone banks as a group now appear very attractively valued. In addition, Portugal has sufficient national reserves to meet its current and prospective needs.

Outlook

Minutes from the Federal Reserve's June meeting demonstrate the Fed's belief that economic and labor market conditions are improving, thereby supporting the continued tapering of monthly bond purchases. The minutes also set the expectation for quantitative easing to end at the October meeting. In terms of interest-rate policy, we anticipate that the Fed will raise short-term rates in the fourth quarter of 2015.

In Europe, weaker-than-expected economic data released during the past week added to the market's apprehension over Portugal. However, these softer European releases are likely a function of the region's very mild winter, which pulled demand earlier into the calendar year. In addition, leading economic indicators suggest that Europe is on track for moderately improving growth through the remainder of this year.

With regard to equities, whether the past week's volatility is the start of a summer correction remains to be seen. For now, we do not think this is the case, as the reasons typically cited for other recent pullbacks are not especially convincing in the current market: fear of Fed tightening (June's minutes were benign); a less-robust-than-expected economy (signals have been mixed, but remain firm); and weak earnings releases (second-quarter earnings for Alcoa, whose results traditionally kick off each earnings season, were well ahead of consensus, and overall earnings revisions are trending upward). In addition, hedge funds and Wall Street strategists continue to underweight equities—contrarian signals that suggest the current rally is not yet over.

In fixed-income markets, the current volatility is not surprising given extended periods of gains. Despite the recent safe-haven appeal of U.S. Treasuries, we generally expect Treasury yields to rise through the rest of the year. In the meantime, high-yield and investment-grade categories, along with emerging-markets debt, continue to benefit from strong inflows that need to be put to work while supply is lighter during the summer months, creating a positive supply/ demand dynamic.

For an in-depth analysis of the U.S. and global market landscape, read the mid-year outlook prepared by TIAA-CREF's Chief Economist Timothy Hopper and Global Investment Strategist Daniel Morris.

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