Weekly Market Update

U.S. equities reach new highs, but jobs report fails to impress markets

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Article Highlights

- U.S. equity markets record a third consecutive week of gains.
- Despite underwhelming the markets, October's employment report is solid.
- Treasury yields are flat for much of the week but rally on below-consensus job growth.
- The European Central Bank signals greater likelihood of QE.
- We expect a slight downward revision to third-quarter U.S. GDP growth.

November 7, 2014

Equities

U.S. equity markets added to their recent gains, with key benchmark indexes reaching new record highs. The S&P 500 Index closed at 2,031 on Thursday, November 6 and finished one point higher the next day. At current levels, the S&P 500 is close to our expected highs for the year and on track to finish 2014 up more than 10%, extending the rally that began in 2011. Meanwhile, small-cap and mid-cap stocks continued to make up lost ground during the week but remained short of setting new highs.

European equities finished the week modestly lower. Markets warmed to "dovish" language from European Central Bank (ECB) President Mario Draghi, who effectively signaled that further monetary stimulus will be forthcoming (despite Germany's reluctance) if Europe's growth and inflation data falter. The welcome prospect of eventual quantitative easing (QE), however, was offset by news of escalating conflict in Ukraine and generally uninspiring economic releases.

Fixed Income

U.S. Treasuries traded within a relatively tight range for most of the week as fixed-income investors digested the latest batch of mixed economic data. The week's releases were capped by October job growth that was modestly lower than consensus forecasts. This prompted a rally in the bellwether 10-year Treasury note, which saw its yield drop from 2.39% to 2.32% on November 7. (Yields and prices move in opposite directions.)

TIAA CREF Financial Services

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Returns for most non-Treasury sectors were marginally negative for the week through November 6, based on Barclays indexes. Investment-grade corporate bonds underperformed their high-yield counterparts; although fund flows remained positive for both, high-yield bonds traded more in sympathy with rising equities. Structured products, including agency and non-agency mortgages, asset-backed securities, and commercial mortgage-backed securities, were relative outperformers thanks to significant investor demand and only modest supply.

For additional fixed-income insights from TIAA-CREF Portfolio Manager Joseph Higgins, view our Weekly Market Perspective Video.

Current updates are available here.

Despite underwhelming the markets, October's employment report is solid

Equity market reaction to October's employment release was tepid, as investors were expecting monthly payrolls to rise by more than the 214,000 reported. Nonetheless, on balance the report was a positive sign that employment conditions continue to improve. Importantly, payrolls for August and September were revised upward, to 203,000 and 256,000, respectively. History shows that the Labor Department's models can fall behind the curve during periods of changing dynamics in the labor market. Consistent upward revision of monthly job totals is a signal that the business cycle has turned and is accelerating. Year to date through October, job growth has averaged 229,000 per month, a healthy pace. We expect this trend to continue in the coming months.

While job creation is on track, wage growth remains anemic. This is a positive in the sense that it keeps a lid on inflationary pressures, but it also shows a degree of dysfunction, because tightness in the labor market is not putting upward pressure on wages as we would normally expect.

Among the week's other economic releases:

- **Weekly first-time unemployment claims** fell by 10,000, to 278,000, and the four-week moving average declined to 279,000, hitting its lowest level in 14 years.
- **Manufacturing activity** accelerated in October, with the monthly Institute for Supply Management (ISM) index rising to 59 (readings above 50 indicate expansion). The sub-indexes for new orders, employment, and imports were strong.
- **Non-manufacturing activity** also continued to expand (57.1) but at a slightly slower pace than in September, according to the ISM. The non-manufacturing employment sub-index, however, hit a nine-year high.

Data was mixed in other areas of the economy: construction spending declined modestly, the trade deficit widened, and automobile sales inched higher.

Outlook

September turned out to be a less robust month for the U.S. economy than previously thought, as some industrial weakness bled over from August. Accordingly, we expect a slight downward revision to the government's initial 3.5% estimate of third-quarter GDP growth, with stronger inventory spending offset by weaker exports. Fourth-quarter GDP, in contrast, is looking slightly better than expected, based on data received so far.

In U.S. equity markets, further gains are possible in 2015, but the advance will likely prove more difficult and far more volatile than we have seen in 2014. The market's challenges may stem from the Federal Reserve's tightening schedule and/or increases at the short end of the U.S. yield curve. The 2-year Treasury yield is currently up by more than 20 basis points (0.20%) from its mid-October low. Typically, equities begin to waver as that rate increase approaches 50 basis points.

For European equities, price-to-book and price-to-earnings (P/E) ratios—key valuation metrics—have declined almost to levels last seen during 2009 market lows. Along with tentative signs that economic conditions in Europe may be starting to improve, these valuations make the region a more attractive investment destination, in our view, than the U.S.

China remains a source of concern amid weaker-than-expected growth and the potential for a property price collapse. Moreover, there is a risk that the falling value of the Japanese yen will prompt China to devalue its own currency in an attempt to support export growth. That in turn, could export deflation to Europe (especially Germany) and the U.S.

In fixed-income markets, we expect spreads (the difference between yields on non-Treasury and Treasury securities) to narrow modestly in most sectors. For now, investors seem assured that any increases in the federal funds rate will be modest and paced far apart, as the Fed is more likely to err on the side of caution and not raise rates too quickly. We continue to look primarily to upcoming European economic releases for further direction on U.S. interest-rate sentiment.