Weekly Market Update

Global equity markets are volatile amid U.S. jobs report, ECB policy

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Article Highlights

- U.S. stocks rally in response to November's solid jobs report.
- Disappointment over ECB stimulus sends European stock and bond prices lower for the week.
- Treasury yields swing widely to finish the week slightly higher.
- November's employment numbers cement the case for a December rate hike.
- Although the Fed has emphasized a slow pace of tightening, higher inflation could force a faster rate trajectory.

December 4, 2015

While all eyes will soon turn to the Federal Reserve's December meeting for a widely expected increase in short-term interest rates, during the past week global markets focused on the Fed's Eurozone counterpart, the European Central Bank (ECB).

Stubbornly weak inflation readings bolstered expectations that the ECB would move aggressively to expand its quantitative easing program at its December 3 policy meeting in a bid to bring inflation closer to its target of just under 2%.

At that meeting, the ECB announced that it would:

- cut its deposit rate to -0.3% from -0.2%—effectively charging financial institutions even more to leave money with the ECB;
- reinvest bond proceed as they mature, which will ultimately provide additional stimulus; and
- extend its €60 billion (about $65 billion) per month bond-buying program for another six months, until March 2017 "or beyond."

Equities

Despite the ECB's healthy dose of stimulus, global equity markets had hoped for greater monthly bond purchases and deeper rate cuts. In the U.S., the S&P 500 Index fell almost 2% for the week through December 3 but erased those losses on

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December 4 following the release of a solid November jobs report to post a small gain for the full week.

In Europe, the STOXX 600 Index declined 3.1% on December 3 alone and 3.4% for the week. (Both figures are in local currency terms.) The euro strengthened against the dollar in the wake of the ECB's announcement, improving the return to about -0.7% in USD terms.

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

Fixed income

European bondholders were likewise disappointed with the ECB. Yields on long-dated Eurozone bonds surged, as investors sold off their holdings. (Price and yield move in opposite direction.) For example, yields on 10-year German, Spanish, and Italian government debt all rose more than 20 basis points (0.20%) for the week.

The rise in European rates lifted longer-dated U.S. Treasury yields. Amid tight liquidity, the yield on the bellwether 10-year note, which began the week at 2.22%, spiked 15 basis points (0.15%), to 2.33%, on December 3, before closing at 2.27% on December 4.

Returns for U.S. spread sectors (higher-yielding, non-Treasury securities), were broadly negative, although high-yield corporate bonds bucked that negative trend with a modest gain.

November's jobs report keeps the Fed on track for a December rate hike

The U.S. economy generated 211,000 jobs in November, while the unemployment rate held at a seven-year low of 5.0%, as more people returned to the labor force. Importantly, employment gains for September and October were revised upward by a combined 35,000, and the labor participation rate ticked higher. Average hourly wages rose 0.2% in November and 2.3% versus a year ago.

Other U.S. economic releases were mixed to negative. Among the reports:

- **First-time unemployment claims** increased by 9,000, but remained near a 15-year low. The less-volatile four-week moving average, however, edged down to 269,250.
- Following two months of declines, **pending home sales** rose 0.2% in October but fell short of forecasts.
- **Manufacturing activity** unexpectedly contracted in November, measured by the Institute for Supply Management's (ISM) index, which dropped to 48.6, a 6½-year low. (Readings below 50 indicate contraction.) A similar manufacturing indicator from Markit also downshifted, to 52.8.
- **Service-sector activity** slowed in November, according to the ISM non-manufacturing index, but remained firmly in expansion territory (+55.9). Markit's non-manufacturing index, meanwhile, increased to 56.1.

- The **U.S. trade deficit** climbed 3.4% ($1.4 billion) in October from September's upwardly revised figure, as exports fell to their lowest level in three years. A strong dollar and weak global growth contributed to the soft trade picture.

Outlook

In our view, it's possible that ECB officials did not act more aggressively because they believe the Fed, by raising rates later this month, will do some of the "heavy lifting." A stronger dollar—which should accompany higher rates at home—mirrored by a weaker euro, will boost Eurozone inflation and exports.

Even as the November jobs report helps pave the way for a Fed tightening, the key for markets remains the pace and scope of subsequent rate hikes, which the Fed has indicated will be data dependent. Subpar U.S. manufacturing releases, along with consumers' tendency to save rather than spend thus far in this cycle, both support the case for a gradual rise in rates. On the other hand, average hourly earnings are rising, and a further pick-up in wages would put upward pressure on inflation, perhaps prompting the Fed to accelerate tightening faster than it might care to. This is the greatest risk we see in the coming year.

For equity markets, sharply higher wages could also pressure corporate profit margins and earnings, and thus stock prices. Under that scenario, we would expect the S&P 500 to deliver low single-digit returns in 2016. A more bullish case for equities could develop if the dollar were to weaken as the Fed tightens monetary policy, a phenomenon that historically has occurred about half the time. A softer dollar makes U.S. exports more competitive overseas and could boost corporate earnings.

In fixed-income markets, we believe bond yields in Europe may move back lower despite the past week's spike given further targeted ECB purchases and reinvestment. This should help create demand for U.S. debt and, short of an inflation surprise, put a lid on higher Treasury yields. Year-to-date outflows have hurt both high-yield and investment-grade corporate bonds, and we expect these outflows to continue into 2016 as rates rise—likely producing lower returns or even modest losses. Given low expectations for defaults, we believe higher-quality high-yield bonds offer good value, while investment-grade debt is only fairly valued.