Weekly Market Update

Global equities brace for heightened volatility following Fed rate hike

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Article Highlights

- As expected, the Fed raises interest rates for the first time in nearly a decade.
- U.S. stocks give back gains following Fed "relief rally," while European shares recover from a two-month low.
- Treasuries take news of the decision in stride, but high-yield bonds continue to struggle.
- Housing and jobs data stand out in a week of mixed economic data.
- The pace and scope of future rate hikes will be highly dependent on the path of actual inflation.
- Both fixed-income and equity markets have the potential to perform well as interest rates rise, but not without periods of volatility.

December 18, 2015

The past week was dominated by the Federal Reserve's December 16 decision to raise the target federal funds rate—the rate banks charge each other for overnight loans—by 25 basis points (+0.25%), from a range of 0% to 0.25% to 0.25% to 0.50%. More perspective on the Fed's decision—including our Weekly Market Perspective Video featuring TIAA-CREF Portfolio Manager Joseph Higgins—along with additional insights related to interest rates and the implications for investors, are available here.

Current updates are available here.

Equities

U.S. equities endured a volatile week—a scenario we will likely revisit over the next year as markets cope with the normalization of interest rates. The S&P 500 Index rose sharply for the week through December 16, but then retreated as the price of oil tumbled to a seven-year low. For the full week, the index lost 0.3%.

Europe's STOXX 600 Index also saw wide price swings but gained 1.5% for the week (in local currency terms). Meanwhile, the economic picture in Europe

continues to brighten, with domestic demand set to accelerate, as providing additional security and refugee support will require increased fiscal spending.

Emerging markets as a whole returned 2.2% for the week according to the MSCI Index, bolstered by much-better-than-forecasted economic releases. An exception to the positive data surprises was China, where economic reports showed some slippage. While this may lead to more stimulus by the Chinese central bank and provide a short-term fix, additional intervention could stunt the government's longer-term reform program, raising the risk of potential recession.

Fixed income

With the Fed's move a foregone conclusion, fixed-income markets had largely priced in rate "liftoff." The yield on the bellwether 10-year U.S. Treasury rose to 2.30% on the day of the Fed's announcement before closing at 2.21% on December 18. (Yield and price are inversely related.)

Returns for non-Treasury "spread sectors" were broadly negative. High-yield bonds continued to struggle, with total returns now down 5.5% for the year to date through December 18. This sharp decline was not unexpected, given that commodity and energy producers comprise about 20% of the high-yield market. If prices for oil and other core raw materials stabilize, the high-yield market would likely regain its footing. That said, a further drop in energy prices could spark concerns over rising defaults in the high-yield space, driving prices even lower.

Markets largely ignore a full slate of economic data

With investors focused on the Fed's decision, the past week's mixed economic data did little to sway markets, although both the housing and labor markets remained sources of strength. Among the positive reports:

- **First-time unemployment claims** dropped by 11,000, to 271,000, one week after touching a five-month high. The less-volatile four-week moving average, considered a more accurate predictor of labor-market direction, ticked down by 250 to 270,750.
- The index of **leading indicators** published by The Conference Board topped forecasts with a 0.4% increase in November, helped by a jump in building permits and rising stock prices.
- **Housing starts** rose 10.5% in November, while **building permits**, a forward-looking indicator, leaped 11% to an annualized rate of 1.29 million, the highest level since June.
- **U.S. consumer prices** were flat in November, but "core" inflation, which strips out volatile food and energy costs, rose 0.2% for the third straight month and 2% over the past 12 months—the first time that has happened since May 2014.

Among the weaker releases:

- **U.S. manufacturing** slowed in December to 51.3**, t**he lowest reading in more than three years and just above the 50 mark separating expansion from contraction, according to the "flash" (preliminary) Purchasing Managers' Index (PMI) published by Markit. Low oil prices and a strong dollar remain major headwinds for the manufacturing sector.
- **Regional manufacturing indexes were mixed,** as the Philly Fed unexpectedly fell sharply in December, while the Empire State Index improved slightly.
- **Homebuilder confidence** slipped slightly in December according to the NAHB, but builders remained optimistic about the housing market.

Outlook

With the Fed's first rate hike in the books, the emphasis now shifts to the path of tightening. At her press conference following the Fed's two-day meeting, Chair Janet Yellen assured markets that the timing and magnitude of future increases are likely to be gradual. Whether the Fed will be able to deliver on its generally dovish rhetoric remains to be seen, as economic conditions—especially the pace of inflation—will drive the schedule of upcoming rate hikes. Inflation has underperformed the Fed's target for the last several years.

For now, the Fed's projected pace of increases, or "dot plot," shows four rate hikes of 25 basis points each next year, with the median federal funds rate edging up to 1.375% by the end of 2016. This projection was a bit more hawkish than markets were expecting but continued to represent very accommodative monetary policy. Our own forecast calls for three rate hikes in 2016 as inflation approaches 1.5%, still below the Fed's 2% target. Even so, we remain wary of the possibility that the economy will heat up faster than anticipated, which would require the Fed to accelerate its tightening timetable.

For equity investors, past tightening cycles have been a toss-up. While anticipating outcomes is always difficult—-and this economic recovery has been highly unpredictable—inflation has been the key variable. When inflation has been high (above 4%), stocks have tended to deliver negative returns in the year following the first rate hike. However, when inflation is under control, as it is today, positive returns are possible.

Meanwhile, we believe fixed-income price performance will remain choppy even as the economy continues to improve, given the likelihood that higher-yielding debt will have to compete for inflows amid a higher "risk-free" (Treasury) rate. Currently, bonds appear fairly valued, having priced in liquidity risk and interest-rate risk, among others, but we may see only modest spread tightening.

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