Weekly Market Update

Strong U.S. jobs report offers little relief from pain of China turbulence

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Article Highlights

- Global equities tumble amid Chinese currency and stock market turmoil, exacerbated by new tensions in geopolitical hot spots.
- Reduced risk appetite benefits Treasuries and hurts high-yield bonds.
- December's employment numbers cap off a solid year for U.S. hiring.
- Dollar strength and low oil prices have remained a headwind for U.S. manufacturing.
- We expect ongoing rough patches in China but do not believe a deeper crisis is likely.

January 8, 2016

For most of the past week, investors were laser-focused on China. A steep drop in the value of China's currency, the yuan, evoked memories of last summer's global market selloff, sparked when Beijing announced it would allow its tightly managed currency to trade within a wider band versus the dollar.

In an encore of that performance, global equity markets sold off this past week, interpreting the yuan's weakness as fresh evidence of a worsening slowdown in the world's second-largest economy—with potentially negative consequences for global growth. Recent reports showing disappointing Chinese manufacturing and service-sector data reinforced the market's view of the country's economic weakness. In addition to China, geopolitical fears added to investor unease during the week.

Equities

After plunging for the first four days of the week, Chinese equities rallied on January 8, as China's central bank stepped in to strengthen the currency.

In the U.S., the S&P 500 Index dropped almost 6% for the week—its worst opening five-day stretch ever—as better-than-expected U.S. jobs numbers and a stabilization of Chinese markets failed to provide a lift.

Financial Services

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European stocks suffered their worst week since August 2011, falling 6.7% in local currency terms. Eurozone economic news of late has been good: the region's manufacturing and service-sector activity expanded in December at their fastest pace in more than four years, unemployment fell to its lowest level since October 2011, and business confidence is on the upswing. At the same time, inflation remains stubbornly low.

Current updates to the week's market results are available here. Read TIAA-CREF Asset Management's 2016 economic and investment outlook, "Modest global growth and market returns," here.

Fixed income

U.S. Treasuries rallied in the week's risk-off environment, with the yield on the bellwether 10-year note closing at 2.12% on January 8 after beginning the week at 2.27%. (Yield and price are inversely related.)

Despite net outflows across many fixed-income categories, returns for non-Treasury "spread sectors" were broadly positive, led by investment-grade corporate bonds and commercial mortgage-backed securities. High-yield corporate bonds continued to struggle. Among emerging-market debt returns, commodity-related names suffered significantly.

December's jobs report far exceeds consensus forecasts

The U.S. labor market ended 2015 on a high note, generating 292,000 jobs in December. The unemployment rate remained at 5%, largely because nearly 500,000 people joined the work force. Moreover, payrolls for October and November were revised up by a combined 50,000. For 2015 as a whole, job growth averaged 221,000 per month, compared to an average of 260,000 per month in 2014. Disappointingly, average hourly wages remained largely unchanged.

Other U.S. economic releases were mixed:

- **First-time unemployment claims** dropped by 10,000, to 277,000. For all of 2015, new claims averaged about 278,000 a week, a 42-year low. The less-volatile four-week moving average, considered a more accurate predictor of labor-market direction, dipped by 1,250, to 275,750.

- **Manufacturing activity** contracted for the second straight month in December, as measured by the ISM Purchasing Managers' Index (PMI), which fell to 48.2. (Readings below 50 indicate contraction.) Dollar strength and weak oil prices have remained major headwinds for the manufacturing sector. A similar manufacturing indicator from Markit also declined for December but remained in expansion territory.

- **Service-sector activity** dipped to 55.3, according to the non-manufacturing index published by the Institute for Supply Management.

- The **U.S. trade deficit** sank 5% in November, to $42.4 billion, down from $44.6 billion in October. Although exports fell to their lowest level since early 2012, imports dropped even faster.

Outlook

In light of the past week's volatility, we are keeping a close eye on key support targets. We could see the S&P 500 drop toward 1,900 or even 1,850, although we do not anticipate an extended downturn given how deeply oversold the market now appears, coupled with our still relatively positive view on U.S. growth potential. Overall, stocks in the index are trading about 4% below their 20-day moving average, a level that historically has triggered subsequent rebounds. Furthermore, only 20% of stocks are trading at or above their 50-day moving average, another potential technical positive. Meanwhile, market sentiment is at extremely negative levels, a contrarian indicator often associated with an upturn.

While we remain cautiously optimistic about equity markets, several macroeconomic and geopolitical issues could develop into crises: North Korea's nuclear ambitions, tensions in the Middle East, Russia's involvement in Eastern Europe, or another terrorist attack. Any of these could trigger short-term market declines, further damage sentiment, and feed back into economic weakness. Despite the potential for these external shocks to occur, on balance we believe the current market sell-off is temporary.

Longer-term concerns include the possibility that the U.S. may grow even faster than now expected. This could lead to more aggressive tightening by the Fed—a potentially unfavorable head wind for stocks. (At the same time, continued sluggish wage growth could dampen inflation, allowing for a slower pace and scope of rate rises.) While we believe China is stabilizing, a collapse in real estate prices, were it to occur, would severely disrupt Chinese consumer spending, further pressuring U.S. and European exports. In our view, these longer-term risks are real, but not currently in scope. Lastly, the Chinese government's opaque communications, which can exacerbate market swings, are another concern.

In U.S. bond markets, credit spreads are at their widest levels in years, indicating that a significant amount of risk has already been priced in. We would note, however, that risk indicators are not pointing to panic over economic growth, which makes spread products increasingly attractive at this time.

Financial Services

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