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TIAA GLOBAL ASSET MANAGEMENT

Sluggish global growth and a disappointing jobs report weigh on equity markets

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Article Highlights

- U.S. and European stocks both fall for the second straight week.
- A more cautious tone in fixed-income markets benefits U.S. Treasuries and hurts high-yield bonds.
- April's employment numbers disappoint, but rising wages are a bright spot.
- Despite the lackluster jobs report, we still expect one, and possibly two, Fed rate hikes this year.
- The current rough patch for U.S. stocks is not surprising, and we still expect the S&P 500 to reach new highs by year-end, while potentially lagging European stocks.
- In the near-to-medium term, the bond market is likely to be driven by technical factors rather than by fundamentals, which remain sound.

Equities

Equity markets declined this past week amid underwhelming corporate earnings reports and renewed concerns over slowing global growth. With the Federal Reserve set to meet next month, investors anxiously awaited the release of April's payrolls report on May 6. Markets initially reacted poorly to the report before turning positive later in the day. For the full week, the S&P 500 Index lost about 0.4%, its second straight weekly decline.

In Europe, stocks extended the previous week's losses by logging their worst one-week return since mid-February, with the broad STOXX 600 Index sliding 2.9% in local currency terms. After a string of largely encouraging data releases, economic news turned mostly downbeat: the European Commission reduced its inflation and growth forecasts for the Eurozone, and the region's retail sales fell sharply in March. On the positive side, Eurozone producer prices rose in March, the first month-to-month increase in a year.

Current updates to the week's market results are available here.

Fixed income

U.S. Treasuries rallied this past week, as falling equities and a slight drop in oil prices contributed to a more cautious tone in fixed-income markets. The yield on the bellwether 10-year U.S. Treasury, which began the week at 1.83%, fell steadily to 1.76% on May 5 and finished the week at 1.78%, as the jobs report had little effect on sentiment. (Yield and price move in opposite directions.)

Returns for non-Treasury “spread sectors” were broadly positive, with fund flows supporting investment-grade corporate bonds. In contrast, negative fund flows took a heavy toll on high-yield corporate bonds.

April’s jobs report disappoints, but wages perk up

The U.S. labor market generated a below-consensus 160,000 jobs in April. We were not surprised by this soft number, given the recent batch of slow economic readings. In addition, employment gains for February and March were reduced by a combined 19,000, lowering the first-quarter’s average job growth to 200,000. Although the jobless rate remained at 5%, the labor force participation rate fell for the first time in seven months, to 62.8%. Encouragingly, wages rose 0.3% in April and 2.5% compared to a year ago.

Among the week’s other reports:

- **First-time unemployment claims** climbed by 16,000, to 274,000, while the less-volatile four-week moving average edged up by only 2,000, to 258,000.

- The **trade deficit** shrank in March, to $40.4 billion, down from $47 billion in February. Although exports fell 0.9%, imports dropped an even steeper 3.6%, to a five-year low.

- **Manufacturing activity** slipped to 50.8 in April, according to the index published by the Institute for Supply Management (ISM), but remained above the 50 mark separating expansion from expansion for the second straight month.

- **Service-sector activity** grew at its fastest pace this year, with ISM’s nonmanufacturing index hitting 55.7 in April.

Outlook

Overall, we expect the pace of U.S. employment growth to decelerate this year. However, we have long held that slower job growth alone does not signify that the labor market is deteriorating. Other measures, such as the average work week (which increased modestly in April), productivity, and wages are equally, if not more important, gauges of the labor market's health, with wages especially important. If we see a significant rise in wages this year, it will likely translate to increased consumption, greater demand, and faster economic growth. It will take a string of monthly employment reports to assess where wages are really heading.

In terms of future rate hikes, we think it is doubtful the Fed will change course based solely on April's employment numbers. Therefore, we still expect one rate hike of 25 basis points (0.25%) this year, most likely in June, with any second hike contingent on further wage data.

For the broad U.S. economy, annual growth is roughly in the 1.75%-2.25% range, probably closer to the bottom edge of that range. Markets have been focusing on weak data that poses a risk of derailing the economy, but in our view, the U.S. remains on a slow, steady growth track.

Regarding U.S. equities, the recent rough patch is not surprising, and further downward pressure is possible. The likely longer-term trend, though, remains up; we continue to believe the S&P 500 can surpass its previous high of 2,134 by year-end. Supporting our cautiously optimistic view are improving leading economic indicators and high-yield bond spreads that have narrowed relative to their January and February levels—usually a good sign for both the economy and stocks.

Europe may be an even more attractive equity investment destination than the U.S. Although corporate earnings releases have been unimpressive, we are encouraged by Europe's forward-looking economic readings and by a long-awaited resurgence in France's economy, the Eurozone's second-largest. Moreover, Eurozone profit margins remain below their historical average, offering significant upside potential.

Meanwhile, China remains our chief concern. The Chinese economy, while improving, has not meaningfully responded to the government's stimulus. We are keeping an especially close eye on the direction of China's currency. Another round of yuan depreciation could lead to market turmoil, as was the case last summer and earlier this year. Recently, though, the dollar's weakness has lessened the pressure for Beijing to devalue further.

In the near-to-medium term, U.S. fixed-income markets are likely to be driven by technical factors, rather than by fundamentals, which remain sound. Default rates outside of energy-related high-yield debt issuers have stayed low, and harmful mergers & acquisition (M&A) activity has been subdued. We are adopting a more cautious stance on spread-sector assets, although investment-grade corporate bonds could continue to benefit from indirect demand stimulated by the European Central Bank's corporate bond purchases. If and when we see sustained growth in wages and/or business investment, which has yet to appear during this economic recovery, bond prices could drop significantly, akin to the "taper tantrum" of 2013.