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Stocks overcome Fed rate fears to finish up for the week

TIAA GLOBAL ASSET MANAGEMENT

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Article Highlights

- A late-week rally helps U.S. and European stocks recover after a June Fed rate hike appears more likely.
- The potential for a Fed move hurts fixed-income returns.
- U.S. economic data is broadly positive, providing further evidence of a stronger Q2.
- Although Fed-induced volatility is likely to persist, we continue to expect stocks to reach new highs, led by value shares and small caps.
- As interest rates eventually rise, diversifying across a wide range of sectors will be key to dampening volatility in fixed-income portfolios.

Equities

It was a challenging week for U.S. equities. While higher oil prices provided some support for stocks, increased fears of a rate hike by the Federal Reserve at its June 14-15 meeting sent equities lower, as markets had generally written off the possibility of such a near-term move. Speculation over a sooner-than-expected rate hike was fueled by a series of positive economic data releases, minutes from the Fed's April meeting (released May 18) indicating that the Fed was open to raising interest rates this summer, and hawkish rhetoric from several Fed officials. Worries over the Fed eased as the week drew to a close, sending stocks higher.

The S&P 500 Index snapped its two-week losing streak with a modest gain. Overseas, Europe's broad STOXX 600 Index did marginally better, rising 1% in local currency terms. Chinese equity markets fell about 1.5% amid another batch of mixed economic reports, including higher home prices in April and missed expectations for industrial output and retail sales.

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

Fixed income

Bonds underperformed equities for the week, although fixed-income investors did not have as visceral a reaction to this round of Fed communications as they did during the 2013 “taper tantrum” (when then-Fed Chairman Ben Bernanke implied that the Fed would soon begin to taper the Fed’s quantitative easing bond purchases). This is primarily because markets have become acclimated to the Fed’s sensitivity to global conditions, and the Fed has voiced increased awareness of how its actions can affect businesses and consumers worldwide.

Against this backdrop, the bellwether 10-year U.S. Treasury note jumped 16 basis points (0.16%), to 1.87%, by midweek and traded around that level for the rest of the week. (Yield and price move in opposite directions.)

Returns for non-Treasury “spread sectors” were negative for the week through May 19. Investment-grade corporate bonds (-0.83%) lagged, while high-yield corporates (-0.08%) were relative outperformers.

Broadly positive economic data offers further evidence of a stronger second quarter

On the heels of the prior week’s strong wage and retail sales gains, the latest batch of data releases offered additional signs of economic vigor. Among the week’s reports:

- After rising for three straight weeks to reach a 14-month high, **first-time unemployment claims** fell by 16,000, to 278,000, while the less-volatile four-week moving average increased, by 7,500, to 275,750.

- **Consumer prices** jumped 0.4% in April, their biggest one-month advance since February 2013, mostly because of higher oil costs. Over the past 12 months, however, prices have risen just 1.1%. Stripping out volatile food and energy costs, so-called “core inflation” increased 0.2% in April and 2.1% compared to a year ago—just above the Fed’s 2% target and a level associated with a steadily expanding economy.

- **Home-builder sentiment** held steady in May for the fourth consecutive month, based on the NAHB/Wells Fargo Index. Overall, builders continue to believe that robust job creation, low mortgage rates, and pent-up demand will spur growth in the housing market.

- **Housing starts** topped forecasts by climbing 6.6% in April, following March’s steep drop. Building permits, a forward-looking indicator, also rebounded in April.

- **Existing-home sales** rose a better-than-expected 1.7% in April, and March's figures were revised up slightly.

- Following an essentially flat first quarter, The Conference Board's index of **leading economic indicators** picked up sharply (+0.6%) in April, suggesting that the U.S. economy will maintain its moderate growth trend this year.

- **Regional manufacturing** unexpectedly slipped in April, according to the Empire State and Philly Fed indexes. In contrast, **industrial production** grew at its fastest one-month rate (+0.7%) in 17 months.

Outlook

Although periods leading up to a Fed rate hike are often volatile for equities, actual Fed tightening historically has not sparked market downturns. This is because the conditions that prompt the Fed to raise rates typically favor stronger earnings growth, a positive for stocks.

Along those lines, we still expect the S&P 500 Index to breach its previous high of 2,131 on its way to and perhaps through 2,250 over the next 12-18 months. Value and small-cap stocks, which have led the market higher since it bottomed in February, should continue to outperform, underpinned by a brightening economic picture.

Negative investor sentiment, a contrarian indicator that often presages a market advance, supports our cautiously optimistic outlook, as do market valuations. While stocks are not cheap on an absolute basis, they are attractively valued compared to bonds and, in our view, will remain that way as long as the 10-year note trades at 3% or below. Meanwhile, Europe continues to be our favored equity investment destination, as shares there are more attractively valued than in the U.S.

Our chief concern remains China. In addition to its mixed economic data, the possibility that Beijing is considering another round of currency depreciation to boost exports is not out of the question. Such a move roiled global equity markets last summer and again early this year. In the short term, the yuan's decline versus the dollar may simply be a result of the dollar's strengthening amid the Fed's rate-rise chatter.

In fixed-income markets, we believe some of the riskier asset classes (e.g., lower-rated high-yield bonds and local-currency emerging-markets debt) could experience greater spread widening than investment-grade corporate bonds, which may be better positioned to outperform during the period of slow, steady rate hikes that we expect will unfold. As rates do gradually rise, diversifying across a wide range of sectors will be key to dampening volatility in fixed-income portfolios.

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