June 3, 2016

TIAA GLOBAL ASSET MANAGEMENT

May's poor jobs report takes a toll on equity markets

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA PUBLIC INVESTMENTS

Article Highlights

- The S&P 500 slips from a seven-month high, while European stocks end a three-week winning streak.
- Treasuries rally in the face of the disappointing employment data.
- Most of the week's other releases are favorable, suggesting an expanding U.S. economy.
- Although markets may have written off a June Fed rate hike, we believe such a move is still in play.
- We still expect the S&P 500 to reach new highs this year, but a correction would not surprise us.
- Fixed-income markets will likely be volatile as the "Brexit" vote approaches and investors weigh data releases.

Equities

Investors remained cautious during the past week. With Federal Reserve Chair Janet Yellen's recent statement that a rate hike would be "appropriate" in coming months if the economy continued to improve, markets hoped May's jobs data would provide some clarity about the Fed's next move.

Instead, the disappointing employment report muddied the waters, sending markets lower following its release on June 3. The S&P 500 Index retreated from a seven-month high to finish about flat for the week. European stocks broke a three-week winning streak by declining 2.4% in local currency terms. On a positive note, the European Central Bank upgraded its growth and inflation forecasts for 2016, while still warning of downside risks related to the global economy and the "Brexit" vote on June 23.

In Asia, Chinese equities surged 4.2% for the week, with most of the gain coming early in the week amid expectations that the global index provider MSCI might include China's domestic shares in its indexes. Broad emerging-markets (EM) equities also rallied despite a weakening yuan. We take this EM performance as a positive sign, because Beijing's sharp currency devaluations last summer and again early this year destabilized global equity markets.

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

Fixed income

U.S. Treasuries rallied during the week. The yield on the bellwether 10-year note, which began the week at 1.85%, moved lower in the wake of May's surprisingly meager jobs number to end the week at 1.70%. (Yield and price move in opposite directions.)

Returns for most non-Treasury "spread sectors" were mildly positive. Investment-grade corporate bonds performed well, bringing their year-to-date gain through June 2 to 5.5%, while their high-yield counterparts continued to benefit from inflows and stabilizing oil prices.

Despite May's poor employment showing, the economy is growing at a steady pace

The U.S. labor market generated a far-below-consensus 38,000 jobs in May, the smallest one-month increase since the fall of 2010. In addition, employment gains for April and March were reduced by a combined 59,000. The unemployment rate unexpectedly fell to 4.7%, a drop almost entirely due to 664,000 people leaving the work force. This drove down the participation rate from 62.8% to 62.6%. Disappointingly, wages rose only 0.2% in May and 2.5% compared to a year ago.

Other economic releases, especially in consumer spending and income, were mostly upbeat. Among the week's reports:

- **Consumer spending** topped expectations by leaping 1% in April, its biggest one-month gain in nearly seven years; **personal income** also picked up (+0.4%) in April.

- **Housing prices** maintained their solid gains, with the S&P/Case-Shiller 20-City Composite Index rising 0.9% in March and 5.4% versus a year ago.

- **Manufacturing activity** exceeded forecasts by increasing in May to 51.3, according to the index published by the Institute for Supply Management (ISM). (Readings above 50 indicate expansion.) Manufacturing has now expanded for three straight months. **Factory orders** rose 1.9% in April, their second strong month in a row.

- **Service-sector activity** eased in May to 52.9, its slowest pace in more than two years, as reported by the ISM.

- **First-time unemployment claims** dipped by 1,000, to 267,000, a five-week low, and the less-volatile four-week moving average also fell, by 1,750, to 267,750.

- **Inflation,** as measured by the Fed's preferred inflation barometer (the PCE index), rose 0.3% in April and 1.1% over the past 12 months. The "core" PCE index, which excludes food and energy costs, increased 0.2% in April and 1.6% compared to a year ago.

- The **Citi Economic Surprise Index** has moved higher since late April. This index gauges the extent to which economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises.

- **Consumer confidence** declined in May, according to The Conference Board index, as consumers remained cautious about the outlook for business and labor market conditions.

Outlook

Although job creation in May was weak, a strike by Verizon workers likely reduced the overall tally by about 35,000. Moreover, payroll data can be highly volatile. Therefore, we believe May's total will be revised higher. At the same time, the economy's job engine has begun to slow, as we had anticipated: on average, only 116,000 jobs per month have been created over the past three months.

The lack of significant wage growth is a bigger concern. With other wage measures beginning to improve, we would have expected more progress on this front. Wage pressure is important for continued growth in the overall economy. For example, the surge in personal consumption, which feeds directly into GDP, was fueled by the boost in wages during the first quarter.

Given May's employment miss, markets are now writing off a June Fed rate hike, but we believe a move is still very much in play. Fed officials have made it clear that they want to raise rates, and they believe the economy is reasonably healthy. Moreover, economic growth has not changed materially since December. In our view, only January's market volatility and fears of a China-induced global slowdown prevented the Fed from raising rates earlier this year. Since then, markets have settled down, employment growth has slowed—a trend the Fed believes is necessary—while wages have grown (at least through the first quarter). Against this backdrop, June may be a suitable time for the Fed to resume tightening.

In terms of U.S. equities, we still expect the S&P 500 to reach and exceed its previous highs, although a correction would not surprise us. Meanwhile, fixed-income investors are likely to face heightened volatility in the coming weeks as the “Brexit” vote approaches and economic data provides clues to the economy’s strength.

TIAA Global Asset Management provides investment advice and portfolio management services through TIAA and over a dozen affiliated registered investment advisers.
Foreign stock market returns are stated in U.S. dollars unless noted otherwise.
Please note that equity and fixed income investing involve risk.
© 2016 Teachers Insurance and Annuity Association of America-College Retirement Equities Fund, 730 Third Avenue, New York, NY 10017
C31887