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TIAA GLOBAL ASSET MANAGEMENT

The S&P 500 pauses after nearing an all-time high

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Article Highlights

- U.S. and European stocks post modest gains after the prior week's strong rally.
- Interest rates continue to climb, weighing on both Treasury and non-Treasury fixed-income assets.
- Upbeat retail sales, labor market, and housing data highlight a solid week for the U.S. economy.
- We believe the economy is reaccelerating following a period of below-trend growth.
- While a pickup in bond-market volatility may create buying opportunities, negative fund flows are likely to cause headwinds.

Equities

The past week was highlighted by the dollar's late-week surge to a 13-year high against a basket of currencies and markets pricing in a near-certain December Fed rate hike. Despite these headwinds, on November 17, the S&P 500 Index came within three points of August's record-high close. The index slipped the next day, trimming its gain for the week to about 0.9% on the heels of a 3.9% advance the week before. Equities got a boost from rising oil prices and some encouraging U.S. economic data.

The dollar's rise has been fueled by a number of factors, including expectations that a Trump administration's plan for aggressive fiscal stimulus will lead to faster economic growth and higher inflation. This, in turn, may prompt the Fed to raise interest rates at a brisker pace than previously anticipated.

In overseas equity markets, Europe's broad STOXX 600 Index rose 0.6% (in local terms) for the week, after posting its best one-week performance in four months. Buoyed by a weakening yen, Japan's Nikkei 225 Index entered bull market territory on November 18, having risen 20% from its recent low in June.

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

Fixed income

Global bond markets continue to be driven by heightened inflation expectations. The yield on the bellwether 10-year U.S. Treasury, which moves in the opposite direction of its price, climbed to 2.34% on November 18, its highest level in more than a year, after beginning the week at 2.15%. In anticipation of Fed tightening, the 2-year note, which is highly sensitive to the outlook for Fed policy, closed the week at 1.07%, its highest mark since last December. Yields on European sovereign bonds, including German, Italian, and Spanish debt, also moved higher.

Negative fund flows, along with rising interest rates, took a toll on non-Treasury “spread sectors.” For the week through November 17, losses ranged from -0.20% for high-yield corporate bonds to -0.81% for their investment-grade counterparts. Emerging-market debt remains the hardest hit fixed-income asset class post-election, although performance stabilized during the week.

A strong week of U.S. economic data

This past week’s data releases featured additional signs of labor-market vigor, forecast-topping retail sales, and a multi-year best in the housing market.

- **First-time unemployment claims,** the first economic release to reflect post-election data, plunged by 19,000, to a 43-year low of 235,000. While one week does not make a trend, similar reports would reflect more robust job demand. The less-volatile four-week average also fell sharply, by 6,500, to 253, 500.

- **Retail sales** jumped 0.8% in October after September’s revised 1% gain, the best two-month stretch since 2014. However, we don’t expect such strength to continue through year-end, as data suggests that seasonal hiring may drop amid expectations for slower sales by some retailers.

- Following a sharp drop in September, **housing starts** surged 25.5% in October to their best level in nine years. It is possible, however, that this impressive one-month advance—the biggest since July 1982—was driven by mild weather. This allowed more homes than usual to be completed, and thus more new construction to begin, leading to a surge in starts. October’s modest (+0.3%) uptick in **building permits**, a forward-looking indicator, supports our view. Meanwhile, **home builder confidence** held firm in November.

- **The Consumer Price Index** rose 0.4% in October, its fastest pace in six months, and 1.6% compared to a year ago, its biggest increase in two years. Excluding food and energy costs, so-called “core” inflation edged up 0.1% in October but a healthy 2.1% over the past 12 months.

- **Regional manufacturing gauges** were mixed in October. While the Empire State index rebounded following three months of contraction, the Philly Fed index eased slightly but remained in expansion mode. **Industrial production**, a

measure of output from U.S. factories, power plants, and mines, was unchanged in October.

- The Conference Board's index of **leading economic indicators** rose slightly in October for the second consecutive month, suggesting that the economy will continue expanding into early 2017.

Outlook

The past week's mostly upbeat data seemed to feed into the positive mood in equity markets since the election, as well as the likelihood of a Fed rate hike next month. (Indeed, market odds for Fed action in December exceed 90%.)

We believe the economy is merely reaccelerating toward 2% growth—the average annual GDP gain during this recovery. This return to trend follows a slowdown that lasted from the fourth quarter of last year through this summer, when GDP plodded along at a 1% clip. Some strong September data suggests that the government's estimate of third-quarter GDP will be revised upward, from the original reading of 2.9% to around 3.1%.

Over the next few months, we expect a pickup in bond-market volatility as investors assess the potential outcomes of the new administration's policies. Such periods of wide price swings may offer the opportunity to buy bonds at prices that are lower than today's. However, fixed-income outflows may serve as a headwind, pressuring credit spreads.

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