

Global equities brace for heightened volatility following Fed rate hike

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Article Highlights

- As expected, the Fed raises interest rates for the first time in a year.
- U.S. stocks finish roughly flat for the week, while European shares reach a 2016 high.
- The 10-year Treasury yield rises for the sixth consecutive week.
- Homebuilders' and small-business owners' sentiment improves, although retail sales disappoint.
- Diversification among asset classes and sectors should help mitigate the impact that higher interest rates can have on investor portfolios.

The past week was dominated by the Federal Reserve's December 14 decision to raise the target federal funds rate—the rate banks charge each other for overnight loans—by 25 basis points (+0.25%), from a range of 0.25%-0.50% to 0.50%-0.75%. More perspective on the Fed's decision, along with additional insights related to interest rates and investment implications, is available for [institutional investors](#) and [retail investors/participants](#).

Equities

U.S. equities endured a volatile week—a scenario we will likely revisit over the next year as markets cope with the normalization of interest rates. The S&P 500 Index notched yet another record high on December 13 on the back of rising oil prices, as non-OPEC producers agreed to output cuts. The index then retreated to finish the full week roughly flat.

Europe's broad STOXX 600 Index gained 1.3% (in local currency terms) for the week en route to establishing a 2016 high. Shares were supported by a slide in the euro against the dollar to a 14-year low. (A declining currency makes exports more competitive in overseas markets.) Likewise, a weaker yen helped Japan's exporter-heavy Nikkei 225 Index reach its best close since last December.

Current updates to the week's market results are available [here](#).

Fixed income

Fixed-income markets continued to assess the reflationary aspects of the new administration's proposed policies and the Fed's acknowledgment that market-based measures of inflation expectations had increased materially since its September meeting. After heading lower through mid-week, the 10-year U.S. Treasury yield began to rise on December 14 before closing at 2.60% on December 16, a more than two-year high. (Yield and price move in opposite directions.) This marked the sixth consecutive week in which the 10-year yield has risen. The 2-year note, which is highly sensitive to changes in Fed policy, finished the week at 1.25%, its highest level since June 2009.

Rising rates took a toll on non-Treasury "spread sectors," whose returns were negative for the week through December 15.

More evidence of rising confidence emerges

The past week's economic data included consensus-topping outlooks from homebuilders and small business owners. These reports follow recent signs of encouraging consumer optimism. In contrast, retail sales disappointed.

Among the week's releases:

- **Homebuilder confidence** soared to an 11-year high in November, according to the NAHB index, while **housing starts** tumbled to an 11-year low. October's starts, however, were revised to their highest rate in more than nine years. Building permits, a forward-looking indicator, dropped 4.7% in November.
- Expectations of higher sales and better business conditions pushed the NFIB **small business sentiment** index to a two-year high.
- **Retail sales** advanced just 0.1% in November, their smallest gain in three months, but were up a healthy 3.8% compared to last year.
- The **Consumer Price Index** increased 0.2% in November and 1.7% compared to a year ago. Excluding food and energy costs, so-called "core" inflation rose 0.2% in November and 2.1% versus last year.
- In another sign of the improving manufacturing sector, **the Philly Fed** and **Empire State indexes** both jumped in December. Firms surveyed expressed optimism about plans for capital spending and employment, along with business conditions overall.
- **First-time unemployment claims** fell by 4,000, to 254,000, while the usually less-volatile four-week average rose by 5,250, to 257,750.

Outlook

At her press conference following the Fed's December 13-14 meeting, Chair Janet Yellen assured markets that the Fed will continue its "gradual" approach to raising rates. Moreover, as we had forecast, the Fed also signaled a slight acceleration in its pace of tightening, with a "dot plot" of expected future increases now showing three hikes in 2017, up from two previously. On balance, the Fed indicated that monetary policy will remain "accommodative."

Markets, however, interpreted the Fed's language and dot plot as more hawkish than anticipated. Whether the Fed will be able to assuage the markets' concerns remains to be seen, as economic conditions will drive the schedule of upcoming rate hikes. With labor markets strengthening and signs of wage growth emerging, the Fed's twin goals of full employment and stable inflation appear close to being realized.

While rising rates are a positive indicator of the economy's health, elevated stock market volatility is common around monetary policy changes, though history suggests that equities can weather a full interest-rate cycle well. Fixed-income investors will likely have to endure near-term pain as interest rates continue to rise. Nevertheless, the long-term case for holding bonds remains strong. Overall, diversification among asset classes and sectors should help mitigate the impact that higher interest rates can have on investor portfolios.

A complete outlook on financial markets and the global economy in 2017 from TIAA Chief Economist Tim Hopper and TIAA Investments Chief Investment Strategist Brian Nick is available [here](#).



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