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Global equities meet the new year, same as the old year

Brian Nick, Chief Investment Strategist, TIAA Investments

Article Highlights

- Positive manufacturing data helps U.S. and European equities rally to start the year.
- Markets take December's below-forecast jobs report in stride.
- We believe the S&P 500 will return around 10% in 2018.
- The "risk-on" mood hurts Treasuries, helps high-yield bonds.
- We will be monitoring a number of factors to determine the 10-year Treasury yield's direction.

Quotes of the week:

"To business that we love we rise betime,
And go to't with delight."
– Marc Antony ("Antony & Cleopatra")

Lead Story: A "ho-hum" employment report to close 2017

The labor market showed more strength than expected throughout 2017, but December was a minor exception. Payroll growth of 148,000 (versus expectations for 193,000) was underwhelming but by no means disastrous. A similar monthly pace in 2018 would be enough to push the unemployment rate, which stayed at 4.1% in December, below 4%. This payroll "miss" was apparently due to an overestimation of the number of retail jobs added during the holiday season, a symptom of online shopping's continuing erosion of traffic at brick-and-mortar stores. During the fourth quarter, the U.S. economy created 612,000 jobs, bringing the total for 2017 as a whole to 2.1 million—a solid sum but the lowest since 2010. Disappointingly, wages grew a respectable 0.3% in December but just 2.5% over the past 12 months.

In a sign that investors are taking this jobs data in stride, market-implied odds of a Fed rate hike in March remained at 79%, the same level where they were on January 4, the day before the report's release. Amazingly, the odds were a mere 10% only four months ago.

After finishing 2017 at 2.40%, the 10-year Treasury yield closed the first week of the new year at 2.47%, a rise that reflected less demand for low-risk assets as the equity bull market continued. (Yield and price move in opposite directions.) In determining the 10-year's future path, we will monitor a number of factors. These include demand for U.S. assets, the likelihood of higher domestic inflation, and movement in the labor-force participation rate (LFPR), which could heavily

influence the magnitude of wage gains. A higher LFPR should reduce wage pressure, enabling the Fed to raise rates more slowly. This, in turn, could extend the economy's late-stage momentum. Should the LFPR not increase, though, stronger wage growth may soon follow. That might encourage the Fed to tighten more aggressively over time, possibly triggering an economic slowdown.

Returns for non-Treasury sectors were largely negative for the week through January 4. High-yield bonds rallied, however, benefiting from the "risk-on" mood and oil's rise above $60/barrel for the first time in 2½ years.

In other news: No holiday hangover for global equities

2017 was quite a year for U.S. equity investors. Amid serene, almost bond-like volatility, the S&P 500 Index notched 62 record-high closes en route to a 21.83% gain. The index capped the year with a healthy 6.64% fourth-quarter return, as investors' focus on corporate tax cuts fueled optimism about 2018 earnings.

That optimism has spilled over into January's first four trading days. Driven by last year's top-performing sector, Technology, the S&P 500 rose more than 2.5% for the week shortened by the New Year's holiday.

What can we expect over the remaining 250 or so trading days? We believe the new 21% corporate tax rate (down from 35%) will boost 2018 corporate profits by an average of 5%-7% beyond what they would have been otherwise. We therefore expect S&P 500 earnings per share to rise by a total of 17% in 2018.

In terms of valuations, stock prices have largely incorporated the tax cuts' expected benefits, but analysts have been slow to adjust their earnings forecasts higher. Consequently, at a current multiple of 18.5x forward earnings, the S&P 500 may appear to have richened significantly since November. Once earnings are revised up, however, this valuation should fall, to around 17.6x.

The bottom line: We believe the S&P 500 will end the year at around 2,900, with a total return just shy of 10%. The bull market, which began in March 2009, lives on.

European equities also started the year strongly. Buoyed by further signs of the Eurozone's recovery, the STOXX 600 Index jumped 2.24% and 2.10% in U.S. dollar and local currency terms, respectively.

Below the fold: Global manufacturing heats up in December

Although December's jobs report made major headlines, **U.S. business activity** also garnered plenty of attention during the week. The ISM manufacturing index topped forecasts by jumping to 59.1, substantially above the 50 mark separating expansion from contraction. For the full year, the index posted a robust monthly average of 57.6, as companies amped up investment and benefited from synchronized global growth. In a familiar refrain among employers across industries, 65% of ISM survey respondents reported difficulty finding qualified candidates, with nearly half increasing starting pay to attract workers.

Eurozone manufacturing also surged, with Markit's gauge of the region's activity reaching 60.6 in December—its best level since the survey began in mid-1997.Leading indicators bode well for the manufacturing sector: new orders increased dramatically, purchasing growth hit a new peak as firms readied themselves for higher production, and job creation hovered near November's record-setting pace.

Back Page: The S&P 500 Index looked "Sharpe" in 2017

A combination of strong returns with low volatility was a defining characteristic of the S&P 500 in 2017. Indeed, its Sharpe ratio, a widely used measure of risk-adjusted performance devised by Nobel Laureate William F. Sharpe in 1966, reached its second-highest level ever last year, at 4.82. (The higher the ratio, the more attractive the risk-adjusted return.) In stark contrast, the S&P 500's average Sharpe ratio over the past 40 years was only 0.81.

The unusually high Sharpe ratio for 2017 indicates that equity investors enjoyed a remarkably stress-free rally last year. In fact, there were just eight days in which the S&P 500 rose or fell by 1% or more in a single trading session. On a daily basis, the index rose or fell by 50 basis points (0.50%) or less 80% of the time. Moreover, it provided a positive return in every month of the year for the first time ever, without a single correction of 5% or more.

Because volatility is notoriously challenging to forecast, it's hard to predict how the S&P 500's Sharpe ratio will fare this year. Even if it turns out to be a little less "sharp" than it was in 2017, we expect risk-adjusted returns will be anything but dull in 2018.

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