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TIAA

It takes more than the threat of a government shutdown to derail the S&P 500

Brian Nick, Chief Investment Strategist, TIAA Investments

Article Highlights

- U.S. and European equities continue their “January jump.”
- Amid expectations for higher inflation, the 10-year Treasury breaches 2.60%.
- Upbeat news for U.S. manufacturing counters lower homebuilder and consumer optimism.
- Ongoing euro strength may slow the ECB’s plans to dial back stimulus later this year.
- The market’s skepticism about Fed hikes is likely based on lingering doubts about its forecasts for growth and inflation.
- While we don’t believe a government shutdown would affect U.S. stocks, it could present minor economic challenges.

Quotes of the week:

“Now everything's a little upside down
As a matter of fact, the wheels have stopped.
What's good is bad, what's bad is good
You'll find out when you reach the top.”
-Bob Dylan, “Idiot Wind”

Lead Story: The ECB says, “Enough already!”

The euro’s ascent to a three-year high ($1.226) on January 15 marked the latest leg of an unwelcome trend for the European Central Bank (ECB). While the stronger currency reflects optimism in the Eurozone’s recovery, it also hampers the region’s exporters by making their goods less competitive in overseas markets. Complicating matters further is the ECB’s desire to begin winding down its quantitative easing program later this year. However, the euro’s rise threatens to pin inflation, currently around 1%, below the ECB’s ~2% target. It’s unlikely the ECB will begin to tighten policy with inflation at such a low level.

What can the ECB do to stem the common currency’s increase? For starters, it can jawbone. Indeed, during the week ECB official Ewald Nowotny said the euro’s recent strength against the U.S. dollar “is not helpful.” Adding to the dovish rhetoric, Vitor Constancio, the ECB’s second in command (behind President Mario Draghi), opined that sudden movements in the exchange rate “don’t reflect changes in fundamentals.”

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There are other factors at play that could soften the euro, making life easier for the ECB. In the near term, political jockeying in the U.S., such as that seen amid the past week's threat of a government shutdown, could boost the dollar versus the common currency, as investors seek cover in perceived safe-haven assets. Over the long term, Federal Reserve rate hikes also tend to be dollar positive.

While the ECB may be fretting the euro's move, dollar-based investors certainly are not. Europe's broad STOXX 600 Index rose 0.52% in local terms for the week but a far better 1.33% in U.S. dollars, the STOXX 600's fifth consecutive week of 1%+ returns in dollar terms. For the year to date, the index has advanced 2.92% and 4.71% in local and dollar terms, respectively.

Meanwhile, strong fourth-quarter earnings reports helped the S&P 500 Index (+0.9%) climb for the third week in a row and eight week out of the last nine.

In other news: Why not trust the Fed?

As of January 19, the market has priced in about 2½ Fed rate hikes this year, while the Fed anticipates three. In 2019, traders expect just one hike, compared to 2-3 for the Fed. While we're somewhat puzzled by this discrepancy, we think it's because traders are not quite as optimistic as the Fed regarding U.S. economic growth and inflation.

In our view, inflation should begin to accelerate, driven by a number of factors: a tightening labor market, with first-time jobless claims hitting a 45-year low; fiscal stimulus through tax cuts; and reduced slack in the U.S. economy, as reflected by December's pickup in capacity utilization. (Capacity utilization finished the year by rising a better-than-expected 77.9%. While this is still below pre-recession levels, a move above 80% could signal rising production costs and prices are on the way.)

Treasuries seem to be coming around to our somewhat higher inflation outlook. On January 18, the yield on the bellwether 10-year note broke through 2.60% for the first time since last March before closing the Martin Luther King Jr. holiday-shortened week at 2.66%.

Below the fold: Upbeat news for U.S. manufacturing counters lower homebuilder and consumer optimism.

Difficulty finding skilled labor and the rising costs of materials weighed on the NAHB/Wells Fargo **homebuilders sentiment** index, which dipped in January but remains at a strong level. Builders remain confident that tax reform will help the housing sector and the broader economy.

Consumers weren't quite as chipper. Despite brisk economic growth, a steadily rising stock market, and expectations for individual tax cuts, **consumer sentiment** fell in January, according to the preliminary reading of the University of Michigan index. We'll see if slightly heftier paychecks later in the first quarter help turn consumers' assessments around.

In the meantime, there was good news for U.S. manufacturing. After contracting in November, **industrial output**—a measure of output at factories, mines and utilities—roared back in December,

capping its best year since 2010. The cold weather that swept across most of the country raised demand for home heating fuel, while higher oil prices lifted crude production.

Back Page: Equity markets may ignore a government shutdown

Since 1976, the U.S. government has shut down 18 times. The last one occurred in October 2013, when U.S. stocks fell a cumulative 4% before fully recovering within 10 days of hitting their trough. As shutdowns go, that one stirred up considerable volatility: on average, government closures have lasted seven days, during which time U.S. equity markets have fallen a mere 0.6%, on average.

As of late Friday afternoon, no agreement had been reached on Capitol Hill to continue funding the government beyond midnight on January 19. Given the market's extraordinary ability to shrug off natural disasters, geopolitical concerns, and terrorist attacks, perhaps it comes as no surprise that U.S. stocks have continued to rally. Overall, we don't expect this round of political brinksmanship to affect equities significantly.

The economic impact may be more discernable, however. Because a government shutdown would withhold paychecks from hundreds of thousands of government employees, a furlough would slow consumption temporarily. For every week the government's doors remain closed, GDP growth could shrink by 0.1%-0.2%, losses that would largely be made back when "non-essential" workers return to work.

This impact, while small, would add to relatively minor economic challenges percolating in the first quarter—the largest of which is the increase in commodity prices, which has led to higher gasoline and home heating costs. Nonetheless, we believe these headwinds will be superseded by tailwinds created by tax cuts and ad hoc corporate bonuses, triggering an uptick in consumption in the first half of this year.

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