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TIAA GLOBAL ASSET MANAGEMENT

September's modest jobs gains and Brexit concerns weigh on global markets

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Article Highlights

- U.S. and European equities stumble to begin the fourth quarter.
- High-yield bonds are the star performers in an otherwise down week for fixed-income markets.
- September's jobs report, while below expectations, is probably strong enough to keep the Fed on track for a December rate hike.
- Other U.S. data releases are positive, led by gains in both the manufacturing and service sectors.
- With Eurozone inflation unlikely to reach the ECB's target by early next year, we believe QE will continue through September 2017 or longer.

Equities

Global equities struggled to gain traction during the past week as they looked ahead to the October 7 release of the September U.S. jobs report. A rally in oil prices and some encouraging U.S. economic data provided a boost for stocks. However, concerns over Brexit and rumors that the European Central Bank (ECB) might announce intentions to scale back its bond purchases before next March, when its quantitative easing (QE) program is scheduled to end, sent both U.S. and international shares lower. The moderately disappointing employment data failed to generate the hoped-for bounce. The S&P 500 Index began the fourth quarter by losing about 0.6% for the week.

In Europe, U.K. Prime Minister Teresa May announced that she would invoke Article 50 of the Lisbon Treaty in March, setting the stage for the U.K. to leave the European Union (EU) two years from that date. (An extension beyond two years is possible but would require the unanimous consent of the EU's 27 other members.) May also indicated that she would seek a clean break (or "hard" Brexit), with few concessions on trade and migration. At the same time, European leaders began to prepare for a tough round of Brexit negotiations. This uncertainty sent the British pound tumbling over 4% and weighed on Europe's broad STOXX 600 Index, which fell 1.0% for the week (in local terms).

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

Fixed income

The multi-week selloff in U.S. Treasuries continued apace, fueled by the prospect of reduced QE by the ECB, some strong U.S. economic releases, and growing expectations that the Fed will take action in December. With sentiment shifting away from Treasuries, the yield on the bellwether 10-year note rose steadily, from 1.60% to start the week to 1.73% on October 7. (Yield and price move in opposite directions.) Although yields remain lower in Europe, they rose in tandem with those in the U.S. For example, the German 10-year *bund* closed at 0.02% on October 7, up 14 basis points from -0.12% a week ago.

Despite positive inflows, returns for non-Treasury "spread sectors" were broadly negative for the week through October 6. High-yield bonds, however, bucked that trend with the help of a 3.2% rally in crude oil prices, bringing their year-to-date gain to 15.6%.

September's moderate jobs report is balanced by better manufacturing and service-sector data

The U.S. economy added 156,000 jobs in September, fewer than forecast but likely enough to keep the Fed on track to raise interest rates in December. For the third quarter as a whole, job gains have averaged a healthy 192,000 per month. The unemployment rate rose from 4.9% to 5.0% last month, but for a positive reason: 400,000 people entered the work force. As a result, the labor-force participation rate ticked up to 62.9%. While the measure has risen over the past year, it remains near a 40-year low. Payrolls for July and August were revised downward by a combined 7,000. Average hourly wages increased 0.2% in August and 2.6% over the past 12 months.

Despite the modest jobs growth, the U.S. economy is improving as we expected, with data on both manufacturing and service-sector business activity outstripping forecasts. In fact, this week's releases have begun to reflect our position that the economy's pause in August was mostly driven by seasonal weakness in data measurement rather than lackluster underlying demand.

Among the week's other reports:

- **First-time unemployment claims** fell by 5,000, to 249,000, and the less-volatile four-week moving average dropped by 2,500, to 253, 500.
- After contracting in August, **manufacturing activity** grew in September, with the Institute for Supply Management (ISM) index rising to 51.5, above the 50 mark separating expansion from contraction. In another sign that the manufacturing sector may be gaining some traction, **factory orders** increased in August.
- **Service-sector activity** also jumped in September, with ISM's non-manufacturing index reaching 57.1, an 11-month high.

- The **trade deficit** widened 3% in August, to $40.7 billion, as imports climbed to their highest level in 11 months, outpacing exports, which grew to their highest level since last July.

Outlook

In our view, the weakening British pound reflects a new period of Brexit-related uncertainty. Although it's impossible to predict how negotiations between the U.K and the rest of the EU will proceed next year, they will likely be accompanied by heightened market volatility in the region. Despite the past week's speculation that the ECB may trim its QE bond purchases in March, we expect the ECB to extend its QE program until at least September 2017. This is because Eurozone inflation is not likely to approach the central bank's target of just under 2% by early next year.

Meanwhile, the Fed has positioned itself to raise interest rates in December. Barring a major economic or financial market shock, we believe a rate hike of 25 basis points (0.25%) is in store. The U.S. economy remains on a 2% growth path, a trajectory we don't expect to change in coming quarters.

In fixed-income markets, a rising-rate environment should allow investment-grade (IG) corporate bonds to outpace both their below-investment-grade counterparts and emerging-market debt, as credit spreads compress further in the IG space. Shorter-dated asset-backed securities and leveraged loans may also be poised to outperform. Bonds overall remain highly susceptible to continued communications from the ECB and the Fed, as both dovish and hawkish central bank guidance can have an outsized impact on market interest rates.