January 6, 2017

U.S. equities begin the year with a record high

WILLIAM RIEGEL, CHIEF INVESTMENT OFFICER, TIAA INVESTMENTS

Article Highlights

- Solid economic data, including December's job report, propels the S&P 500. Stocks in Europe and Asia also advance.
- U.S. Treasuries continue to rally, while robust demand and low supply boost non-Treasury fixed-income assets.
- As we expected, a scarcity of labor supply has translated into a slower pace of job creation, putting upward pressure on wages.
- In fixed-income markets, floating-rate loans look particularly attractive. In contrast, we believe high-yield and investment-grade corporate bonds are fully valued.
- Positive equity fund flows point to investor confidence that the S&P 500 will break its streak of three consecutive losing Januaries.

Equity

U.S. equities concluded 2016 without the benefit of a "Santa Rally"—a rise in stock prices often observed in the week between Christmas and New Year's Day. However, fueled by strong economic data, the S&P 500 rallied to kick off 2017. In a holiday-shortened week, the index reached an all-time high, finishing the week with a gain of about 1.8%.

Across the Atlantic, bullish data reports for December helped the broad STOXX 600 Index advance 1.1% (in local terms) for the week and move into bull-market territory, having surged more than 20% from its February low. The Eurozone's manufacturing and service sectors grew at their fastest pace since 2011, with the currency bloc's three largest economies—Germany, France, and Spain—all showing improved business growth. Moreover, rising oil prices pushed the region's consumer prices up a healthy 1.1% compared to a year ago, the fastest rate in more than three years.

Asian markets joined in the rally. Encouraging manufacturing data boosted Chinese stocks, even as the government imposed new restrictions designed to contain capital outflows amid a weakening currency. Expectations for a soft yen helped Japan's Nikkei 225 Index gain 1.8% (in local terms) for the week, notching a 13-month high along the way.

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

Fixed income

The equity market's firm tone carried over to a wide range of non-Treasury fixed-income "spread sectors." Positive fund flows, low supply, and robust data releases supported emerging-market bonds, floating-rate loans, and both high-yield and investment-grade corporate bonds. A continuing turnaround in Treasury yields also helped performance. Since closing at a more than two-year high of 2.60% on December 16, the yield on the bellwether 10-year U.S. Treasury fell for the third consecutive week. It closed at 2.42% on January 6. (Yield and price move in opposite directions.)

As we had anticipated, U.S. hiring continues to slow while wages accelerate

The U.S. labor market added 156,000 jobs in December, a solid showing. Payrolls for October and November were revised up by a combined 19,000. At 4.7%, the unemployment rate remained near a nine-year low. The labor force participation rate (62.7%) changed little in December and was flat for the year as a whole. Most encouragingly, average hourly wages jumped 0.4% in December and 2.9% in 2016—the fastest annual increase in seven years.

We've been expecting labor markets to tighten, leading to rising wages and decelerating job growth as employers struggle to find workers to fill positions. Indeed, employment gains this year have averaged 183,000 per month versus 225,000 per month in 2015. In our view, both of these trends will continue this year. Higher wages are a key to lifting the current low rate of inflation to a healthier level and likely led to slightly better personal consumption in the fourth quarter.

Among the week's other reports:

- **Manufacturing activity** picked up additional steam in December, improving for the fourth consecutive month to a two-year high. The index published by the Institute for Supply Management (ISM) jumped to 54.7, as new orders and production surged. (Readings above 50 indicate expansion.)

- **Service-sector activity** also grew in December. The ISM's non-manufacturing index held steady at November's 57.2 level—its best showing since October 2015.

- **Auto sales** capped their strongest year ever with a 3% rise in December.

- **First-time unemployment claims** plunged by 28,000, to 235,000, while the usually less-volatile four-week average fell by 5,750, to 256,750. The sharp drop in claims, however, may have been exaggerated by the Christmas and New Year's holidays, as some people may have delayed filing because of the short weeks.

- The **trade deficit** climbed 6.8% in November, to $45.2 billion. Imports, led by oil, reached their highest level since August 2015, while exports slipped.

Outlook

Although January historically has been a positive month for the S&P 500, the last three have produced sizeable losses, including last year's 5.0% drop amid fears of a slowdown in China's economy. Whether the index will buck that trend this year, of course, remains to be seen. Investors seem to think it will; inflows into U.S. equity funds (mainly ETFs) have totaled about $55 billion since the U.S. election.

What makes the start to the year particularly intriguing is that more companies tend to "preannounce" earnings in January than in any other month. (Preannouncements are communications issued by companies that let investors know when profits or revenues are going to be significantly better, or worse, than analysts expect.) In order to support future equity markets gains, those companies offering negative preannouncements in January will need to provide more-positive forward guidance for 2017 and beyond. However, uncertainty over President-elect Trump's economic policies, among other factors, may make issuing such guidance difficult.

In fixed-income markets, we believe floating-rate loans are particularly attractive. First, their variable coupon offers protection in a rising rate environment. Additionally, among high-yield securities, they tend to be higher-quality. Lastly, a surge in defaults is unlikely given the anticipated unveiling of fiscal stimulus under the Trump administration. In contrast, investment-grade corporate bonds and their high-yield counterparts both look fully valued.

Looking ahead, we expect bond-market volatility to increase as the year progresses, creating potential buying opportunities for active management. Shifting foreign demand for U.S. Treasuries and investment-grade bonds is a potential source of this instability and will be monitored closely. With this in mind, we remain underweight mortgage-backed securities, which tend to underperform when fixed-income markets turn volatile—even though we believe home prices will rise moderately during the year.

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