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TIAA GLOBAL ASSET MANAGEMENT

Central bank inactivity sends global equities lower

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Article Highlights

- The ECB makes no changes to its asset purchase program or main interest rates.
- Stocks in Europe and the S&P 500 both decline for the week.
- Global government bond yields rise in the wake of the ECB's decision.
- In a light week for U.S. data releases, the service-sector disappoints while the labor market shines.
- Among fixed-income sectors, investment-grade and emerging-market bonds offer attractive valuations.

Equities

With the Federal Reserve and Bank of Japan scheduled to convene later this month, and with few U.S. economic data releases to digest, markets focused on the September 8 meeting of the European Central Bank (ECB).

Those hoping for the ECB to take action were disappointed. Despite stubbornly low Eurozone inflation, the central bank opted against raising its monthly asset purchase target of €80 billion or extending the program's duration beyond its current March 2017 end date. Moreover, the ECB left its key interest rates unchanged. The decision to stand pat weighed on Europe's broad STOXX 600 Index, which lost 1.4% for the week (in local currency terms).

In the U.S., the S&P 500 Index shrugged off some sluggish economic data early in the week to climb within four points of its all-time high before following European stocks lower. The index slumped 2.5% on September 9, its first loss of greater than 1% since Brexit in late June, and about 2.4% for the week. Talk of tightening by a voting Fed official, along with falling oil prices, added to the selling pressure. With the U.S. economy slowing at the margin, the equity market looking stretched, and short-term investor optimism reaching bullish levels, the S&P 500 may slip further in the near term.

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

Fixed income

Markets perceived the ECB's meeting as hawkish. This view helped push the yield on the 10-year German government bond, which has been suppressed by the ECB's bond purchases, into positive territory for the first time since mid-July. Equivalent maturity Italian and Spanish sovereign debt, whose yields have been similarly restrained, also saw their yields rise. (Yield and price move in opposite directions.)

Meanwhile, U.S. Treasury markets took their cue from Europe. The yield on the bellwether 10-year note rose from 1.61% on September 8 to 1.67% the next day, leading to a steeper yield curve. (Yield and price move in the opposite direction.)

Returns for non-Treasury "spread" sectors were mixed for the holiday-shortened week through September 8. High-yield bonds led the way, bringing their year-to-date return to 14.8% based on the Barclays index.

A light week for U.S. data releases

There were few major U.S. economic reports during the week, but two of the more closely watched indicators were mixed:

- **First-time unemployment claims** fell by 4,000, to 259,000, a two-month low, while the less-volatile four-week moving average also declined, by 1,750, to 261,250. In addition, job openings surged to a record high in July.

- **Service-sector activity** grew at its slowest pace in more than six years, as the non-manufacturing index published by the Institute for Supply Management (ISM) fell to 51.4 in August. (Readings below 50 indicate contraction.)

Outlook

While we were disappointed by August's weak service-sector report, we expect a modest September rebound. August data releases typically have been both underwhelming and unreliable. In terms of U.S. GDP, we are still forecasting annual growth of about 2% in the second half of the year.

Despite the rise in the 10-year Treasury yield, we don't expect a sustained increase to 2% by year-end given sluggish global growth and low levels of inflation around most of the world. We do, however, believe fixed-income trading activity will snap out of its summer lull. The fall season, especially during an election year, has historically been volatile.

In terms of fixed-income security selection, some of the riskiest debt, including lower-quality high-yield corporate bonds, have outperformed strongly since Brexit and appear richly valued. In contrast, investment-grade corporate bonds offer relatively attractive valuations. Their supply, though, is likely to approach record-high levels this month and next, temporarily pressuring spreads. We are also mindful of the increasing use of

leverage in the corporate bond space. This could lead to credit downgrades if the U.S. economy contracts, a scenario we don't currently anticipate. Emerging-market debt remains attractive as well despite its robust performance so far this year. This asset class, which is sensitive to dollar strengthening, should benefit from gradual, as opposed to more abrupt, Fed tightening.

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