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TIAA GLOBAL ASSET MANAGEMENT

Global equities struggle to gain traction

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Article Highlights

- The S&P 500 gives back some of November's solid gains, while European equities end a three-week winning streak.
- Treasury yields are volatile in a challenging week for fixed income.
- We believe the U.S. economy will decelerate in 4Q after heating up in 3Q.
- Although job creation was solid, November's employment report reveals some weaknesses behind the headline numbers.
- In fixed-income markets, we currently favor select floating-rate loans and emerging-market debt opportunities.

Equities

All eyes will soon turn to the Federal Reserve's December meeting for a widely expected increase in short-term interest rates. During the past week, however, surging oil prices commanded attention following a November 30 agreement by the world's largest oil producers to reduce output in a bid to reduce global oversupply. In response, oil prices rose more than 11% for the week (to about $51 barrel). Also in the spotlight were several key U.S. data reports, including the December 2 release of November's U.S. nonfarm payrolls report.

In the U.S., the S&P 500 Index fell about 1% for the week after notching a fresh record high on November 25. Thanks to a post-election rally in which it gained 2.6% through the end of November, the S&P 500 returned 3.7% for the month as a whole.

Europe's broad STOXX 600 Index also lost ground in the past week (0.9% in local terms), ending a three-week winning streak. Investors remained cautious ahead of Austria's presidential election and Italy's constitutional referendum, both scheduled for December 4. In the Eurozone, economic releases for November were encouraging: unemployment dipped below 10% for the first time since 2009; economic confidence improved to an 11-month high; and the manufacturing sector expanded at its fastest rate in almost three years, supported by a weaker currency and improving demand.

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

Fixed income

Strong U.S. economic data and inflation concerns put upward pressure on U.S. Treasury yields for most of the week. After beginning at 2.36%, the yield on the bellwether 10-year U.S. note rose to 2.45% on December 1, its highest level since June 2015. (Yield and price move in opposite directions.) The 10-year yield dropped on December 2, however, amid concerns that populist outcomes in Italy and Austria could destabilize Europe.

Returns for non-Treasury “spread sectors” were mostly negative. High-yield corporate bonds bucked that trend, supported by higher oil prices.

A mixed jobs report concludes a mostly solid week for U.S. data releases

The U.S. economy added 178,000 jobs in November, close to most forecasts. In 2016, employment gains have averaged 180,000 per month, down from 228,000 last year. This drop is in line with our projections of slowing job growth as the economy approaches full employment. Average hourly wages improved 2.5% over the past year, evidence that demand for labor is stable to rising.

But there were some soft spots in the report. For example, the average workweek did not change, and average hourly wages in November fell 0.1%. Moreover, while the unemployment rate hit a nine-year low of 4.6%, that drop was mostly due to some 400,000 unemployed people leaving the workforce.

Among the week’s other releases:

- According to the government’s second estimate, **U.S. GDP** grew at a better-than-expected 3.2% annual rate in the third quarter—its strongest showing in more than two years—up from last month’s initial estimate of 2.9%. The improvement was driven primarily by an upward revision to consumer spending.

- After declining modestly in October, The Conference Board’s index of **consumer confidence** rebounded in November, reaching its highest level since 2007. A more favorable assessment of current conditions, coupled with a more optimistic short-term outlook, helped boost confidence.

- **Home prices** rose 0.1% in September and 5.1% compared to a year ago, according to the S&P/Case-Shiller 20-City Composite Index, while **pending home sales** increased 0.1% in October.

- **Consumer spending** grew 0.3% in October but failed to keep up with September’s 0.7% upwardly revised gain. Meanwhile, **personal income** improved 0.6% in October, the fastest rate of growth since April.

- **Manufacturing activity** climbed to 53.9 in October, equaling a five-month high, according to the index published by the Institute for Supply Management (ISM). (Readings above 50 signify expansion.)
- **Inflation**, as measured by the Fed's preferred inflation barometer (the PCE Index), rose 0.2% in October and 1.4% over the past 12 months, the biggest gain in two years. The "core" PCE Index, which strips out food and energy costs, increased 0.1% in October and 1.7% on a year-over-year basis for the third consecutive month.
- **First-time unemployment claims** jumped by 18,000, to 268,000, but remained near multi-decade lows. The less-volatile four-week average edged up by 500, to 251,500.

Outlook

While third-quarter GDP growth was encouraging, we expect the U.S. economy to slow in the fourth quarter, to around 2%-2.5%. This drop does not signal a weakening economy but rather a return to the long-term growth trend of this recovery. Mixed data for October and November so far supports our view.

Following the post-election rally, we believe the S&P 500 has now reached a level at which a sharp correction is possible. First, market odds for a December Fed rate hike are at or near 100%. Additionally, fueled by rising inflation expectations, Treasury yields may well rise further, making stocks relatively less attractive compared to bonds. Lastly, investor sentiment has reached very bullish levels, a contrarian indicator that has often presaged an equity pullback. Despite these headwinds, we have maintained our S&P 500 target of 2,400 by the end of 2017, led by small caps, financials, and cyclical stocks.

In fixed-income markets, we think higher-quality floating-rate loans offer value given their reduced interest-rate sensitivity in what will likely be a rising-rate environment. We also favor select emerging-market (EM) debt opportunities, as many of these bonds have struggled since the election amid higher rates and a stronger dollar. In our view, much of the risk to this asset class has been priced in, and many EM countries could benefit from improved U.S. growth. Higher-grade, shorter-dated asset-backed securities should also perform relatively well. We expect volatility to persist in 2017, offering opportunities for active managers to buy bonds at attractive prices.

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