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TIAA GLOBAL ASSET MANAGEMENT

July's upbeat jobs report sends U.S. equities to a new record high

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Article Highlights

- A late-week rally erases an earlier loss for the S&P 500 but falls short in Europe.
- U.S. Treasury yields rise on July's consensus-topping jobs data.
- Although wages have increased this year, we're not convinced the trend will strengthen.
- The U.S. economy continues to move in a positive, albeit moderate, direction.
- Despite recent solid payrolls growth, a September Fed rate hike remains unlikely.

Equities

With the second-quarter's corporate earnings season almost complete, markets turned their attention to the August 5 release of July's nonfarm payrolls report. They found further evidence of the U.S. labor market's health reinforcing June's strong employment numbers, which helped offset May's dismal showing. Investors were also looking for global central banks to step up their monetary easing efforts.

In the U.S., equities stumbled early in the week amid a drop in oil prices to below the key $40 per barrel mark. The S&P 500 Index then began to pick up steam, supported by a subsequent rally in oil and July's positive employment data. For the week, the index gained about 0.5%.

European stocks also started slowly, dragged down by slumping bank shares. However, they staged a late-week advance on the back of aggressive stimulus measures announced by the Bank of England (BoE) and the robust U.S. payrolls expansion. The BoE cut its benchmark rate to a record-low 0.25%, expanded its quantitative easing program, revived a corporate bond-buying plan, and will offer cheap loans to banks to spur lending.

Despite the rally, the STOXX 600 Index dropped 0.2% (in local currency terms), ending a four-week winning streak. On the economic front, Eurozone manufacturing and service-sector activity rose to a six-month high in July. This data is especially encouraging, since it suggests the region saw little overall contagion from the U.K's Brexit vote.

Japanese investors were less enthused by Prime Minister Shinzo Abe's latest effort to stimulate Japan's economy. Although the fiscal stimulus package totals some ¥28 trillion

(about $274 billion), ranking among Japan’s largest since the financial crisis, new and direct spending will make up just ¥7.5 trillion, spread out over the next two years.

Disappointment over the plan sent the yen higher versus the U.S. dollar, weighing on the exporter-heavy Nikkei 225 Index, which fell 1.9% for the week (in local currency terms). Stocks in China were flat, while more broadly, emerging-market (EM) stocks posted a small gain for the week through August 4, supported by a rally in EM currencies—led by the Brazilian *real*—and the rebound in oil prices from early-week lows.

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

Fixed income

Treasury yields rose. After beginning the week at 1.46%, the yield on the bellwether 10-year note reached 1.58% on August 5, with about half of that increase following the release of July’s jobs report. (Yield and price move in opposite directions.)

Returns for non-Treasury “spread” sectors were mostly negative. High-yield bonds, however, bucked that trend. Although in our view they are richly priced, investment-grade corporate bonds and asset-backed securities should remain firmly in demand over the coming weeks as yield-hungry investors seek higher-quality spread products.

While July’s jobs report is positive overall, wage growth remains modest

For the second straight month, the U.S. labor market outstripped expectations, generating 255,000 jobs in July. The unemployment rate was unchanged at 4.9%, staying below 5% for the third straight month. Encouragingly, the labor-force participation rate edged up to 62.8%, as more than 400,000 people joined the work force. Payrolls for May and June were revised up by a combined 18,000. Average hourly wages rose 0.3% in July and 2.6% over the past 12 months—about the same pace as the 2.5% year-over-year advance we saw early in the first quarter.

Among the week’s other releases:

- **Inflation,** as measured by the Fed’s preferred inflation barometer (the PCE index), increased 0.1% in June and 0.9% over the past 12 months. The “core” PCE index, which excludes food and energy costs, rose 0.1% and 1.6% compared to a year ago.

- **Consumer spending** jumped 0.4% in July, its third consecutive monthly gain. With **personal income** edging up by only 0.2%, the personal savings rate dropped to 5.3%, matching a 15-month low.

- **First-time unemployment claims** rose by 3,000, to 269,000, as did the less-volatile four-week moving average, by 3,750, to 260,250. These levels are still consistent with a healthy labor market.

- **Manufacturing** activity grew at a slower pace in July, as measured by Purchasing Managers’ Index (PMI) published by the Institute for Supply Management (ISM). At 52.6, the PMI remained comfortably above the 50 mark separating expansion from contraction.
- **Service-sector growth** also slowed, to 55.9 in July, according to the non-manufacturing index published by the ISM.
- **Factory orders** declined 1.5% in June after a downwardly revised 1.2% drop in May. However, orders for non-defense capital goods (excluding aircraft), which are seen as a measure of business confidence and spending plans on equipment, increased 0.4%. This points to better third-quarter manufacturing activity.

Outlook

July’s payrolls report doesn’t meaningfully change our view of the U.S. economy. While wages have risen this year, it remains to be seen whether this trend will strengthen as the economy inches toward full employment. At this point, wage growth is more important than job creation totals or the unemployment rate.

For the U.S. economy, we expect the third quarter to be a reversal of sorts from the second, with personal consumption falling from its robust 4.2% quarter-over-quarter rate and businesses picking up the slack by restocking their inventories. As a result, GDP should increase from its annualized rate of just 1.2% in the second quarter to around 1.7% in the third, further signaling that the economy is moving positively, albeit moderately.

In spite of consecutive back-to-back months of solid jobs growth, a Fed rate hike in September remains unlikely, in our view. December, though, is still in play. Amid ongoing concerns over global growth—demonstrated most recently by the BoE’s easing—the Fed is in no hurry to raise rates.

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