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TIAA GLOBAL ASSET MANAGEMENT

June’s upbeat jobs report helps offset Brexit jitters

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Article Highlights

- The S&P 500 ends the week higher, while a rally in European stocks falls short.
- Fixed-income markets take June’s stronger-than-expected jobs release in stride.
- We would not read too much into the employment numbers, as monthly jobs data has historically been volatile, and the U.S. jobs engine is decelerating.
- Without a steady pickup in wages, we don’t believe the Fed will be in a hurry to raise interest rates.
- Despite some likely Brexit-fueled headwinds, we still believe that attractive valuations and the prospect of further ECB easing make Europe a compelling equity destination.

Equities

Global equity markets nursed losses for most of the week, buffeted by ongoing Brexit concerns. At the same time, investors anxiously awaited the July 8 release of June’s U.S. nonfarm payrolls report, hoping for a rebound from May’s dismal showing.
They were not disappointed. The report easily outstripped expectations, providing a welcome jolt for markets and lifting the S&P 500 into positive territory (about 1.3%) for the week. In Europe, the broad STOXX 600 Index fell 1.5% (in local terms) for the week, as the late-week rally wasn’t enough to make up for steep losses among financial stocks earlier in the week.

In Asia, the yen’s rise against the dollar weighed heavily on Japan’s exporter-heavy Nikkei 225 Index. However, Chinese equities gained about 2% for the week, even as the government guided the yuan lower—a move that in the past has rattled markets.
Current updates to the week’s market results are available here.

Fixed income

Fixed-income markets were not alarmed by June’s strong employment report, concluding that it would not accelerate the Fed’s timetable for further rate hikes. The yield on the bellwether 10-year Treasury note, which began the week at 1.46% and closed at an all-time low of 1.37% on July 5, hovered near that level for the rest of the week. (Yield and price move in opposite directions.) This suggests investors view U.S. Treasuries as reasonably priced relative to the risk of extended wage inflation in the U.S.—a risk that, for now, we deem low. Moreover, Treasury yields are attractive compared to those of other developed-market sovereign bonds.

With the prospect of continued easing by global central banks, investors kept searching for yield. This boosted demand for non-Treasury “spread sectors,” whose returns ranged from mildly to solidly positive for the week through July 7. Investment-grade and high-yield corporate bonds were notable outperformers.

June’s jobs report far exceeds consensus forecasts

The U.S. labor market capped the second quarter on a high note, generating 287,000 jobs in June. As more people entered the work force, the unemployment rate rose from 4.7% to 4.9%, while the labor-force participation rate inched up to 62.7%. Payrolls for April and May were revised down by a combined 6,000.

Even though June’s employment growth was a substantial improvement over May’s revised total of just 11,000, we wouldn’t read too much into the jump. Monthly payrolls data historically has been volatile. Additionally, the U.S. jobs engine, as we had anticipated, is downshifting. On average, 147,000 jobs have been created over the past three months—a solid but slower pace than we saw last year and consistent with the economy’s approaching full employment.

However, after showing signs of picking up earlier in the quarter, average hourly wages rose just 0.1% in June and 2.6% compared to a year ago, levels that are below what we would expect at this stage in the employment cycle. Without further and steady improvement on this front, the Fed is likely to hold off on raising interest rates.

Among the week’s other data releases:

- **First-time unemployment claims** fell by 16,000, to a three-month low of 254,000, and the less-volatile four-week moving average also slid, by 2,500, to 264,750.

- **Non-manufacturing activity** reached its highest level in seven months, with the index published by the Institute for Supply Management (ISM) jumping from 52.9 in May to 56.5 in June, an unusually large one-month move. (Readings over 50 indicate expansion.) This provides evidence that the U.S. economy accelerated in the second quarter.

- The **trade deficit** widened 10% in May, to $41.1 billion, up from a revised $37.4 billion in April, as robust demand for imports signaled a pickup in consumption, while the strong dollar weighed on exports.

Outlook

Although the eventual impact of the British vote on markets is hard to forecast, we believe that the short-run outcomes will include a slowing of economic activity, if not outright recession, in the U.K., along with a slowdown in the Eurozone. The Brexit issue has been compounded recently by concerns over Italian banks, which are burdened by high levels of non-performing loans.

Despite this uncertain and challenging backdrop, we continue to overweight Eurozone stocks. First, valuations in Europe are more attractive than those in the U.S. Also, slower growth on the continent will likely lead to even more European Central Bank stimulus, which often acts a springboard for equity markets.

Meanwhile, China seems to be posing less of a risk to the equity landscape. While we remain concerned about the effects of a further decline in the yuan, the British pound’s steep drop has provided cover for China to guide the currency lower without unsettling markets. Additionally, China’s stockpile of currency reserves increased last month, a sign that capital flight seems to have eased.

As for U.S. stocks, corporate earnings are set to rise after a year of stagnation, supported by a weaker dollar, low interest rates, and higher oil prices. Put together, we believe these catalysts can support a new high for the S&P 500 by year-end.

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