Weekly Market Update

Fed rate-hike signals alleviate uncertainty and boost global equities

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Article Highlights

- Equity markets welcome increasing likelihood of a December rate hike.
- Fixed-income markets are surprisingly calm in the face of possible tightening.
- The U.S. economy shows signs of rebounding from a disappointing third quarter.
- With the ECB likely to boost QE in December, central bank policy divergence is poised to widen.
- Modest rate hikes could support both stocks and bonds.

November 20, 2015

Equities

Global stock markets, resilient in the aftermath of the terrorist attacks in Paris, extended their gains following commentary from the Federal Reserve suggesting that the U.S. economy is strong enough to withstand a December interest-rate hike.

Although equities often pull back at the prospect of higher interest rates, the November 18 release of minutes from the Fed's October meeting, along with "hawkish" rhetoric from Fed officials, reduced uncertainty about future monetary policy. Signs of an improving economy and a rally in energy stocks also supported the S&P 500 Index, which was up 2.9% through November 19 and heading higher as of mid-day trading on November 20.

International equity markets joined in the rally, with Europe's STOXX 600 Index rising 3.3% in local terms (+2.8% in U.S. dollar terms). Investors cheered the prospects of additional quantitative easing (QE) by the European Central Bank (ECB), which pledged to "do what we must to raise inflation as quickly as possible."

Chinese shares also ended the week higher, but in our view the country's economic outlook remains somewhat cloudy. While real estate prices have risen, the manufacturing sector has slowed. Moreover, Beijing's reform program

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appears to have been placed on the back burner, calling into question the government's ability to meet its long-term growth objectives.

Current updates are available here. For additional insights from TIAA-CREF Equity Portfolio Manager Stephanie Link, view our Weekly Market Perspective Video.

Fixed income

Longer-dated U.S. Treasury yields declined modestly during the past week, as fixed-income markets reacted to a possible rate hike with a remarkable degree of calm. As of afternoon trading on November 20, the 10-year note was hovering around 2.26%, after beginning the week at 2.28%. (Yield and price move in opposite directions.) At the same time, short-term Treasury yields have risen in anticipation of a rate hike, leading to a "flatter" yield curve.

Returns for spread sectors (higher-yielding, non U.S. Treasury securities) were mostly positive, although high-yield corporate bonds posted a modest loss. Emerging-markets debt (EMD) has held up well, a surprising development given its historical underperformance during periods preceding Fed tightening. The EMD market has apparently concluded that the pace and scope of rate hikes will be modest, giving issuers significant time to prepare for a period of normalizing rates.

Signs of strength in the U.S. economy include an uptick in inflation

After a disappointing showing in the third quarter, the U.S. economy is demonstrating signs of a fourth-quarter rebound. Among the favorable reports released during the past week:

- **First-time unemployment claims** dipped to 271,000, remaining well below the key 300,000 level, while the less-volatile four-week moving average edged up to 270,750.
- Following small declines in September and August, the index of **leading economic indicators** published by The Conference Board rose sharply in October, supporting the view that the U.S. economy is set to improve in the fourth quarter.
- Although **housing starts** fell in October from a nearly eight-year high in September, **building permits**—a forward-looking indicator— climbed to their highest level since 2007.
- The **consumer price index** ticked up 0.2% in October, largely because of higher costs for rent and medical care. Stripping out volatile food and energy costs, so-called "core" inflation" increased 0.2% and rose 1.9% over the past 12 months—an indicator of improving demand and economic activity.

Other releases were mixed, including:

- **Homebuilder confidence** eased in November from October's upwardly revised reading, according to the National Association of Home Builders/Wells Fargo index.

- **Regional manufacturing indexes** were mixed in November, as the Philly Fed exceeded expectations by showing a mild improvement, while the Empire State manufacturing index dropped for the fourth straight month.

Outlook

Labor markets are either at or extremely close to full employment, inflation is set to start rising again, and the economy has broadly recovered from the recession. Annual GDP expansion remains in the 2.25%-2.5% range. Against this backdrop, we continue to expect the Fed to raise rates at its December meeting.

Although Europe has also rebounded this year amid robust consumer demand and a turnaround in credit growth, we believe its recovery will lag that of the U.S. for some time. Business and infrastructure investment need to rise significantly, and, more importantly, a potential slowdown in the emerging markets could hinder the Eurozone economy, given the region's strong trade ties with the developing world. We not only anticipate that the ECB will announce additional QE in December, but we also would not be surprised if its policy measures are more aggressive than markets currently expect.

In terms of U.S. stocks, we believe the recent 4.5% pullback in the S&P 500 Index has paved the way for a new advance, perhaps to the 2,200 level. Investor sentiment remains deeply bearish, which historically has presaged a market upturn. Additionally, inflation remains relatively low for now, another positive for equities.

Meanwhile, fixed-income assets overall appear fairly valued at current spread levels and prices, but we look for greater volatility both before and after the Fed's imminent rate-hike announcement. Consistent and gradual wage growth could lead to a "Goldilocks" scenario in which stocks benefit from growing top-line revenue, while bonds are also supported.

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