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Post-election stock market rally pushes indexes toward new highs

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Article Highlights

- U.S. equities climb sharply, defying expectations that a Trump win would send markets tumbling.
- Pharmaceutical, industrial, and financial stocks lead the rally, while health insurers, tech stocks, and utilities lag.
- European and Japanese stocks also gain for the week, though trading is choppy.
- U.S. Treasuries and many other fixed-income sectors post losses as yields surge on heightened inflation expectations.
- With the economy looking strong in the near term, a Fed rate hike remains on track for December.
- Against this backdrop, the stage is set for a seasonal equity market rally into year-end. We are cautious on Treasuries but see select opportunities in other fixed-income sectors.

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Equities

Equity markets have surprised investment strategists, economists, and pundits by behaving in exactly the opposite way than expected following Tuesday's election result. Prior to November 8, conventional wisdom said that a Hillary Clinton victory was priced into the market and that a win by Donald Trump would trigger a sharp decline—at least until investors had a chance to adjust to the new reality.

Instead, after an initial overnight swoon in S&P 500 Index futures that was almost identical to the drop recorded immediately after June's Brexit vote, U.S. stocks roared back. Through Thursday's close, the S&P 500 was up 3.9% for the week, and the Dow Jones Industrial Average rose 5.1% while setting a new all-time high. While there was a pause in the post-election rally on Friday, with stocks finishing mixed amid light Veteran's Day trading, the Dow closed at another new record high. European and Japanese equity markets also gained for the week despite a "Friday fade." Contributing to the positive mood was the president-elect's acceptance speech, which struck a more conciliatory tone than his campaign rhetoric, and the prospect of a pro-growth, pro-business agenda that would be supportive of stocks, particularly in key sectors.

Not all stocks fared equally well. Among those getting the greatest post-election lift were banks (because of rising interest rates and the likelihood of less stringent financial regulations under a Trump administration) and pharmaceuticals (threatened by potential new drug pricing controls if Clinton had won). Industrial names also benefited, reflecting hopes for increased infrastructure spending, as did coal and fossil-fuel energy industries, which otherwise may have been subject to closer environmental and regulatory scrutiny.

Underperformers included health insurers likely to be most affected by an overhaul of the Affordable Care Act, technology companies that could suffer from possible trade and tariff issues, and high-dividend-paying stocks (utilities, real estate investment trusts, and consumer staples) that generally become less competitive as interest rates rise.

Additional TIAA perspective on post-election equity market performance can be found here.

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

Fixed income

Treasury and non-Treasury yields alike have climbed significantly since the election. However, the spread, or yield differential, between Treasuries and most other fixed-income sectors has been fairly stable, suggesting an orderly transition to higher rates. The rise in yields reflects market concern that tax cuts and increased infrastructure spending, should they come to fruition, could potentially overheat the economy, resulting in faster wage gains and higher inflation—a negative for bond prices. This concern is somewhat speculative for now, and we should have greater clarity over the next few months.

Note: U.S. bond markets were closed on November 11 for the Veteran's Day holiday

Outlook

Despite the past week's post-election surge, renewed volatility is possible in the near term due to lingering uncertainty about how the Trump administration will perform. One early clue may come if he identifies a cabinet before his swearing-in on January 20. If so, markets may well have a clearer sense of the direction in which he will lead, based on his choices. It's more likely, however, that a full understanding of Trump's agenda—and thus, any truly market-moving policy decisions—may have to wait until the first quarter of 2017.

Such a lull between now and then may create the setting for a move to new highs for equities, with the potential for a seasonal market rally into year-end. Sentiment has been negative (a contrarian indicator), while corporate earnings estimates have moved higher.

In general, we think performance will likely continue to vary along the sector-specific preferences that began to play out this week.

In fixed-income markets, it's possible that the surge in Treasury yields has been overdone. The jump in the bellwether 10-year yield to levels above 2% is a move that may be tempered by the massive global demand for yield. This demand supports Treasury prices, which in turn helps keep a lid on yields. (Price and yield move in opposite directions). That said, we think Treasuries will remain challenged until more specific policy details emerge from Washington. Among other sectors, we think investment-grade corporate bonds should do well in light of rising yields, helped in part by large-scale foreign buying. Bank debt has room to rally further amid a steepening yield curve and potentially reduced financial regulations.

For the economy overall, we see continued strength in the near term, with further support from the prospect of increased fiscal spending and healthier inflation. With that in mind, we fully expect the Fed to remain on track for a rate hike in December, and we now expect the10-year Treasury yield to end the year at 2.25%, up from our previous estimate of 1.9%. Our forecast for fourth-quarter GDP growth currently stands at 2.1%.