Market comment for the week of February 2, 2018

Good-bye to all that?

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Not-so-distant drums. Inflation worries and rising interest rates shadowing stocks throughout the week came to a head Friday, sending the S&P 500 to a 2½-week low in a steep decline across all 11 sectors and 119 of the 125 constituent industry groups. Volatility, measured by the VIX "fear gauge," move above its average for the first time since last August in climbing to a November 2016 high. Solid economic reports supporting the rally in recent months were turned on their head as their impact on stocks now was seen through more their impact on bond yields than on profits. Fed and Treasury announcements weighed on the markets, too, the Fed with nuanced "hawkishness" in its FOMC communique and the Treasury's response to an unusual, late-cycle rise in the budget deficit with increased quarterly debt sales skewed toward shorter-term securities likely squeezing an already narrowing gap between yields on shorter- and longer-term rates.

Touching off Friday's bond rout was January's solid jobs report, capped by added evidence of increased wage pressures stoking inflation worries enough to send the benchmark 10-year Treasury yield to a 2014 high of 2.84%. The stock market's steep decline here and abroad paced a broad-based decline across most asset classes, sending a simple risk portfolio down to a five-week low against its "safe-haven" counterpart. The dollar was among the few beneficiaries of higher rates—with the notable exception of its rate against the safe-haven Swiss franc—regaining traction as yields moved up enough to stanch the flow of funds moving abroad in recent weeks. Dollar strength helped sink commodity prices, taking S&P 500 energy and other materials stocks to the bottom of the benchmark's performance rankings.

Investors mulling the S&P 500's steepest decline in two years can take comfort in still-solid fourth-quarter earnings growth and in the stock market's resilience in this long rally to increasingly "rich" valuations, a weak, stop-go growth cycle, a well-engineered turn from aggressive monetary stimulus by the Yellen Fed, plus financial and geo-political crises in Europe and elsewhere. What is different now is a threatened sea change in the low inflation, subdued interest-rate environment supporting rising financial-asset prices since the early 1980s. At issue now is a) the scope for further interest-rate increases, assuming added wage-price pressures, b) implications of higher inflation for the pace and duration of the Fed's interest-rate "normalization," and c) the ability of the stock market, saddled with rich, interest-sensitive valuations, to weather a further rise in bond yields if inflation accelerates.

Yields, still low relative to economic growth and inflation, have the potential to move higher if the economic outlook remains upbeat. Investors' inflation expectations, based on the "break even" rate for a ten-year Treasury inflation-protected security (TIPS), only now match current CPI inflation of just over 2.1%, with no allowances for further, long-term increases. Inflation-adjusted rates, lifted to a December 2015 high by an improved growth outlook, still are just a fraction of their long-term norm. Financial-market conditions still are "easy," and a still-negative Treasury "term premium" on the ten-year note signals investors still aren't convinced that bond yields will be higher a decade from now. Investors also may be behind the "curve" in their Fed-policy expectations. The Fed funds futures market still is not pricing fully the three rate increases forecasted by the Fed for this year, according to Bloomberg estimates, even as market speculation builds of a fourth rate hike by investors wary of the inflation outlook and the message from a recent "steepening" of the Treasury yield curve in which inflation-sensitive, longer-term rates have been leading the rise.

Diminishing financial stress and a still-sanguine rate outlook leave room for still higher yields

Source: Bloomberg Financial News, as of January 31, 2018.

And the stock market's reaction to last week's abrupt interest-rate rise raises questions about its sensitivity to further increases, particularly as a supportive earnings season fades from view. The economy typically carries stocks through the early stages of an interest-rate up cycle by sustaining earnings growth. However, interest sensitivity of the economy and, by extension, the stock market, may have been raised by years of historically low rates. For one thing, the resulting increase in "duration," or sensitivity of bond prices to a given change in yields, effectively has increased the potency of even modest rate increases to the allure of bonds vs. stocks.

The economy also may have become more sensitive to rate increases from historically low levels encouraging leveraging and stoking asset values. Housing "affordability," inflated for home buyers by ultra-low mortgage rates, is vulnerable to downward pressure as rising borrowing costs are applied to now-inflated home prices. Aggressive corporate borrowing—much of it for stock buy backs and for other financial "engineering"—lifted corporate leverage back near its post-recession peak in late 2009 by last year's third quarter, contributing to a recent decline in interest coverage (earnings as a percent of interest expense) to an eight-year low. The Federal budget and government debt could quickly become an issue, too, already being nudged higher by an early pickup in entitlements growth out-weighing the usual late-cycle support to revenue growth and restraint on cyclically sensitive spending. Moreover, the decision to rely on more "liquid," short-term borrowing to finance much of the recent tax cut will delay efforts to extend debt maturities, leaving Federal interest expenses all the more vulnerable to future rate increases.

A second threat to the economy is through asset prices, vulnerable to a reversal of interest-rate declines inflating values throughout this unusually long growth cycle. Asset-price adjustment could boost financial-market volatility, as investor portfolios are realigned with underlying risk tolerance, undercut economic growth, by lowering business and household net worth and borrowing capacity, and, at the extreme, disrupt financing availability in a replay of the credit-induced recession a decade ago.

Recoupling. Good news on the economy in an event-filled week turned out to be a little too good, as ongoing economic strength, a "tight" labor market and dwindling excess capacity translated, at last, to a pick-up in wage inflation. Activity data continued to show the kind of broad-based strength consistent with stock-supporting growth of corporate profits. Solid, broad-based growth extended beyond remarkably resilient, early-cycle manufacturing, housing and consumer spending to moderating, but still solid gains in investment spending. Easing worries over an auto-sales stumble at the start of the year, amid an unusually low saving rate, were historically high January consumer confidence and solid gains in household wealth—i.e., returns on past savings lessening the need to divert income from spending. Housing provided double-barrel support, directly from an increase in December pending-home sales to a March 2017 high and, indirectly through an accelerated rise in November home prices supporting gains in household wealth.

January's nearly blemish-free jobs report was the big market mover on the week, less because of a satisfying gain in headline employment than because of another sizable increase in hourly earnings lifting 12-month wage inflation back to a post-recession high. That increase added to evidence of gathering wage pressures coming from fourth-quarter employment costs earlier in the week. That wage pressures have yet to spill over to inflation at the end of last year was made clear by news Monday of still subdued inflation measured by the PCE deflator, the Fed's preferred price gauge. Odds of a sustained rise this year are building, however, with wage pressures on the rise, dollar weakness threatening to lift import costs and, of course, oil prices back to a June 2014 high. The good news for asset-market stability and returns is that inflation's future increases should be restrained by global competition, weakened labor unions, industrial restructuring, online shopping, associated increases in consumer-price transparency, and other technological innovations.

There's little rest for the weary in the coming week as a seemingly modest, front-loaded data calendar gives way Thursday to the Thursday expiration of a three-week "continuing resolution" raising the specter of yet another government shutdown. Congress likely will kick the can down the road with another short-term spending resolution, though highly charged immigration and other ancillary issues are enough to keep the financial market on edge. As for the data, Monday's purchasing managers' report for January non-manufacturing activity will be the week's most visible release, followed Tuesday by December foreign trade plus the Labor Department's report on job openings and labor turnover for the month. Also on tap will be a $66 billion three-day sale of three-, 10- and 30-year Treasury securities beginning Tuesday. Overseas, investors will be splitting their attention between Monday's purchasing manager reports for January services and overall activity, released by Markit, Inc. Monday, and the outcome of Thursday's policy meeting by the Bank of England.