Market comment for the week of February 9, 2018

High road, low road

Gary Schlossberg

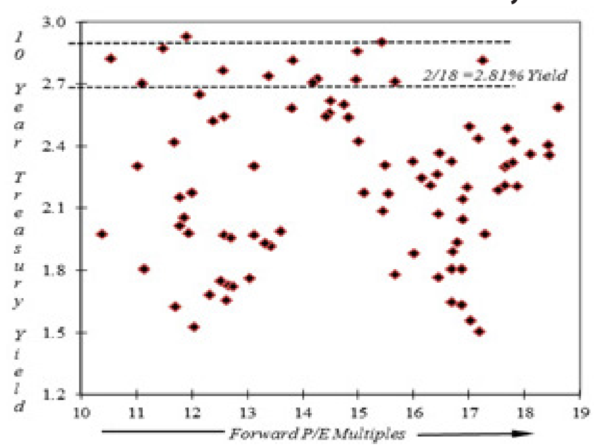
Wringing out, or ringing out? Stocks were decked a second time in as many weeks in a no-contest tug of war between inflation worries and rising bond yields versus an upbeat economic and earnings growth outlook. The S&P 500 Index's steepest decline in over two years was broad and deep across all eleven S&P 500 sectors and all but seven of the benchmark's 125 industry groups. An unsurprising pop in VIX volatility, to double its long-term norm on the week, was the tip of an iceberg containing massive losses on bets against volatility that have become the poster child for the week's sell-off in stocks. Bonds were caught in their own tug of war between debilitating increases in inflation expectations plus deficit-related supply concerns versus safe-haven demand for government securities. Safe-haven support wasn't enough to prevent three weak auctions last week of government notes and bonds further undercutting the market. Foreign demand for U.S. securities at times may have reversed the usual cause-and-effect relationship between the dollar and U.S. interest rates during currency swings contributing to opposing moves with interest rates rather than the usual parallel changes. Widening quality spreads in corporates, lifting the yield premium on non-investment over investment grade securities to a one-year high, still left the benchmark with a loss just a fraction of the 5.2% S&P 500 decline.

Twin debates in the wake of the global markets' steep sell-off are the monetary-policy impact here and abroad, and the implications for stocks in the months ahead. Recent declines in policy-sensitive, shorter-term rates run counter to the stay-the-course view of central-bank policy here and abroad, underscored by the past week's hawkish remarks by Governor Carney after the Bank of England's policy meeting. The reduced probability in the Fed Funds futures market of rate increases signaled a more uncertain outlook over the timing of the Fed's moves this year, perhaps reflecting a wariness over potential disorderly market conditions—like those in the late 1990s—capable of sidetracking policy decisions. Policy uncertainties joined investors' rotation into less rate-sensitive, shorter-term rates in pulling yields lower, leaving the gap with longer-term rates at its widest since October in a pattern typically associated with economic strength. What's clear is that grappling with fall-out from the Fed's interest-rate normalization amid rising inflation will pose greater challenges for incoming Fed Chairman Powell than last year's surprising disinflation did for his predecessor, creating market risks similar to those facing untested Volcker, Greenspan, and Bernanke at the start of their tenures.

An even more immediate issue for the asset markets is the cause of the latest sell-off—either more of a one-time technical adjustment to market froth or a reaction to a fundamental change in a remarkable, secular tailwind for financial investments. Optimists can point to the economy's recent strength, synchronized global growth, double-digit earnings gains, and historically low interest rates, even after the latest backup, as supporting arguments for this rally's staying power. The more guarded outlook rests on the sea change from disinflation, aggressive monetary stimulus, and ultra-low interest rates as threats to a stock market still priced for that friendlier backdrop.

History sides with optimists counting on resilience to yield increases, until those increases weigh more heavily on economic and earnings growth. However, those more guarded on the outlook could point to a market still rich despite recent declines.

S&P 500 still "rich" versus bonds at the current 10-year Treasury yield



Source: Bloomberg Financial News, IBES, Federal Reserve Board

The current S&P 500 price-earnings (P/E) multiple of 17.3 times projected earnings is nearly 18% above its long-term average and above the median forward P/E of less than 14.4 times expected earnings when the yield on the 10-year Treasury note has straddled the current 2.8% in the 2.7% to 2.9% range. The same group also could point to the risk of potentially more interest-sensitive housing, other credit-sensitive and overall economic activity to a stock market yet to be tested by a sustained rise in interest rates that may now be getting underway. In fact, the yield backup already is creating head winds for economic growth here and abroad through bumps in the flow of credit, judging from the noticeable rise in the past week's financial stress indexes to a more stressful negative reading for the first time in over a year and from an increase to a seven-month high in the term premium on the 10-year Treasury note measuring investors' long-term expectations for that yield. Also weighing on the growth outlook is the effect of higher interest rates on stock, bond, and other asset prices propelling household wealth, borrowing, and spending power. Higher yields and an associated rise in the dollar typically are deflationary for the global economy, as well, by dampening commodity prices, by adding to the local-currency repayment burden on overseas debt, and by luring funds from overseas financial markets. Translation losses on overseas income of U.S. multinationals and of U.S. investors add a more local angle to that dollar strength, even as it boosts U.S. living standards by reducing the cost of goods and services plus purchases of overseas assets.

Even a stronger case for a more technical rather than economically driven sell-off in the past week is superseded longer-term by an even more powerful, enduring argument for a low inflation, low interest-rate environment as the ultimate force behind asset bubbles, whose unwinding strikes at the heart of the low market volatility and moderate, stable economic growth preceding it. Cheap money and low returns on higher-quality assets create an incentive to reach for return in riskier investments, working with low-cost leveraging to inflate market values increasingly vulnerable to reversal. In parallel is the financial engineering also encouraged by low interest rates and a reach for stock-boosting returns, leaving corporate finances vulnerable to the same unwinding of markets and ultra-low interest rates driving them.

…To a slow boil. Last week's light calendar of economic data stayed on message in conveying enough late-cycle strength to sustain investors' elevated inflation expectations ahead of this week's key price reports. The biggest blow for economic growth came early with Monday's stronger-than-expected purchasing-manager report for dominant non-manufacturing just under a rule-of-thumb, boom-like threshold and the strongest reading in nearly 13 years. The labor market remained tight enough to support a further buildup of wage pressures, despite unexpected declines in job openings and hiring countered by a further rise in voluntary quitters (viewed as a barometer of job-market confidence) and by news of a new, 45-year low in weekly jobless claims during the period to February 3. Even a growth-sapping increase in the December foreign trade deficit to a ten-year high offered encouragement from another sizable increase in exports (a by-product of strong global growth and competitiveness boosting declines in the dollar) out-weighed by an even stronger jump in imports reflecting strong domestic spending.

Added evidence of brisk, underlying spending came from another solid increase in sales by wholesalers, triple the rise in inventories and bringing the inventory/sales ratio down to a three-year low. Yellow flags in the week's economic data came from two reports on household debt. December consumer credit posted an increase strong enough to sustain double-digit growth in credit-card debt and a ratio of non-mortgage debt to after-tax income at a record high of over 26%. And fourth-quarter mortgage delinquencies shrugged off economic and housing-market strength in climbing to a 2½-year high despite a restrained run-up in mortgage debt in this cycle, raising questions about credit quality's resilience to a more sustained rise in interest rates.

Top-tier data will dominate a full, back-loaded calendar in the coming week, updating conditions across a broad swath of the economy during the opening months of the year. Also on tap will be Monday's scheduled release of the president's 2019 budget, likely including plans for stepped-up infrastructure and defense spending, plus Friday's $7 billion sale of 30-year Treasury inflation-protected securities (TIPS). Capping the week's economic reports will be the mid-week release of January consumer prices, with a supporting role by the following day's producer, or wholesale, prices for the month, scrutinized for evidence of inflation's turn higher anticipated by a market driving up bond yields. An unexpectedly weak consumer-price increase for January could raise doubts about the inflation outlook by a market keenly aware of last year's unexpected easing of price pressures, potentially shoring up inflation-sensitive bonds and stocks undercut by recent yield increases. January retail sales will be the key activity report on the week, offering a glimpse of early-year strength in the economy's dominant sector and complemented by updates on early-cycle manufacturing and housing strength critical to the depth, breadth, and staying power of this unusually long growth cycle.