Market comment for the week of February 23, 2018

“Normalizing!”

Gary Schlossberg

Losing the battles, winning the war. Stock-market “bulls” ended triumphant after struggling most of a holiday-shortened session, propelled by a powerful rally Friday lifting the S&P 500 back to a February 2 high in a second straight weekly gain. A steady retreat in VIX-based volatility left this “fear gauge” only slightly above its long-term average. That, plus a second straight gain in a narrow, risk-based portfolio against a similar collection of “safe-haven” investments signaled a return of market confidence after the upheavals early this month. However, a changing interest-rate outlook was the asset market’s main driver much of the period. Interest-rate worries weighing on the market much of the week cleared with a seemingly benign semi-annual policy report from the Federal Reserve ahead of Chairman Powell’s Congressional testimony next week, easing concern over the pace of this year’s rate increases. The report took a measured view of a tight labor market, firming wage-price inflation, and rising asset values without breaking new ground or investor confidence in a “normalizing” economic environment gradual enough to steady the financial markets. Added support to the end-of-week rally came from upbeat earnings reports and other company news, a reminder of stocks’ main source of strength behind their impressive rise from a week ago.

The market’s strong finish left it with a broad, but fairly shallow gain on the week, across 9 of 11 S&P 500 sectors but just 74 of 125 industry groups. More depth and breadth to the gains will be needed to move the rally to a broader, more stable footing. That much is clear from the growing contribution to benchmark gains from the top five (you guessed it, mostly large tech and near-tech) companies, accounting for more than 50% of S&P 500 gains thus far this year compared to less than 24% in 2017. As for last week, a strange-bedfellow combination of tech and yield-oriented utilities led the way, the former lifted by ongoing strength in reported earnings, the latter drawing support from the noticeable, late-week drop in interest rates to a 1.5-week low of less than 2.87% in the 10-year Treasury yield. Friday’s yield was up nearly a half percentage point from the end of last year, enough to leave the benchmark 10-year Treasury note with 3.7% year-to-date loss. Historically low yields and associated increases in “duration” (or sensitivity of a security’s price to a given change in interest rates) are leaving notes and bonds exposed to modestly greater losses than pre-crisis declines, better cushioned then by higher yields.

The dollar continued its unusual, inverse relationship with U.S. yield premiums to foreign rates—a negative correlation maintained virtually throughout the year depicted in the chart below—finishing the week higher despite lower interest rates. Commodity prices bucked their usual dollar relationship in rallying on the week despite the currency’s strength, by enough to leave the Bloomberg index just barely in the black on the year. The currency’s tendency this year to dip when U.S. yield premiums widen versus those abroad and to rise when interest spreads narrow is at least a partial response to the ebb and flow of foreign investment supporting or undercutting simultaneously demand for U.S. bonds and the exchange rate. Stocks and bonds have been moving in tandem since the market’s early-February “correction,” shifting to a weak, positive correlation that has undercut bonds’ diversification value as the debt market responds to turbulence and subsequent recovery in much the same way as stocks.

Correlations gone haywire?

Percentage points

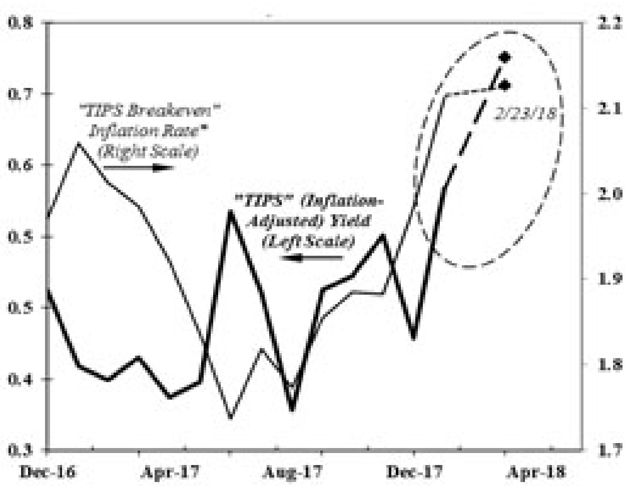
Sources: Bloomberg Financial News, Inc., ICE BofAML, as of February 23, 2018.

Policy and financial-market “normalization” likely will make interest-rate uncertainties and their effect on stocks and other risk assets a recurring issue in the foreseeable future. The multi-faceted debate over interest rates has centered on the Fed’s pace of future rate increases, reaction to “normalization” by market-driven interest rates and the stock market’s threshold of pain for future increases. Policy uncertainty is apparent from market speculation after this week’s release of the FOMC minutes over more frequent rate hikes than the three in Fed forecasts, even as the Fed funds futures market has yet to price fully the three already on the table, according to Bloomberg data. Powell may be viewed as a clone of his predecessor on policy (despite his reservations with “quantitative easing” expressed during the debate several years ago), but a changed landscape of firmer inflation and healthier economic growth makes a comparison less relevant. Beyond policy, per se, is the market’s uncertain reaction to the end of “financial repression” by the central bank through more regular rate increases and to a wind down of its balance sheet effectively lowering the Fed’s safety net (or “put” in futures market jargon) supporting the financial market over the years.

Debate over an interest-rate trigger for a stock-market decline includes a nominal (or observed) yield threshold—as low as 3%, according to some—to a “real,” or inflation-adjusted yield sufficient to dampen economic and earnings growth. A threshold for real-rates is the more plausible of the two, providing a better measure of the “bite” to interest rates on economic activity. If so, then shifts in the drivers of interest rates potentially have adverse consequences for stocks. The chart below shows that rising interest rates this year have been driven more by their “real,” or inflation-adjusted component than by the increased inflation expectations driving them last summer and early fall. Higher real rates are more benign for stocks if propelled by strengthening economic (and associated earnings) growth, and are less so if in response to increased government borrowing or to uncertainties boosting a yield’s risk premium. Recent increases in real rates coinciding with a worsening budget outlook and heightened market volatility suggest headwinds ahead for stocks.

Inflation-adjusted yields behind the latest rise in Treasury interest rates

The yield & “breakeven” inflation rate* on a 10-year TIPS, in percentage



*Yield differences, conventional, 10-year T-notes versus comparable TIPS.
Source: Bloomberg Financial News, Inc., as of February 23, 2018.

Also complicating the outlook is that past may not be prologue in determining interest-rate levels capable of sinking the stock market. Increases in seemingly low interest rates risk an out-sized economic impact in the wake of debt levels and asset values inflated by years of historically low financing costs, leaving the economy vulnerable to sizable declines in housing “affordability,” material increases in household and business interest expenses on variable-rate debt and to more burdensome financing costs on increasingly “stretched” government finances.

A “do-no-harm” economy? A light data flow in the latest week on balance reaffirmed broad-based growth despite scattered hints of reduced momentum, as important as the economy’s recent strength and longevity (set to become the second longest expansion on record if sustained through April) by cushioning the economy against unforeseen “shocks.” The data didn’t directly aggravate swings in the asset markets, though they may indirectly have done so by reinforcing the transition to a more normal economic and interest-rate cycle. A reminder of tight labor-market conditions was provided by an unexpected decline in February 17 jobless claims to within shouting distance of early January’s 45-year low. And a “green light” for satisfactory economic growth came from another solid, broad-based increase in the January index of leading indicators. Housing activity was less upbeat, including an unexpected drop to a four-month low in January re-sale activity and a decline in mortgage applications for home purchases and for refi activity in the latest week serious enough to lower four-week moving averages for both a second straightperiod. Housing is approaching a crossroads at which rising mortgage rates are undermining still healthy “affordability” amid solid job-market confidence, improving demographics, and strength in other non-interest “fundamentals.”

The light data calendar of the past few days ends with a bang in next week’s overloaded lineup, capped by Fed Chairman Powell’s inaugural policy testimony Wednesday and Thursday to the House Financial Services and Senate Banking committees, respectively. Data, on balance, should convey respectable economic growth into early 2018 at, or slightly above the revised, 2.5% pace expected in a mid-week Commerce-Department announcement. Other releases with the greatest market-moving impact will include Tuesday’s durable-goods orders for January, February consumer confidence out that same day and a Thursday report on January personal income and spending. Overseas, attention will center on the mid-week release of February purchasing manager indexes for manufacturing activity, attracting added interest in the wake of recent reports hinting at a loss of European growth momentum.