Market comment for the week of March 9, 2018

"Those who fail to learn from history…"

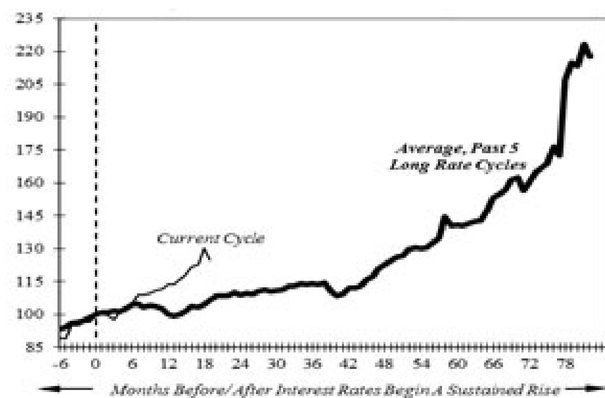
Gary Schlossberg

It's policy. Stocks marked their rally's ninth anniversary with a stunning rise Friday, lifting the S&P 500 to within 3½% of its record January 26 close in the week's broad, deep rally across all 11 sectors and 109 of its 125 industry groups. Triggering the high note, and ending a week of policy ups and downs, were stunning reports on February employment and reaction to a forthcoming meeting between the U.S. president and North Korea's Kim Jong-un. Utilities and other yield-sensitive sectors drew the short straw, Friday and on the week, from a backup in Treasury yields to nearly 2.9% on the 10-year Treasury note on the strong jobs data and earlier Fed-policy concerns. The stock market's second powerful rally in the last four weeks paced a rise in a simple portfolio of risk assets leaving them at a late January high against their safe-haven counterparts. The dollar's rise with interest rates on the week masked more unusual, intra-week counter-moves to daily rate changes. More predictable were commodity prices, edging lower in response to the dollar's rise and to signs of slowing growth in key consumers China and Europe.

As impressive as Friday's rally was the stock market's resilience to policy's twists, turns, and fall-out in the days leading up to it. Small caps were propelled past the more internationally oriented, mega-cap S&P 100 a second week by investors seeking shelter from trade uncertainties atop this high-tax group's greater exposure to tax cuts. Financially engineered stocks also remained in vogue, paced by spin-offs plus M&A targets, as did firms with large capex and R&D budgets. International developed-country and emerging-markets stocks lagged on signs of slowing global growth, worries over U.S. trade policies, and the hawkish spin to the latest ECB policy meeting. Investors took comfort in the run-up to the late-week rally from a friendly growth and inflation outlook fostering both still-adequate earnings growth and cautious interest-rate normalization by the Fed in supporting financial assets, underscored by a tilt toward a further easing of already lax financial-stress indexes. Investors also were heartened by the talk of potential exceptions to worrisome tariff announcements, leaving stocks ripe for a powerful rally on Friday's jobs numbers directly, by reinforcing an upbeat earnings outlook, and indirectly via modest wage growth supporting cautious normalization of rates by the Fed.

Late-week's euphoria notwithstanding, loose ends still could side-track the rally and perpetuate the market's seesaw pattern of recent weeks. First, there's the Fed's take on fresh signs of economic strength sufficient to increase the scope for rate hikes by lifting a theoretical neutral rate balancing the risk of overheating against a rate-induced economic slowdown. Second is trade policy's uncertain effect on economic growth, corporate profits and stock prices keyed, in part, to the extent of the tariffs' pass-through to successive industries processing intermediate and, ultimately, final products, the scope for steel and aluminum substitution, sourcing decisions by multinationals with facilities abroad and the extent to which U.S.-based firms are hit by retaliatory restrictions. Auto manufacturers and aerospace companies, most sensitive to the Bush steel tariffs in place between March 2002 and December 2003, could be more insulated this time if the Administration acts on reports extending national security protection to them. Also at issue is China's response to more threatening U.S. penalties on perceived intellectual property theft and other trade issues.

A resilient stock market to past interest-rate "up cycles"
Cumulative percentage change in the S&P 500; Interest rate cycle start=100



Sources: Federal Reserve Board; Standard & Poor's.

Increased debt supply is a third concern, already contributing to higher interest rates and with the ability to do more as deficit financing needs continue to rise with the budget shortfall. Fourth, seemingly path-breaking negotiations between the U.S. and North Korea leave the market vulnerable to a let-down if the talks fail to produce tangible results. Lastly, there's still the issue of inflation and its effect on interest rates and stock valuations, capable of moving back to center-stage with a larger-than-expected increase in the February CPI. That's countered, to some extent, by higher inflation's support to margins from increased pricing power. Overlooked by investors, as well, is the market's resilience to much of past interest-rate up cycles, as indicated in the chart above.

Just a whistle-stop on the way to an historic cycle? February's solid jobs report suggested recent soft spots in data, ranging from February auto sales to January retail sales, housing demand and capital-goods orders (the last despite strengthening business investment-spending plans), more likely signaled a brief growth pause after last year's impressive gains than an extended shift to more modest growth. Signs of labor-market strength, plus news Monday of a near boom-like purchasing-managers' index of dominant non-manufacturing

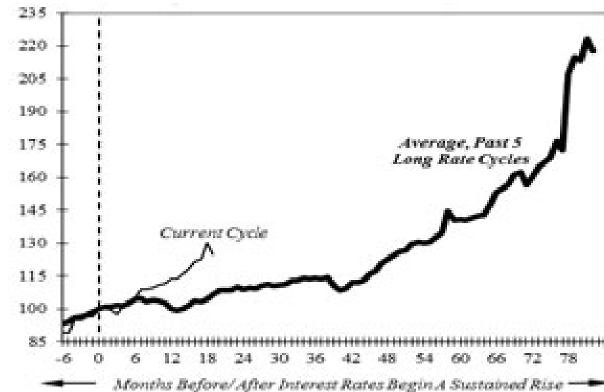
activity, left this growth cycle on track to become the second longest on record if sustained through April (and the longest if it continues through June 2019). Financial market turbulence serious enough to unwind asset values and disrupt the flow of credit—the most visible threat to the growth cycle—is being suppressed by restraints on future increases in inflation, ranging from weaker labor unions and foreign competition to online and other market innovations and signs of improved productivity growth.

As impressive as February's 313,000 job gain—and a steady, 4.1% unemployment rate buoyed by a gratifying jump in the labor force even larger than the employment surge—was the report's implications for unusual, consumer-led growth this late in the cycle. Support to the consumer comes at an opportune time, amid challenges to remarkably resilient housing from tight supply plus the effects of rising mortgage rates and rapid home-price increases on affordability. Most notable in Friday's jobs report, perhaps, was February's increase in the average workweek, viewed as a leading indicator of hiring and providing support for solid growth of weekly earnings (an income-growth proxy) despite a modest rise in hourly wages. Signs of stronger income growth, combined with an earlier report of another solid increase in fourth-quarter household wealth (and associate borrowing capacity), bode well for consumer spending in coming months.

On tap next week is another full events calendar, laced with top-tier economic data and accompanied by a $62 billion sale of 3-, 10- and 30-year Treasury securities. The data-filled lineup will include February inflation updates on consumer and wholesale prices, plus broad coverage from activity data of consumer spending, manufacturing, and housing. Investors are counting on upcoming data to clarify further the growth cycle's strength muddied by mixed economic signals in recent weeks. Equally important will be needed clarification of wage-price pressures from the latest inflation reports after news today of a surprisingly modest wage increase last month. Inflation pressures clearly were building through January, with the core PCE deflator (excluding food and energy), the Fed's preferred inflation gauge, breaching its 2% target in the three months to January. Pressure was becoming less easily reversible as the share of out-sized increases (of 3% or more) in the deflator's price components climbed to a May 2015 high of 49%. Cyclical increases in wages, combined with dwindling excess capacity here and abroad and, perhaps, further oil-price increases, could nudge inflation higher in coming months.

Ample "liquidity" helps underpin a remarkably strong performance by non-investment grade securities

Rolling 13-week risk-adjusted* returns, annualized and in percent



*Nominal returns adjusted by their rolling, 13-week standard deviation.

Sources: Data from BofA Merrill Lynch, Inc.; Bloomberg Financial News, Inc.

Junk? Call them what you want, but high-yield, non-investment grade or simply junk bonds have done surprisingly well against higher-quality, investment-grade securities in both risk- (or volatility-) adjusted and nominal terms in recent years amid market liquidity ample enough to weather this year's heightened turbulence. The annualized, three-month loss of less than 1% in the ICE BofAML index of high-yield securities was just a fraction of the near-9% decline in the investment-grade benchmark. Some of the credit for high yield's strength in recent years goes to its shorter duration (or price sensitivity to a given change in interest rates), its close link to a rallying stock market, and to the market's heightened risk tolerance buoyed, in part, by the Fed's largesse. More modest declines in nominal returns have countered greater volatility in limiting risk-adjusted losses to less than half that of the near-11% investment-grade decline since early December. Looking ahead, the environment for these lower-grade securities may get more challenging, as the Fed slowly winds down aggressive stimulus. The operative word, however, is "slowly" if, as expected, economic growth remains moderate and inflation firms only gradually, lessening the risk of a wrenching adjustment to the market, credit quality, and the availability of funds.

Wells Fargo Asset Management (WFAM) is a trade name used by the asset management businesses of Wells Fargo & Company. WFAM includes but is not limited to Analytic Investors, LLC; ECM Asset Management Ltd.; Galliard Capital Management, Inc.; The Rock Creek Group, LP; Wells Capital Management Inc.; Wells Fargo Asset Management (International), LLC; Wells Fargo Asset Management Luxembourg S.A.; Wells Fargo Funds Distributor, LLC; and Wells Fargo Funds Management, LLC.

Wells Capital Management (WellsCap) is a registered investment adviser and wholly owned subsidiary of Wells Fargo Asset Management Holdings, LLC. WellsCap provides investment management services for a variety of institutions. The views expressed are those of the author at the time of writing and are subject to change. This material has been distributed for educational/informational purposes only and should not be considered as investment advice or a recommendation for any particular security, strategy, or investment product. The material is based upon information we consider reliable, but its accuracy and completeness cannot be guaranteed. **Past performance is not a guarantee of future returns.** As with any investment vehicle, there is a potential for profit as well as the possibility of loss. For additional information on WellsCap and its advisory services, please view our website at wellscap.com or refer to our Form ADV Part II, which is available upon request by calling 415-396-8000. Wells Capital Management does not serve as an independent advice fiduciary during the sales process to any investor. WCM 309705 03-18