Market comment for the week of March 23, 2018

A wall of worry not climbed

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Tapped out? Trade and Fed-policy uncertainties, worries over tech, oil prices, and global economic growth over-rode signs of economic revival after a weak start to 2018, leaving the S&P 500 with its worst weekly setback—nearly 6%—since China's financial crisis II at the start of 2016. The take-no-prisoners decline extended across all 11 S&P 500 sectors and to all but 3 of its 125 industry groups. Energy stocks were most resilient to the carnage, on higher oil prices supported by fresh geo-political uncertainties tied to the appointment of the hawkish John Bolton as National Security Advisor. Tech again was hit hard by social-media concerns as was financial services by flight-driven yield declines squeezing banks' net interest margins and insurance companies' net interest-income stream. A less friendly global outlook was kindest to domestic-oriented small caps in lifting them past the mega-cap, more international-oriented S&P 100 index to an October 2017 high in a fourth straight week of out-performance. Overseas stocks were better insulated by unsettling U.S. trade-policy and other international news, out-performing the U.S. market a second straight week despite the importance of more export-oriented companies in key European stock indexes.

The stock market's slump was part of a broader risk-off trade sending a narrow basket of highly charged assets to a six-month low against safe-haven investments in a broad-based decline against equally broad-based gains by the safer assets, the most abrupt reversal in over two years. Flight-related demand pushed both Treasury yields and stocks toward their lows during the worst of the market's correction early last month, leaving the benchmark 10-year rate at little more than 2.81% in a second weekly decline. Trade and other international concerns quickly out-weighed a short-lived yield increase before and immediately after an FOMC policy announcement viewed as a bit more hawkish than expected in its outlook for rate increases beyond this year.

Technical and other policy responses were more important than economic fundamentals in moving market-driven interest rates and rate premiums, magnifying the effect on borrowing costs of the Fed's latest rate increases at a time when at least one financial-stress index has climbed to a November 2016 high. Treasury bill rates were whipsawed by deficit-related increases in borrowing and by safe-haven demand, sending rates higher and then lower on the week. LIBOR was propelled to a November 2008 high by rising Treasury bill rates, by recent tax reform's effect on overseas banks' funding needs, and on U.S. multinationals' incentive to hold cash abroad. Ripple effects of LIBOR's rise still are working their way through the global financial market because of its still-critical role as a global lending benchmark. Yield premiums on corporate bonds versus comparable Treasury securities also widened, due less to credit-quality concerns than to a pullback by foreign investors facing increased hedging costs, to a shift by U.S. multinationals from corporate-bond investments to buybacks and other purposes under the new tax law, and to the flight-related rally in Treasury securities.

Is the stock market temporarily tapped out, or has it topped out for this cycle? No two market cycles are the same, but stocks consistently have enjoyed double-digit gains in the final twelve months of a rally during the last eight major economic cycles back through 1960, even as interest rates continued to rise in most cases. This cycle already has enjoyed a good run on subdued interest rates boosting asset valuations and, more recently, on a healthy earnings growth outlook powering the S&P 500 to a near-15% gain in the past 12 months. With the drivers of economic and earnings growth intact, there's still room for further market gains even if interest rates continue to rise. Investors nonetheless will be bracing for the kind of heightened volatility lifting the VIX "fear gauge" of market volatility above its long-term average late last week until policy uncertainties sort themselves out. With it has come a steady rise in S&P 500 sector returns dispersion to its highest reading in over a year in the latest 13 weeks, good news for active managers if risk-off trading subsides and, as is likely, the pattern extends to constituent S&P 500 industries and companies.

However, stocks and other risk assets could be kept off balance by recent tremors just beginning to play themselves out. At issue with Iran and the oil-price outlook is, first, whether the U.S. will pull out of its agreement with the country, second, the extent to which others will follow, and third, the impact on OPEC-led production cuts. Unclear in the U.S.-China trade dispute are future U.S. trade restrictions, the full scope of China's retaliation, the effect on global supply chains, and their impact on global trade and economic growth. Threatened sales of U.S. securities by China could be restrained by limited investment alternatives and by China's self interest in preventing steep declines in the U.S. market. Securities sales likely would be muted, as well, by official and private purchases elsewhere, though at higher Treasury rates adding to market turbulence during the adjustment. And not likely to be resolved quickly is U.S. economic policy's "pincer effect" on highly charged assets, from the threat of fiscal-driven rate increases by the Fed on the one hand and from growth-sapping trade restrictions on the other. Both likely won't persist simultaneously, risking stagflation if they do, but either, individually, pose a lose-lose situation for a market accustomed to win-win scenarios in the past year.

Inflation poses the more immediate threat to the Fed's mixed policy outlook of ongoing caution this year and slightly more aggressive rate increases in 2019 and 2020. Underscoring the Fed's leap of faith in a benign inflation outlook was a broad-based rise in the three months to February—to a 10-year high—in the pace of core price increases (i.e., excluding the volatile food and energy components) and, further up the pipeline for trade-sensitive goods prices in the CPI, the biggest three-month rise in import prices for manufactured goods since April 2011 after years of deflation. Add in the oil-price risk from disruptions to Iranian supplies and the outlook appears degrees removed from the Fed chair's view that there is little sign in recent data of accelerated inflation. The Fed's seeming complacency may stem from notoriously volatile three-month price changes, still-subdued wage pressures and/or understandable caution after last year's unexpected inflation slowdown threw off track the interest-rate up cycle.

Inflation pressures, if sustained, inevitably would resurrect the issue of good versus bad price changes debated several years ago as disinflation (or slowing inflation) was getting underway. Bad inflation, typically driven by exogenous pressures beyond the economy's internal workings (oil-market disruptions among the most visible), pose a more immediate threat to growth and to profits by pressuring corporate margins and household purchasing power without any accompanying lift to incomes. Good inflation, supported by endogenous or internal economic strength, is more supportive, for a time, to economic growth and to stocks through its lift to business pricing power and to household incomes. It, too, ultimately poses a threat by lifting real (inflation-adjusted) interest rates carrying a greater bite to economic activity.

Back on track? Economic data's tone improved last week, evidence that the economy's slow start to the year centered less on weak fundamentals than on such easily reversible technicals as payback from storm-related strength and still-faulty, first-quarter seasonal adjustment. More encouraging sales of new and existing homes last month countered earlier signs of softness in easing concern over reduced support from housing. That, plus ongoing strength elsewhere, could lift the first quarter's real-time growth estimates from the modest, sub-2% rate based on data through Friday. Better-than-expected purchasing-manager reports through late March and February durable-goods orders showed leading-edge manufacturing continuing to benefit from lingering strength in markets abroad, supportive domestic spending, recent tax cuts, and from higher operating rates lifting investment spending. And another solid increase in the February index of leading indicators signaled continued growth into the spring. Moreover, initial jobless claims and a weekly consumer confidence index continued to see-saw through the March 17 week at levels critical to sustaining consumer incomes, sentiment, and spending.

A full events calendar will be more evenly distributed across the upcoming Good Friday week than the one just past. Upcoming reports will begin with the broad, Chicago Fed National Activity Index for February, followed by data covering most key sectors of the economy. Potentially market-moving reports will include March consumer confidence, February personal income, consumer spending, and advance foreign-trade data plus the March purchasing-manager survey of Chicago-area manufacturing. Also on tap: the Treasury's $94 billion sale Monday through Wednesday of conventional two-, five- and seven-year notes plus a $15 billion Tuesday offering of two-year floating-rate notes. Data likely will add to recent evidence of a return to growth more consistent with further rate increases by the Federal Reserve. Policy crosscurrents, replacing the usual cyclical strains from rising inflation and higher interest rates, pose the greater threat to a growth recovery a month away from becoming the second longest on record back to the 1850s. The more immediate concerns over fiscal and trade policy have less to do with their direct effect on economic growth and more with their indirect impact on interest rates in a still-fragile and leveraged financial market supporting inflated asset values.