Market comment for the week of April 13, 2018

More than just an interlude?

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A waiting game. The stock market's race for the gold at the start of the year has evolved into trench warfare between policy uncertainties, geo-political strains, and a more clouded economic outlook versus a still-upbeat outlook for 2018 profits. The S&P 500 last week retraced the previous period's decline in posting its best finish nearly four weeks ago, tethered to the ebb and flow of trade and Middle East developments in a rise with run-of-the-mill breadth and depth across 8 of 11 sectors and 90 of the benchmark's 125 constituent industry groups. International stocks in developed and emerging markets lagged the U.S. benchmark in both local-currency and dollar terms, restrained in developed markets by even-more-noticeable signs of a growth slowdown than in the U.S. Lagging performance by emerging markets was a break from this year's relatively strong performance through early April, raising hopes that the group can weather higher interest rates and financial turbulence likely to accompany it than the group did in 2013.

Active managers in the U.S. continued to have the wind at their back with sector returns dispersion still hovering at a March 2017 high. Energy stocks were the clear-cut favorite on diminishing over-supply and global inventories lifting crude prices to a December 2014 high. Tech's performance ranked second on the week in a vote of investor confidence in industry fundamentals, out-weighing company-specific problems weighing on the sector recently. Yield-sensitive real estate, utilities, and telecommunications drew the short end of the stick, by contrast, losing ground on a second straight weekly rise in Treasury yields. That yield increase still left the 2.82% rate on the benchmark 10-year Treasury note well short of its 2018 high of less than 2.95% and the 3% threshold viewed by some as creating a headwind for the stock market. Bond yields, hemmed in this year by safe-haven support versus a combination of reduced securities demand from the Federal Reserve (Fed) and increased deficit-related supply, may be about to get unexpected help from a more sanguine inflation outlook keyed to April's mixed price reports and from signs of slowing growth.

An even more significant increase in the policy-sensitive two-year Treasury note last week, propelled to a decade-high 2.35% in sympathy with still-elevated Treasury-bill rates and on an increased probably of a sixth rate "hike" in this cycle at the June 13 policy meeting, left the gap between two- and ten-year Treasury yields at its narrowest since 2007 in a bear-market flattening of the Treasury yield curve, ultimately debilitating for the economy than the unusual bull-market flattening driven by declining long-term yields in recent weeks. Unexpectedly hawkish minutes to the Fed's March policy meeting contributing to the rise in shorter-dated yields contrasted with more dovish minutes to the latest meeting of the European Central Bank (ECB), increasing the chances of more dollar-supportive policy divergence between the two key central banks during the balance of the year.

The dollar continued to trace an unusual, opposing path to interest-rate changes by moving lower on the week despite the yield increases. Foreign demand offers one explanation for the unusual relationship between yields and the dollar, weakening the currency and domestic bond prices by rotating into other, non-dollar markets. Investors are apparently anticipating further currency weakness in coming weeks, judging from the largest short position against the currency in five years. The weaker dollar helped supercharge a strong rally in commodity prices, paced by a big oil-price rise on a tightening supply-demand balance and by an even more powerful rise in aluminum prices propelled by a sanctions-related decline in Russian supply.

The immediate issue in the outlook is the ability of stocks and other risk assets to draw support from an unusually upbeat earnings outlook in countering policy and geo-political uncertainties, particularly now that once-sticky interest rates are showing signs of becoming unmoored by rising inflation expectations (measured by the so-called breakeven rate on ten-year Treasury inflation-protected securities) approaching a September 2014 high. Rebounding oil prices, strengthening economic growth, and mounting optimism over mega-cap FAANGS in tech and in the consumer cyclicals sector helped ignite an initial increase in earnings growth expectations from less than 4% at the end of 2016 to nearly 10% before soaring to double that by March in the run-up to expected tax reform and optimism on its impact. First-quarter earnings growth could well live up to advance billing, supported, significantly, by strengthening revenue growth. At issue now is whether the bar has been set high enough to leave investors unusually sensitive to cautious outlook commentary forming part of those earnings reports, particularly amid heightened non-economic uncertainties. Failing to meet double-digit earnings growth expectations during the balance of the year could have a double-barrel effect on stocks, sending prices lower without the usual decline in valuations contributing to a subsequent rally as conditions improve. The S&P 500's price-earnings (P/E) ratio fell from about 18.5 times forward earnings in January to a still-rich 16.5 times by Friday, partly on the market's decline from its late-January peak but also because of ramped-up earnings growth expectations. Actual earnings growth short of expectations could deflate earnings expectations along with stock prices, in a race to the bottom limiting the decline in valuations for the wrong reasons.

The more fundamental issue, beyond immediate policy and geo-political uncertainties, is how well asset markets navigate portfolio realignment with risk tolerance, as an end to post-meltdown adjustment is signaled by a more sustained rise of inflation. Heightened volatility in the market for risk assets can be viewed as a harbinger of the market's reaction to gathering evidence of that transition.

Disinflation redux? Mixed economic data in the latest week added to doubts over a springtime growth recovery from the first quarter's hurricane-related payback and from faulty seasonal adjustment understating the economy's strength in recent years. Disappointment registered with a second straight weekly decline in the Citigroup Economic Surprise Index of actual versus expected data results, sending it to an October 2017 low. (The indexes' tumble has been even worse in Europe, where an even steeper decline left the shortfall at its weakest since the 2012 debt crisis.)

Last week's batch of mixed, but reasonably encouraging, data built on earlier signs of strengthening growth from a weak start to the year; good news for the earnings outlook supporting stocks but worrisome for a recent bond rally at risk of becoming over-extended. Signaling an economy still on the upswing was a second-straight rise in the Citigroup Economic Surprise Index, measuring actual against expected strength in the latest data reports, and an upward revision to at least one real-time growth estimate for the first quarter to nearly 2.5% from a sub-2% consensus just a few days ago. Soft spots in the data lent support to the bond market's cautious outlook for the economy embodied in recent interest-rate declines. For starters, inventory building, not underlying demand, was behind much of the upward revision to estimated GDP growth, providing a temporary lift to manufacturing that already showed signs of fading with regional purchasing-manager reports for March. An even bigger blow came from a further slowing of consumer-spending growth over the latest three months, to a rate of less than half a percent.

For every data soft spot, there was a silver lining or offsetting strength, however. The threat to future growth from any reversal of inventory building contributes to an improved foreign trade deficit by dampening import growth, even as it weighs on manufacturing. And consumer spending's drivers point toward improvement soon, including solid growth of inflation-adjusted incomes (or purchasing power), an increase in the saving rate to a six-month high, from separate reports showing still-elevated consumer-confidence levels, and from an S&P/ Case-Shiller report showing January home prices with wealth-building increases still running well ahead of inflation. An added hurdle for bonds has come from accelerated core, or underlying three-month inflation measured by the so-called PCE deflator (the Fed's official target index) to a six-year high in an almost uninterrupted string of increases dating back to May 2017.

"Core" inflation's near-steady rise past the Fed's official target rate unnoticed by investors

Rolling 3-month; annualized percent change; 3-month moving averages

Source: U.S. Commerce Department, as of April 13, 2018.

Looking ahead, investors will be keying on Friday's March jobs report and economic outlook speech by Fed Chair Powell. The warm-up to the end-of-week main events will be top-tier purchasing-manager reports on March manufacturing and non-manufacturing activity in a reasonably full, evenly distributed data calendar. The Powell speech, and the subsequent Q&A period, likely will hone in on Powell's current thinking on the outlook for economic growth, amid recent soft spots in the data, and on inflation implications for clues to the frequency of rate hikes by the Fed this year. Upcoming reports, including February factory orders and construction spending, likely will add to early evidence of a growth revival. Investors will have to content themselves with Friday's March report on still-subdued hourly wage inflation for fresh hard evidence on inflation, ahead of the key price reports the following week.