

Market comment for the week of May 4, 2018

Uncertain passage

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Caught in a crosswind. More important than the market's second weekly decline in as many weeks was another seesaw pattern shaped by the ongoing struggle between market strengths and weaknesses. In one corner were fresh signs of consumer price pressures, trade-policy uncertainties, lingering geo-political concerns, and increased Treasury financing needs threatening still higher interest rates in the wake of recent tax cuts and spending increases. In the other were a dovish communique at the Wednesday FOMC meeting and mixed economic reports capped by signs of reduced wage pressures lessening the threat of economic overheating. Symptomatic of the market's drift was the narrow, shallow decline on the week across just 7 of 11 S&P 500 sectors and only 78 of 125 industry groups, tempered by tech's solid gain on upbeat large-company earnings reports for the first quarter.

Bonds did their best to limit the stock market's decline with a gain nudging the ten-year Treasury yield below 2.95%, at one point, from its late-April peak of more than 3%, supporting a still-elevated price-earnings (P/E) ratio of 16.4 times forward twelve-month earnings at week's end that was more than 11% above its 38-year average. The modest gain in ten-year Treasury notes combined with a similar rise in comparable German bunds to lift a basket of safe-haven assets past a similar grouping of stocks and other risk investments for the first week in four. Slippage in the ten-year yield plus a slight uptick in the policy-sensitive yield on the two-year Treasury note left the yield gap between the two at a two-week low, in a flattening yield curve viewed by many as a harbinger of slower growth or a recession.

The benchmark Treasury's low nominal (or observed) rate translated into an elevated real, or inflation-adjusted yield (a measure of its bite to economic activity) by recent standards, but still less than half its long-term average. That historically narrow inflation premium is one indication of still-accommodative financial conditions fostering takeovers, buybacks and other supportive financial engineering, plus a more selective reach for return in more highly charged risk assets. Another is the still-negative Treasury term premium (or the added amount investors demand for locking in a longer-term yield instead of rolling over shorter-term securities), shrugging off an uncertain inflation outlook and a less friendly balance of securities supply and demand. Even several financial stress indexes have become increasingly accommodative since late March.

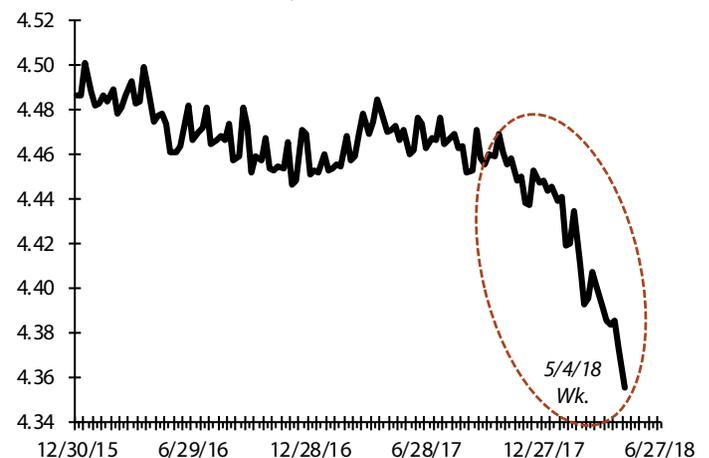
Surprise! Surprises persisted across asset classes for yet another week. The stock market has failed to capitalize on powerful first-quarter earnings growth of nearly 25% from a year ago for the 408 S&P 500 companies reporting through Friday, propelled 10% or more in each of the benchmark's eleven sectors on a combination of tax cuts and healthy (8.4%) sales gains. Cautionary remarks on company outlooks have been partly to blame as have trade and fiscal-policy uncertainties plus worries over the combined effect of higher interest rates, fuel

costs, and the dollar on future earnings growth. Second was the resilience of Treasury yields much of the week to signs of higher wage-price inflation, fortified by a safe-haven bid responding to policy uncertainties, the FOMC outcome, and ultimately vindicated by reduced wage-price pressures in Friday's jobs report. Elsewhere, high-yield bonds held their own against investment-grade securities after out-performing through late April on subdued new-issue activity countering uneasiness over rising leverage and lax financing terms.

The dollar's recovery through periods of lower interest rates has been even more significant because of its pervasive effect on the global economy and capital markets, through its impact on commodity prices, translated foreign income of U.S. multinationals and U.S. investors, dollar-denominated debt of overseas borrowers, and local-market liquidity in emerging and certain other markets. The dollar's rise, to a late-December high, already is having an effect on emerging markets stocks and bonds, with several of the financially more vulnerable countries in the group suffering currency declines serious enough to force local interest rates higher. The debate over the U.S. currency's outlook hinges on the future importance of increasingly attractive U.S. interest-rate premiums compared to yields abroad, set to widen further as U.S. monetary policy and the interest-rate cycle widen their lead over foreign money centers, balanced against dollar headwinds created by U.S. trade and fiscal-policy uncertainties plus hedging costs at times significant enough to erode the U.S. yield advantage.

The Fed's balance-sheet "wind down" kicks into gear

Total Federal Reserve assets; trillions of dollars



Source: Federal Reserve Board, as of May 2, 2018.

Dollar strength or weakness will play a critical role in shaping foreign investment needed to balance demand with increased deficit-related supply of Treasury securities, potentially as big a threat to U.S. interest rates as the turn toward re-inflation. Dollar strength already has

encouraged an unwinding of Treasury holdings by central banks in China and elsewhere, using the proceeds to intervene against the U.S. currency in the foreign-exchange markets. The hope is that the same dollar strength will counter those sales by encouraging stepped-up private investment, lured both by attractive interest rates and currency-related gains. Any increase in foreign investment—and by pension funds, insurance companies, and other investors realigning portfolios with underlying risk tolerance as returns on quality investments improve—will fill a void created by an accelerated wind-down of the Fed's securities portfolio inflated by years of quantitative easing, a back-door policy tightening accompanying the Fed's more cautious increase in short-term rates.

Behind the crosswinds created by the dollar's deflationary strength and accommodative market conditions is a re-leveraging of the economy to a degree not seen since the 2007 pre-crisis period, whose unwinding could pose much the same kind of liquidity test as the Lehman debt default in the fall of 2008. Tougher regulations have shored up bank capital and other market weak spots of that period, replaced by risks from the growth of exchange-traded funds (ETFs), banks' reduced role as bond-market intermediaries, the rise of shadow (non-traditional) banking, and the re-emergence of increasingly lax credit terms and riskier credit structures. Resulting liquidity risk, though a low probability event, nonetheless poses a greater threat to economic and financial stability than interest-rate increases because of its more abrupt, disruptive effect on borrowing and spending.

Cruising speed. A first glimpse of second-quarter economic growth from the past week's data signaled adequate, if not respectable, growth despite enough data shortfalls from expectations to reverse the previous week's increase in the Citigroup's Economic Surprise Index. The April job report's show of late-cycle resilience came more

from an employment gain sufficient to support average, three-month growth of over 200,000—nearly double that needed to lower unemployment—than from a decline in the unemployment rate to a 17-year low of 3.9%, due more to a second straight decline in the labor force than to a healthy rise in household-based employment. Likewise, purchasing-manager indexes for April manufacturing and non-manufacturing declined, but to levels still consistent with an early real-time GDP estimate of 4% second-quarter growth by the Atlanta Fed based on data available through May 3. Added support came from late first-quarter momentum in consumer spending, rebounding in March after earlier back-to-back declines. Less encouraging was a third monthly decline in four by capital-goods orders after explosive gains last fall, raising questions about future investment-led growth.

April's unexpected slowdown in average hourly earnings seemingly countered signs of mounting wage pressures from a further acceleration of first-quarter employment costs, to a ten-year high a week ago, raising fresh doubts about the extent to which an increasingly tight labor market can influence this key driver of services inflation and interest-rate increases creating potential headwinds for financial assets. Looking ahead, key April price data—capped by Thursday's CPI release—will share the spotlight with a Zurich, Switzerland speech by Fed Chair Powell on international finance and a \$73 billion, three-part sale of 3-, 10- and 30-year Treasury securities Tuesday through Thursday. Upcoming price data have taken on added importance amid recent signs of inflation's more sustained rise coupled with mixed wage data clouding the outlook for Fed rate increases during the balance of the year. Thursday's Treasury budget report for April may add to the attention on worsening government finances and stepped-up borrowing weighing periodically on the financial market, in conjunction with an accelerated wind-down of the Fed's balance sheet and associated demand for Treasury securities.

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