Market comment for the week of May 25, 2018

Sound body, troubled mind

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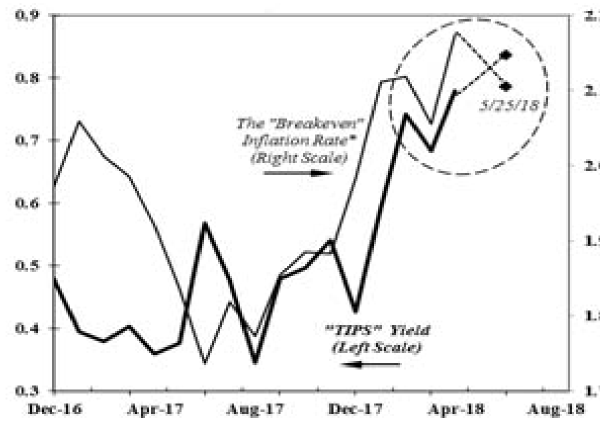
Mere distractions? Rapid-fire geo-political uncertainties propelled safe-haven assets to a three-week high against more modest gains in a portfolio of riskier investments. Stocks were among the risk assets edging higher on the week in choppy trading, confining narrow and shallow gains to just 7 of 11 S&P 500 sectors and 60 of 125 industry groups in keeping with a narrow rally thus far in the second quarter. The benchmark's top five performers have accounted for over 36% of the market's quarter-to-date gain through Friday compared to less than 25% during last year's rise. Interest-rate declines were a main stock-market support, reflecting both risk-unfriendly safe-haven demand and a more supportive, positive spin to the early-May FOMC minutes signaling a go-slow policy toward rate increases even if inflation remains above target. A more benign approach to future price pressures risks leaving the Fed forced into more abrupt, catch-up rate increases if they fall behind an inflation curve, exposing the economy and financial assets to added turbulence.

Yield increases firing on both cyclinders

The yield and "breakeven" inflation rate* on a 10-year TIPS, in %



*Needed to equate the TIPS yield with a conventional, 10-year Treasury yield. Source: Bloomberg Financial News, Inc., May 2018.

Geo-political uncertainties sending the benchmark 10-year Treasury yield to a one-month low of little more than 2.93% at the end of the week lifted bond-like utilities and real estate to the top of the S&P 500 sector rankings and pushed financial services into the red by pressuring banks' net interest margins. It was energy stocks that were hit hardest on the week by a one-two punch from unexpectedly higher oil inventories and from a Saudi pledge of increased second-half oil output to steady the market. The dollar shrugged off lower interest rates in responding to stronger safe-haven demand and to more satisfactory second-quarter growth in climbing to a new November 2017 high as did commodity prices by moving higher against the dollar despite a worrisome decline in economically sensitive industrial metals prices. Developed markets stocks abroad were hurt by political uncertainties in southern Europe and by disappointing purchasing-manager reports on May European manufacturing and services activity, while dollar strength trumped commodity-price increases in leaving emerging markets stocks down on the week.

Trade policy and geo-political worries have distracted investors from still-sound fundamentals supporting the asset markets. Glass-half-full investors view the stock market's inability to capitalize on unusually strong, late-cycle earnings growth as an ominous sign of looming weakness in the market. The half-full contingent views an S&P 500 still less than 2.5% below its early-March, post-correction high as a sign of resilience to what is viewed as non-economic noise. Just what are the growth cycle's strengths? A broad-based second-quarter growth pickup—to 3%-4%, by most real-time estimates—is shoring up prospects for solid earnings growth during the balance of the year. One indication of that strength has been this year's rise in the yield on the ten-year inflation-protected Treasury security (or TIPS), an inflation-adjusted rate usually tied to economic strength and joined by still-elevated investors' inflation expectations.

Signs of ample liquidity, despite recent interest-rate increases, range from low levels of financial stress, resurgent buy-back activity and takeover-related borrowing plus a still-negative term premium on longer-term securities (i.e., discounted against the return on rolling over shorter-term securities during the maturity of a bond). Added evidence of an ongoing reach for return in a low-yield setting comes from both this month's return on low-quality, non-investment-grade bonds and the lagging performance of high-quality stocks. A seemingly elevated yield on the benchmark ten-year Treasury note still is only slightly above its post-meltdown average of the past ten years, despite a sturdier economy, and little more than a third of its average since 1990. The Fed funds target rate of less than 1.7% still is well below its estimated 2.5% neutral rate. All this suggests room for asset prices to absorb interest-rate increases until the rise begins to bite more thoroughly into economic activity.

The U.S. has been less supportive of liquidity expansion abroad, however. Divergent central-bank policies have fostered a widening interest-rate gap favoring U.S. assets, propelling the dollar high enough to attract local-market funds to dollar-denominated securities and, in some cases, forcing foreign central banks to respond with less supportive monetary policies. The multi-faceted impact on emerging markets has been apparent from a strengthening dollar's triple threat to commodity prices, servicing costs on dollar debt and on local-market liquidity. Dollar strength against the euro, based as much in recent weeks on political uncertainties in southern Europe as on attractive interest rates, has become as much a symbol of the region's vulnerability as it has of divergent central-bank policies favoring export competitiveness, adding to the local-currency cost of dollar debt payments and oil prices, not to mention the wholesale funding costs for non-U.S. banks in overseas money markets.

Equally debilitating is trade protectionism's potential impact on the U.S. and global economies. Broadening protectionism now contemplated by the U.S., plus likely retaliation by our trading partners, if implemented, risks slowing U.S. and global growth and exposing both to higher inflation by disrupting established trade flows and supply chains of trade-sensitive firms forced to fall back on more costly, less efficient suppliers. Highly charged, stocks and other risk assets likely would be hurt by the double-barrel effect of heightened market uncertainties and by slower growth and margin pressure. Also at issue for the global economy is protectionism's impact on the dollar and U.S. interest rates. The dollar perversely could strengthen during the initial shock of U.S.-driven trade restrictions, much like U.S. Treasury bonds did following their August 2011 downgrade by Standard & Poor's, on a safe-haven bid by investors fearful of protectionism's adverse effect on growth in more open (trade sensitive) economies abroad. Dollar strength would risk adding to protectionism's debilitating effect on global growth, risk tolerance, and interest-rate normalization, delaying the markets' full recovery from the financial meltdown's after effects.

Mid-cycle form for a late-cycle economy. Economic data on the week added to evidence of a second-quarter growth pickup from its pace during the opening months of the year, despite some softening around the edges in a few of the key releases. As important as the data's recent strength has been its breadth, combining early-cycle strength in housing and consumer spending with the usual late-cycle support from business investment. Moreover, two of the immediate threats to growth, from rising fuel costs and higher interest rates, receded with declines in oil prices and longer-term Treasury yields. Manufacturing remained on track through the early part of May (judging from regional Fed surveys and a preliminary national report from Markit Inc.) despite recent dollar strength and slowing growth abroad, countered by supportive growth in domestic spending. A decline in credit-sensitive new and existing home sales last month—under the microscope amid worries over the effect of even modest rate increases in a seemingly more interest-sensitive economy—still left its rolling three-month average up, again, to a three-month high. Home prices were mixed, with slowing year-to-year increases in official and trade-association estimates countered by a private-company report of the largest such increase in 12 years. Consumer spending continued to shrug off rising fuel costs with a respectable gain in the May 19 week atop the strongest rise of the year the week before. Adding important breadth to the growth cycle was a solid rebound in capital-goods orders after stumbling earlier this year, lifting three-month growth to its best pace since overstated, double-digit gains last fall.

Investors returning from the long holiday weekend will be facing a full data calendar, laced with top-tier data and covering nearly the entire economic landscape. The May jobs report and preliminary purchasing-manager index at the end of the week will be the main event, with plenty to preoccupy investors in the preceding three days. At issue will be the overall tone of the data midway through the second quarter for investors seeking confirmation of a growth pickup shaping the trajectory of policy- and market-driven rate increases during the balance of the year. The Fed's strategy of accommodating above-target inflation, for a time, could be tested by stronger-than-expected economic numbers, beginning with upcoming activity data, and by higher-than-expected inflation readings. Thursday's personal income and spending report for April will include an inflation update, measured by the so-called PCE deflator—the Fed's official price gauge—likely showing signs of firmer, but still moderate year-to-year inflation.