Market comment for the week of June 1, 2018

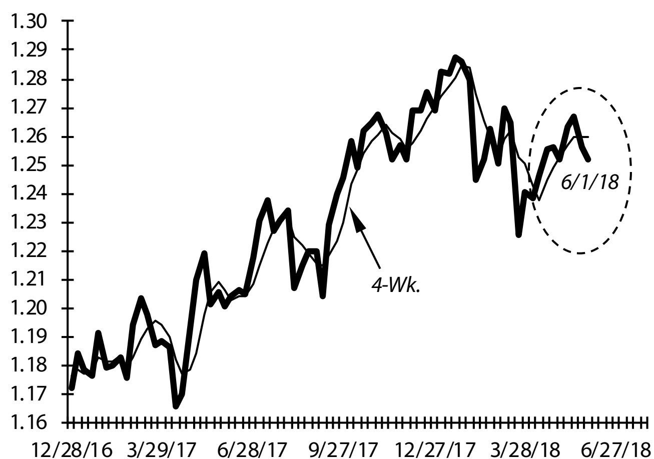
Late-cycle magic

Gary Schlossberg

More than just a relief rally? A solid jobs report and improved clarity on Southern Europe's political situation triggered an end-of-week rally breaching the top of the S&P 500's trading range of recent weeks. An up-and-down week kept benchmark gains narrowly based and vulnerable to future headwinds. Bonds largely mirrored the stock market's moves in nudging the ten-year yield down to just over 2.90%. Lower interest rates outweighed periodic safe-haven support from European uncertainties in pulling the dollar lower, but not by enough to prevent commodity-price declines on weakness in oil, gold, and grains. Interest-rate swings left yield-sensitive stocks mixed on the week. Encouraging economic reports weren't enough to counter worrisome trade-policy developments in preventing industrials from moving lower, while tech was lifted by favorable earnings prospects. Even back-to-back slippage in a narrow group of risk versus safe-haven assets was less than it appeared, largely on declines in emerging markets stocks and bonds and still elevated against the more conservative asset group.

"Risk's" latest setback still leaves it fairly elevated versus "safe-haven" assets

Ratio of total return indexes, risk/safe-haven portfolios, 12/21/05=1.00



Sources: Data from BofA Merrill Lynch, Inc.; Bloomberg Financial News, Inc., June 2018.

Several issues will test the stock market's ability to build on recent gains. First, is the threat of Italian-borne contagion behind us? For now, perhaps, but the populist government's tax and spending proposals risk weighing on the government's fragile finances, bank balance sheets (containing sizable holdings of government debt), and confrontation with Eurozone authorities, raising the specter of a pull-out by the region's third largest economy from the common currency. Second, how big of a threat to the market is trade protection, now that the U.S. has confirmed plans to implement tariffs on imported goods from friend and foe alike? We're still in the discovery stage of a process with uncertainties over the breadth and depth of trading-partner retaliation, the U.S. response to it, and the full, debilitating impact on global growth and cost-push inflation. What is known is that the issue likely will remain a sore point for risk assets most sensitive to uncertainty.

And third, what is the downside to seemingly strong economic growth and potential increases in inflation expectations? The economy's support to earnings growth should allow stocks to absorb what could be as many as three more rate increases by the Fed this year. However, emerging markets risk further pressure from higher interest rates and associated dollar strength, much as they have in recent months. Further dollar increases also threaten commodity prices, serving as a deflationary force in the global market generally and, particularly, in emerging markets economies. Even U.S. earnings growth could be dented by a combination of slowing global growth and by dollar increases tethered to rising interest rates, through their impact on multinationals' overseas earnings that were on the leading edge of first-quarter growth of pre-tax profits.

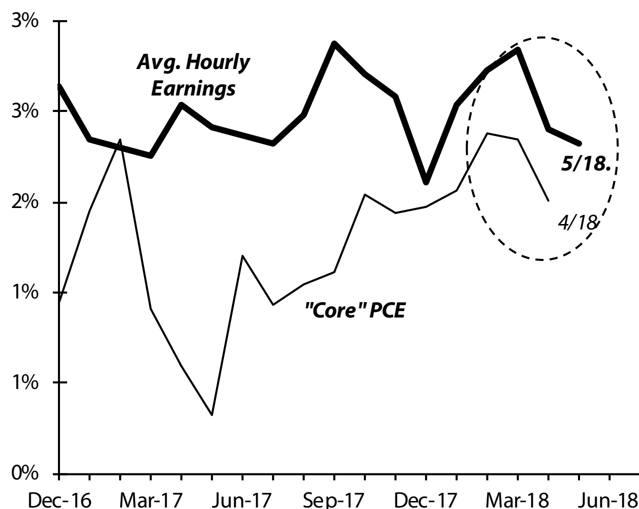
For now, however, calmer geo-political conditions and a U.S. economy firmly on track could encourage investors to look ahead to the June 13 FOMC policy announcement, more for insights to the Fed's second-half outlook for policy than for a decision all but certain to include a sixth rate increase in this normalization cycle. Strong economic reports like those of recent weeks normally would favor three more rate increases this year rather than the two signaled by the latest dot-plot forecast by FOMC members. However, the probability in the Fed funds futures market of a third rate increase by year-end remains stuck at just 33%, according to Bloomberg estimates, largely because of the Fed's willingness to tolerate above-target inflation, for a time, to assure a more elevated level of rates while it continues to realign them slowly with prevailing growth and inflation.

Talk of a sixth increase in short-term rates by the Fed, combined with mixed inflation reports, puts the market on course for a further flattening of the Treasury yield curve in which shorter- and longer-term rates converge; a development unsettling to investors because of its association historically with economic recessions. However, cautious interest-rate normalization during the second half of the year, combined with trade-policy or renewed geo-political disturbances, risk a policy bind for the Fed on either side of that curve-flattening baseline. On the one side is the threatened return of unsettled market conditions delaying multiple rate hikes and boosting flight-related demand fostering broad-based rate declines led by longer-term yields. On the other is the Fed's willingness to tolerate above-target price pressures enough to risk increased inflation expectations driving bond yields higher in a bear-market steepening of the Treasury yield curve.

The final stage? Confidence in a solid growth recovery midway through the second quarter was lifted by the latest batch of economic data signaling broad-based strength—to a 3%-4% range, according to most real-time GDP estimates, and to an impressive 4.8% burst from the Atlanta Fed's usually reliable GDPNow model. Conditions, and performance, are moving into place for a late-cycle mini-burst of economic growth, once atypical but more common during the muted growth cycles of recent decades. Growth-cycle strength tends to be front-loaded, both because of the release of pent-up demand for housing and big-ticket consumer-goods built up during recessions, reinforced by inventory rebuilding to support expanding sales. More fundamentally, the economy is moving through the final stages of its decade-long, post-meltdown adjustment, in which a return to more satisfactory growth fosters sustained re-inflation tempering a highly friendly backdrop for financial assets.

Wage-price reports last week didn't set off alarm bells for asset markets, silenced by declines in three-month inflation measured by the Fed's favored PCE price deflators. Slowing inflation was pervasive, judging from the elevated share of declining price components within the overall index and the smallest share in six months of prices with an inflation rate of 3% or more. As for wages, a larger-than-expected rise in April average hourly earnings failed to prevent a further slowdown in its three-month rate, settling at a December 2017 low of 2.4%. Activity data did keep the heat on, however. May's stronger-than-expected employment gain failed to prevent further slowing of three-month job growth, but to a pace still consistent with an unemployment rate down to a forty-eight year low.

Still no "smoking gun" for sustained wage-price pressures
Annualized percent change from 3 months ago; 3-month moving average



Sources: U.S. Labor Department; U.S. Commerce Department, June 2018.

A solid April gain in consumer spending, even after adjusting for rising gasoline and other prices, signaled revival from its sluggish, first-quarter pace, though a saving rate at a four-month low left spending growth vulnerable without re-acceleration of gains in income or household wealth. April's lower pending home sales followed a strong February-March pace lifting its three-month moving average. Strength in the job market, consumer spending, and housing combined with April's narrowing trade deficit and rebounding capital goods orders to signal broad-based strength consistent with upbeat, real time GDP estimates for the period. Growth's breadth has supported early-cycle manufacturing, capped by May's solid rebound in the purchasing managers' index from a respectable April. Even healthier shipments, order backlogs, and new orders (especially relative to inventories) point to good momentum into the third quarter. Still, manufacturing's exposure to U.S. trade protectionism and looming retaliation could be tested in coming months, much like some of its more visible stocks recently.

A moderate data flow in the coming week will allow investors to split their attention between economic reports, capped by Tuesday's purchasing manager survey for May non-manufacturing activity, U.S. trade-policy developments, and political events in southern Europe. Investors also will be looking ahead to the following week's FOMC meeting, significant more for fresh guidance on the policy outlook during the balance of the year than on a near-certain rate increase. At issue for the economy and for the asset markets is the ability of both to absorb multiple rate increases by the Federal Reserve made more likely by the latest batch of upbeat economic data.

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