

Market comment for the week of June 8, 2018

A reckoning delayed?

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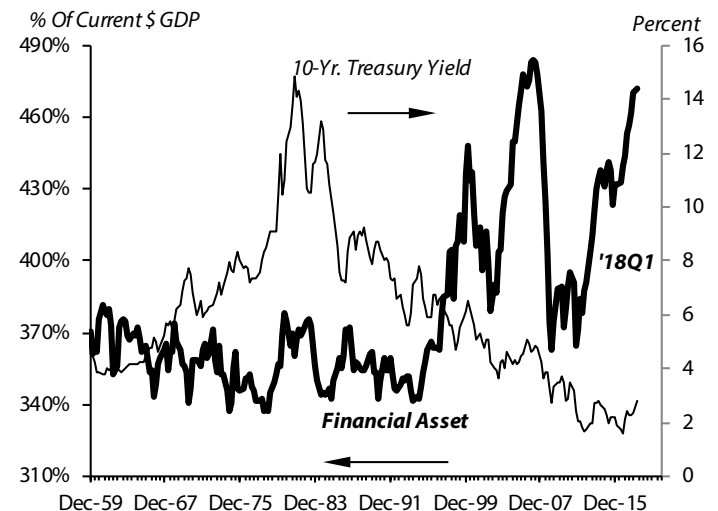
Great moderation II. Upbeat fundamentals outlasted policy and geopolitical uncertainties in sending the S&P 500 to less than 3-1/2% of its January 26 high in a third straight weekly rise. Among the more notable themes during the benchmark's broad, fairly deep gains over the three-week span across 9 of 11 sectors and 90 of 125 industry groups: remarkable, retailing-led strength in the benchmark's consumer discretionary sector joined by an earnings-driven rise in tech powerful enough to stanch the usual rotation toward economically sensitive sectors during periods of strong growth. Cyclical have been sandbagged by middling performance of industrials, hurt by trade-policy concerns and by higher fuel costs weighing on transportation stocks, countering strength in consumer cyclicals. Tech's rally has played itself out in further gains by Russell 1000 Growth to a 17-1/2 year high against its more cyclically oriented Value counterpart by the end of last week.

Bond-like utilities have been hit hardest by periods of rising interest rates, despite an average yield on benchmark 10-year Treasury notes still below the 2.97% average since first breaching 2.9% nearly two months ago. The policy-sensitive 2-year yield largely matched the rise in longer-dated securities to just under 2.95% on the 10-year, Friday, from little more than 2.90% a week ago, steadying the gap between the two after it narrowed to a new decade low Monday in a further yield-curve flattening. Bloomberg data show the Fed funds futures market priced for two more rate increases at the June and September policy meetings, but with the probability dropping to less than 37% for a third rate increase in December. Overshadowed by the 10-year Treasury's periodic assault on the 3% threshold has been a narrowing yield premium on non-investment-grade bonds, even as spreads widen in the investment-grade—particularly BBB-rated—sector. Some of the higher-grade widening has been due to the effect of event risk from stepped-up takeover-related financing, while below investment-grade securities have benefited from reduced new-issue activity and from their close ties to a resilient stock market.

Support for the market has come from brisk, broad-based economic growth providing the foundation for a still remarkably upbeat earnings outlook over the next year, combined with a surprisingly positive spin to economic threats from trade policy, lingering geopolitical concerns, and deepening European political divisions threatening the euro. Elevated stock prices have been met by double-digit consensus earnings-growth forecasts, keeping the S&P 500's forward price-earnings (P/E) multiple of 16.7 times projected earnings elevated, but at the lower end of its three-year range. A supportive earnings backdrop may be needed to counter a more sober view of the policy and geopolitical outlook if current optimism is up-ended by worsening relations with our major trading partners after a contentious meeting of G-7 leaders in Canada Saturday, and by the Italian government's

hawkish budget announcement aggravated by talk of an end this year to quantitative easing's government-bond purchases by the European Central Bank (ECB). These undercurrents are coming ahead of a potentially disappointing U.S.-North Korean summit Tuesday and the Fed's likely rate-increase announcement the following day.

Higher, more volatile financial-asset values accompany the secular decline in interest rates



Sources: Federal Reserve Board; Bloomberg Financial News, Inc., June 2018.

Setting the latest leg of the stock market's rally apart from the norm during this decade-long rally has been its ability to overcome step-wise increases in interest rates, a change from the tailwind of disinflation. That's a fundamental change from aggressive central-bank stimulus and sustained interest-rate declines during much of the past ten years, fostering the highly charged environment of elevated, more volatile asset values illustrated at left. At issue is whether turbulence in front-line emerging markets is signaling the early stages of a sea change away from that favorable, but challenging, setting, as interest rates respond to a global market navigating the final stages of adjustment to the financial meltdown a decade ago.

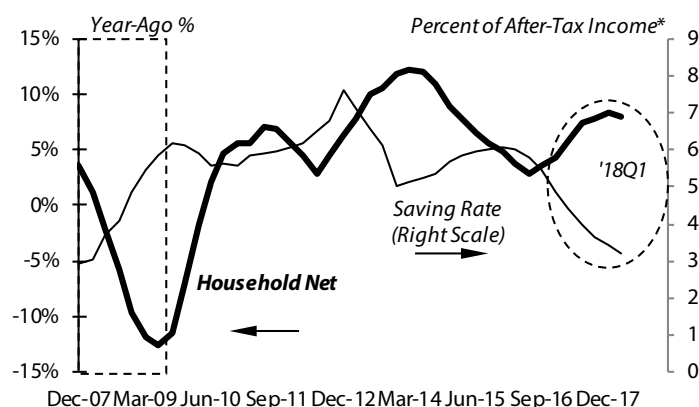
The good news for risk assets is that interest rates and, more generally, gauges of market liquidity still are flashing green, with unusually strong earnings growth perhaps putting off a day of reckoning for stocks and other risk assets—including, perhaps, some in stronger emerging markets—ultimately vulnerable to a less friendly financial environment. The inflation-adjusted Fed funds rate—a measure of the bite to monetary policy on economic activity—is at a decade high, but still well below its reading during similar stages of the last two major interest-rate cycles. The inflation premium on 10-year Treasury inflation-protected securities is at a seven-year high, but just

a fraction of both its pre-crisis reading and at a similar stage of the last two rate cycles. Even more supportive market-liquidity measures, including an increasingly easy financial stress index now back to a late-February low, have combined with low inflation-adjusted interest rates to sustain a golden era for financial assets not unlike that of the great moderation period of low-inflation and sustained economic growth in the decades leading up to the financial market's unraveling ten years ago. Then, like now, the same low inflation supporting steady, sustainable growth, also has helped foster highly charged asset markets prone to a setback.

Ageless? A moderate data flow stayed on message in conveying depth and breadth for a seemingly ageless growth cycle closing out its ninth year. Slippage in the Citigroup Economic Surprise Index, to a new October 2017 low, had less to do with the data's weakness than with more sanguine expectations converging with actual results. In fact, real-time economic growth estimates largely held to the 3-1/2% to 4% range of recent weeks, with the highly regarded Atlanta Fed's GDPNow estimate at an even healthier 4.6%. Solid balance on the supply side was apparent from May's purchasing-manager survey of non-manufacturing activity, enjoying the same uptick from an already healthy level posted by the companion manufacturing index the week before.

Fresh evidence of broad-based demand supporting that balanced growth came from a solid gain in April capital-goods orders, confirming a preliminary estimate earlier, and the narrowest trade deficit that same month since last September on improved non-energy trade. Consumer-spending growth remained intact, judging from another healthy year-over-year gain in chain-store sales during the June 2 week, supported by growth of household wealth through the first-quarter well above inflation and countering a household budget squeeze from elevated fuel costs.

Changes in household net worth a substitute for personal savings



* Four-quarter moving averages. Sources: Federal Reserve Board; U.S. Commerce Dep't., June 2018.

Early-cycle housing, on the other hand, was laboring, demonstrating its heightened interest sensitivity even to a modest rise in rates applied to elevated home prices by cutting affordability (i.e., median family income as a percent of the income needed to qualify for the median-priced home) to a near-decade low. Overall economic strength continues to build the case for heightened inflation pressures, the latest evidence being a second month in which job openings exceeded the number of unemployed.

What is shaping up as one of the most eventful weeks of the year begins with market reaction to last Saturday's contentious G-7 summit in Canada, highlighting trade policy's threat to economic and financial stability, and the start of a \$68 billion sale of 3-, 10- and 30-year Treasury securities Monday and Tuesday. Tuesday's final leg of the Treasury auction (a \$14 billion, 30-year bond sale), will be competing with (if not overshadowed by) that same day's release of the May CPI—joining Thursday's retail sales report for the month as the top two data points on the week with the greatest market-moving potential. Even the CPI release could be just a warm-up to the week's main-event policy communique by the FOMC Wednesday. (If all that isn't enough, a court ruling on AT&T's proposed acquisition of Time Warner is due out sometime during the week, likely setting the legal landscape for entertainment industry restructuring.) Like the key ECB announcement on quantitative easing the following day, market reaction will hinge most on the clarity they provide to the policy outlook—for quantitative easing at the ECB and, for the Fed, the number of remaining rate increases this year beyond a sixth rate hike in this cycle at the Wednesday meeting viewed as a near certainty by investors.

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