Marketing Communication

Market comment for the period through August 16, 2018

Dog Days?

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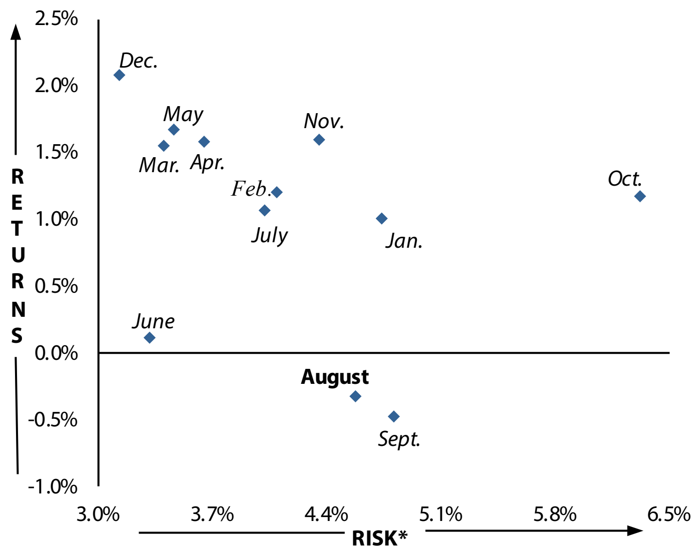
Bulls in a china shop. Dog days of summer have proven to be anything but for yet another year, leaving asset markets caught between Turkey's financial problems, the trade war's ebb and flow, plus solid economic and earnings reports. In fact, an ironic twist to its dog days of summer moniker has saddled August with one of the worst track records during the year, joining September as the only period averaging losses since 1985. Thin trading helps explain why declines are the steepest of any month when the market is down. Bad timing has hurt, too, featuring the 1990 Iraqi invasion of Kuwait; the 1998 upending of the Long-Term Capital Management hedge fund tied, in part, to the Russian default that same month; the 2011 U.S. debt downgrade by Standard & Poor's; and China's financial problems in 2015.

August's difficult "dog days" for stocks

S&P 500 risk* vs. returns by month, 1987-2017 (%)



*As measured by the standard deviation of year-to-year returns. Source: Standard & Poor's, via Bloomberg Financial News, Inc.

Market turbulence since early August was enough to end the S&P 500 Index's assault on its late-January high, falling to a two-week low before retracing much of the decline by midmonth. Safe-haven demand lifted bond prices enough to send the 10-year Treasury yield to a 1-month low and to propel the dollar's exchange rate to a June 2017 high. The return to risk-off trading failed to reverse the decline in gold prices, falling to an 18-month low at one point on dollar strength undercutting demand. S&P 500 Index stock performance was about as mixed as you would expect from a gyrating market. Declines from the market's August 7 high have been spread across just 6 of 11 sectors and 69 of the benchmark's 125 constituent industry groups. Safe-haven-related increases in the dollar and declines in competing bond yields have shaped sector performance rankings, led by yield-oriented telecommunication services, utilities, and consumer staples and hitting hardest at commodity-based energy stocks and materials producers. Unsurprisingly, domestic-oriented small caps outperformed the more internationally exposed S&P 500 Index, which, in turn, suffered far less than overseas stocks in both developed and emerging market countries.

A diplomatic row between two strong-willed heads of state was the catalyst for the latest bout of international turbulence, boiling over to the international capital markets by doubling U.S. tariffs on Turkey's steel and aluminum exports and aggravating Turkey's deepening financial troubles. Stabilization efforts thus far have centered on the symptoms of the country's financial problems—via added commercial bank liquidity and restrictions on bets against the lira in the futures market—with only vague promises to contain yawning balance-of-payments deficits boosting hard-currency debt at the heart of the country's problems. Deepening financial strains are raising the bar for market-satisfying corrective measures, risking a needed move beyond self-imposed austerity to outside discipline (anathema to the president) from a harsh, International Monetary Fund austerity program or, at the extreme, abrogation of independent monetary policy and lira control through establishment of a currency board requiring an exchange rate fixed to the dollar or other hard currency used as backing for 100% of monetary liabilities.

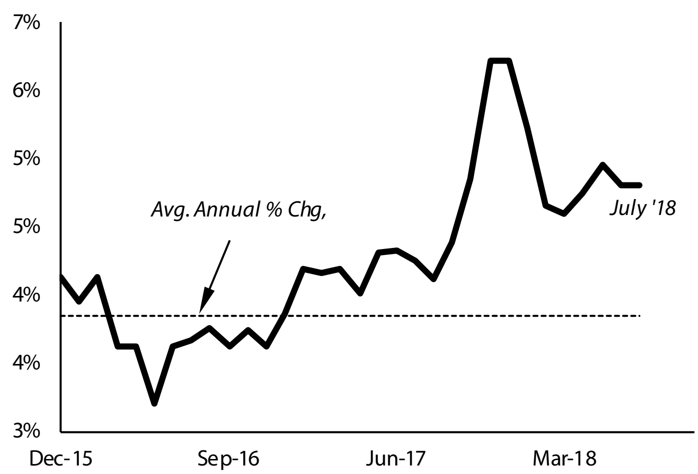
Central to the debate over Turkey's threat to international financial stability is the means by which country-specific risks can become systemic. One flash point is European bank exposure to the ailing country, led by those in Spain, potentially reinforced by the start of Italy's debate over a populist budget risking another showdown with the European Union over centralization. More fundamental is Turkey's potential as a catalyst—alone or in conjunction with other weak emerging market countries—for flight-driven increases in the dollar's exchange rate. Outweighing any resulting improvement in country competitiveness from weaker dollar exchange rates is the deflationary threat to the global economy from a rising U.S. currency, undercutting commodity prices and adding to the burden of dollar-debt repayments atop often-fragile liquidity conditions at home. Disturbances originating in Turkey also leave the Federal Reserve more exposed to a policy error by ignoring the threat of disorderly international market conditions in focusing on interest rate normalization at home amid satisfactory economic growth.

Washington also risks a Pyrrhic victory in pursuit of national goals, ignoring potential international consequences in levering our economic size and the dollar's key-currency role in world trade and finance. The immediate threat from dollar strength and U.S. trade protectionism is to export competitiveness directly and indirectly via the loss of efficient supply chains. Then there's the longer-term costs if the dollar's dominant role as an international currency is threatened by the proliferation of trade restrictions and sanctions, incentivizing others to overcome a highly liquid market for the U.S. currency in seeking alternatives. The tilt toward a more multicurrency system of international finance risks undercutting market efficiency (through more complex, cross-currency transactions) and, for the U.S., eroding the financial benefits of the dollar's role as the dominant currency to the global market. More disruptive U.S. economic policy moves also add to the risk of a collision between financial market excesses and a more disruptive wind-down of international liquidity.

Late bloomer. Atypical, late-cycle strength has been the hallmark of the past three economic expansions, and this one is shaping up as no exception. The economy finally is kicking into gear after disappointing, stop-go growth from the deepest slump since the Great Depression, boosted by recent fiscal stimulus and by adjustment to the after-shocks of the financial meltdown in 2007–2008. Recent data signal unexpectedly strong momentum early in the third quarter from the burst of activity in the spring, supporting full-period growth estimates in the 3.0%–4.5% range from 4.1% in the previous period. Strength is centering increasingly on consumer spending and investment with added potential support to manufacturing from lean business inventories tightening the link between future increases in orders and output. U.S. economic strength is frustrating for the global economy amid a looming trade war, risking an uncoupling of what could be an important growth locomotive for lagging economies abroad.

Still-solid growth of inflation-adjusted retail sales* into the third quarter

Year-ago % change; Three-month moving averages



* Ex. gas stations and building materials; adjusted for the "core" goods CPI.

Source: U.S. Commerce Department.

Retail sales started the quarter on a high note, posting a July increase still running well above prevailing inflation. Brisk consumer spending is coming, in part, from boom-like household formations, the economic unit driving demand for housing and for big-ticket consumer goods. Formations were propelled to a January 1982 high in the second quarter, in part by historically high consumer confidence supported by tax cuts and by a tight labor market. Still-buoyant labor market conditions were apparent in another week of historically low jobless claims and on news of job openings exceeding the number of unemployed for a fourth straight month in June. Housing continued to struggle, despite solid growth of households supporting demand. Home ownership is facing headwinds from higher mortgage rates and from the squeeze on affordability, leaving homebuilder sentiment at an 11-month low and housing starts in the 3 months to July at their slowest pace since last year's August–October period.

Solid growth is supporting a pickup in labor-productivity growth—at a 2.5-year high in the second quarter—lowering unit labor costs (wage and benefit increases adjusted for changes in productivity) for the first time in a year. That's allowing the economy to have it both ways, supporting profit margins while accommodating rising wage and benefit increases strong enough to support consumer-led growth. Inflation's still-gradual rise is remarkable amid solid growth by an economy operating close to full potential. Investors apparently share that view on inflation, allowing the breakeven rate on 10-year inflation-protected securities to fall to a 4-week low by mid-August. Still, the Consumer Price Index (CPI) has climbed to a 6-year high of nearly 3% in the past 12 months, including a 2.3% core rate (excluding food and energy) not seen in a decade. As notable as monthly increases supporting labor-intensive services inflation above 3% was July's first increase in goods inflation (excluding food and energy) since February, despite a stronger dollar normally weighing on this trade-sensitive part of the CPI. The uptick coincided with the initial round of tariffs, perhaps a taste of things to come if the levies proliferate and ripple through the economy.