Marketing Communication

Market comment for the period through August 24, 2018

Sheltered From the Storms

Gary Schlossberg

Eyes on the prize. Repeated attempts at a record S&P 500 Index high succeeded before the clock ran out Friday, cementing the bull market's position as the longest on record. Last week's assault wasn't easy, surmounting jitters over a looming trade war, fresh tremors from Turkey and other emerging market countries, along with policy criticism from the president and within the Federal Reserve (Fed) itself, plus new revelations of possible campaign irregularities and conflict reaching deeper into the administration. Short-lived optimism over U.S.-China trade talks evaporated, punctuated by a fresh round of a mutual $16 billion in import tariffs. Still, market fundamentals ultimately prevailed, most importantly optimism over economic and earnings growth combined with interest rates suppressed by the same safe-haven demand at times working against stocks and other risk assets.

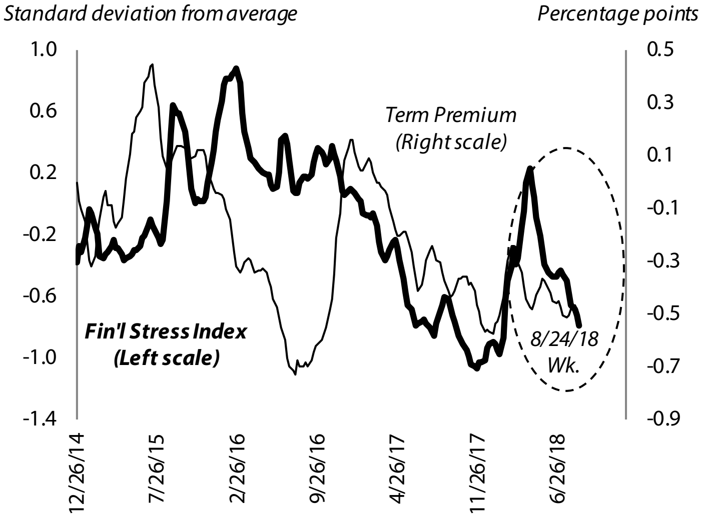
The tug-of-war between market positives and negatives was apparent from its seesaw pattern on the week and from fairly narrow, shallow gains across just 7 of 11 S&P 500 Index sectors and 70 of 125 industry groups. Energy was propelled to the leading edge of the rally on price-induced gains ahead of Iranian oil sanctions later this year, followed by retailing's earnings-driven rally supporting second-ranked consumer discretionary industries. A decline in the yield on the benchmark 10-year Treasury note to a 3-month low of little more than 2.81% on safe-haven demand from overseas and trade-policy uncertainties failed to prevent a drop in all four of the market's interest-sensitive sectors led by bond-like utilities. Lower bond yields combined with an uptick in policy-sensitive 2-year yields to leave the gap between the two at a new decade low in an unusual late-cycle bull-market flattening of the Treasury yield curve. The dollar took its cue from interest rate declines in moving lower, clearing a path for broad-based commodity-price increases paced by fuel and economically sensitive industrial metals.

This unusually long bull market from the depths of the recession in March 2009 hasn't been the most powerful, despite the springboard of the deepest slump since the Great Crash of the early 1930s. What has been impressive, though, has been the support from reasonably strong earnings growth despite a backdrop of modest economic growth and weak pricing power. Building on those gains may require answers to questions potentially shaping performance in the coming months. First, there's the impact of protectionism on the U.S. and global economies, not to mention financial market stability. Hurdles notwithstanding, the U.S. and Mexico are on track for a NAFTA 2.0 agreement that may or may not be in place (or even stick) under the incoming government. However, China next month is facing the specter of a sizable 25% tariff on $200 billion of its sales to the U.S. capable of turning skirmishes into a full-blown trade war. Second is how systemic a threat to emerging markets and to global financial stability are Turkey's worsening financial problems, China's growth slowdown, and scattered signs of less-ample credit along the fringes of the global financial markets. Third is the extent to which the threat to European integration is shifting from Greece (just emerging from a bailout agreement) to Italy ahead of the populist government's budget in mid-October and to a threatened hard (no agreement) Brexit ahead of a March 2019 deadline.

The ground is shifting in the debate over Fed policy, too. Presidential jaw-boning and uneasiness among Fed bank presidents over future rate increases have been met by calls by other Fed officials to lean against emerging inflation pressures with rate increases beyond some neutral rate. Favoring caution are varying degrees of stress across emerging markets, elevated leverage, and asset values plus affordability pressures weighing on housing. Equally compelling arguments favoring the gradual but steady interest rate hikes suggested by Fed Chair Powell in his Jackson Hole speech are normalizing growth and inflation rates in a fully employed economy less dependent on monetary stimulus and the risk of financial market exposure to a wrenching adjustment, if delayed rate increases aggravate financial excesses at home and abroad. Getting wrong the balance between policy restraint and accommodation in the transition from modest growth and disinflation risks disorderly conditions—or worse—in the financial market, historically sidetracking periods of rate increases by the Fed, as in 1997 and in 2016.

Admittedly fallible guideposts in search of the Holy Grail neutral interest rate targeted by the Fed suggest some leeway for further rate increases this year and next before posing a threat to the growth cycle. The chart on the next page shows a steady easing of financial stress indices to a six-month low, accompanied by an increasingly negative Treasury trend term premium (the added yield demanded by an investor to lock in a long-term security for a specified period), implying expected interest rate declines over the longer term. Seesawing yield premiums on investment- and non-investment-grade securities still are historically lean. Transactions-based money has reaccelerated relative to inflation from declines earlier this year, and inflation-adjusted interest rates, measuring their bite to economic activity, are at an October 2017 low. Even the flattening yield curve is less threatening than it appears when viewed beyond the closely watched 2- versus 10-year segment. The difference between rates on federal funds and 2-year maturities, for example, still is more than double its longer-term average in the curve's so-called front end.

Financial stress, expected interest rates still subdued

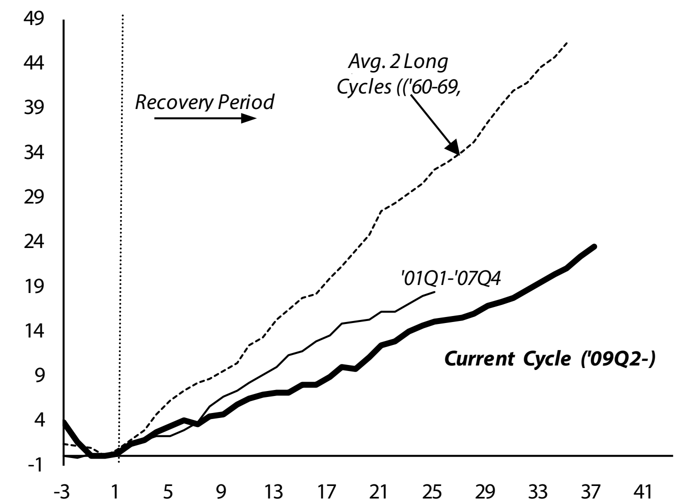


Source: Bloomberg Financial News, Inc.

Gold has been among the most visible deflation signals, dropping to a 2.5-year low relative to inflation. Already entering the debate is the appropriate neutral interest rate at the peak of this cycle. The dot plot's forecast of a 3.5% federal funds rate cycle peak implies an inflation-adjusted rate of less than 1%. That's just a fraction of its norm at the end of the past three major rate cycles, justified, perhaps, by still-fragile financial conditions and the two-track end to stimulus keyed to the Fed's balance sheet wind-down atop its rate increases.

The economy: Miles to go? Seemingly disappointing economic reports in a fairly light data calendar on the week masked enough strength where it counted to lift third-quarter growth estimates—by the Atlanta Fed's highly regarded "GDPNow" model, beyond the second quarter's impressive rate. Strength is centering increasingly on consumer spending and business investment, judging from the return to double-digit growth of equipment orders and earlier strength reported in retail sales for the month. Foreign trade is struggling with payback for accelerated exports in the second quarter, ahead of announced tariffs, while housing's odd combination of affordability pressure in some markets and tight supply in others left the total sales pace in July at a two-year low. Slow and steady has made for several unusually long growth cycles in recent decades, which helps explain this cycle's longevity. That's been particularly true in this cycle, the second longest on record but ranking fifth in strength among the seven since 1960. The low ranking is all the more sobering if the deep recession that preceded it is taken into account, leaving growth from the previous peak at a middling 18%. Adjustment to the financial meltdown during much of the economy's recovery and early expansion phase had much to do with that moderate growth, preventing the usual burst of housing and big-ticket consumer spending in a more vibrant growth cycle. Moving up in the cumulative growth rankings will depend importantly on the economy's ability to avoid bottlenecks while reaping the benefit of stronger productivity gains typical of stronger growth.

So-so growth, thus far, in this long economic expansion
Cumulative real GDP growth, from recovery start, in percent



Source: U.S. Commerce Department.

Potentially market-moving data in this week's full calendar are capable of distracting investors from ongoing policy uncertainties and political developments. Thursday's personal income and spending report will have the greatest potential impact, updating the strength of consumer-led growth and the Fed's official inflation gauge. The data's overall tone should be more than enough to support two more rate increases by the Fed at the September and December Federal Open Market Committee meetings. At issue is the economy's ability to maintain that pace through the end of the year and into 2019 amid ongoing normalization of interest rates. A parallel issue is the asset markets' ability to weather normalization amid gathering financial excesses, leaving them vulnerable to unexpected interest rate or other shocks at home or abroad.