Marketing Communication

Market comment for the period through September 3, 2018

A Federal Reserve for All Seasons?

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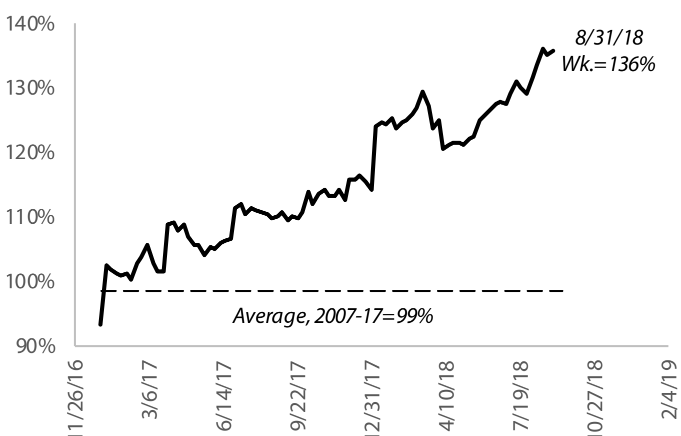
The best of times, the worst of times. Stocks ran their weekly winning streak up to three and to eight of the past nine in a show of resilience to ongoing policy uncertainties at home and to fresh turbulence abroad, capped by another record high at midweek. The latest rise contributed to the best August performance in three years, including a healthy 3.25% return accompanied by the lowest August volatility since 1967—impressive for what historically has been among the most highly charged months of the year. The outsized gain also extended the string of solid S&P 500 Index increases to a fourth month, leaving the benchmark's total return at close to 10.50% since the end of April.

Among the rally's few yellow flags is its narrow breadth, with over 35% of the benchmark's gain last month coming from Apple and Amazon, and more than 45% if third- and fourth-ranked Microsoft and Cisco, respectively, are added to the group. Elsewhere, high-dividend utilities and consumer staples—central to the core of the stock market's defensive quarter—struggled on the month, joining energy stocks in the red despite declines in competing bond yields much of the period. Also striking was the ongoing divergence between market gains in the U.S. and declines abroad, accentuated in recent months by U.S. fiscal stimulus and by protectionist worries hitting harder at more trade-dependent economies abroad. Diverging performance left the S&P 500 Index's trailing price/earnings ratio more than 35% above its long-term average versus that of the EAFE benchmark for developed country stocks.

A second wind to the S&P 500's relative valuation from its recent stand-alone rally

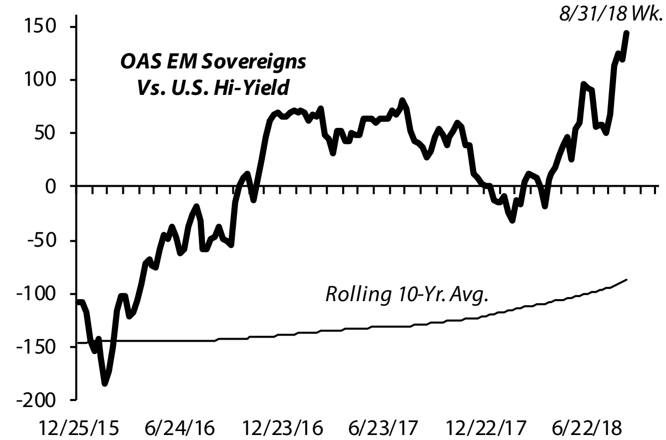
Trailing Price-Earnings (P/E) ratio, S&P 500 versus EAFE



Source: Bloomberg Financial News, Inc.

"Contagion" fears send emerging-market "risk premiums" climbing

Option-adjusted yield differences in basis points



Source: Bank of America-Merrill Lynch, Inc.

The market's sideways move late last week pointed up the ongoing struggle between still-solid economic and earnings growth fundamentals versus fresh worries over trade protectionism following stalled talks with Canada, dollar strength, China's growth slowdown, and spreading emerging market contagion beyond Turkey and Argentina to other financially weak countries in the group. Turbulence has lifted the yield premium on emerging market sovereign bonds to a three-year high versus those on U.S. high-yield securities, in contrast to a slightly discounted 10-year average. (chart above right). Policy and overseas turbulence have had a double-edge effect on the asset markets, contributing to safe-haven-related declines in U.S. bond yields, supporting stock valuations while less directly adding to pressure on commodity prices and on emerging markets by creating a tailwind for a dollar rally.

Recent support to risk assets has come from a more sanguine view of monetary policy. Proponents are counting on an early move by the Fed to the sidelines either on sufficiently modest economic growth by next year's first half or on an approach to a still-undefined neutral interest rate viewed as an appropriate target for an economy slowly returning to normal after extended adjustment to the financial turmoil a decade ago. The burden of proof is on the economy to justify a Fed pullback from normalization as much as a year before that laid out in the official dot-plot forecast. A third-quarter shift to narrower, more sustainable economic growth of 3% to 4% from the spring period's 4.2% rate still is more than adequate to sustain reinflation. Unlike 2017's disinflation-induced decline, support from flight and other overseas capital has outweighed a steady rise in 12-month inflation to a 6-year high in July in driving bond prices higher and yields lower from their most recent peak at the start of August.

An early tilt by the Fed to a neutral policy stance also risks intensifying excesses in still-generally-lax market conditions, signaled in the latest week by a further easing of financial stress indices; by a decline in an already-unusual negative term premium on long-term Treasury interest rates; and, more generally, by a reach for yield and return by investors. Nonetheless, housing affordability at a 10-year low and the historically low percent of University of Michigan survey respondents agreeing that this is a good time to borrow point up the fine line faced by the Fed between moving too aggressively and aggravating financial imbalances by ending rate increases too early.

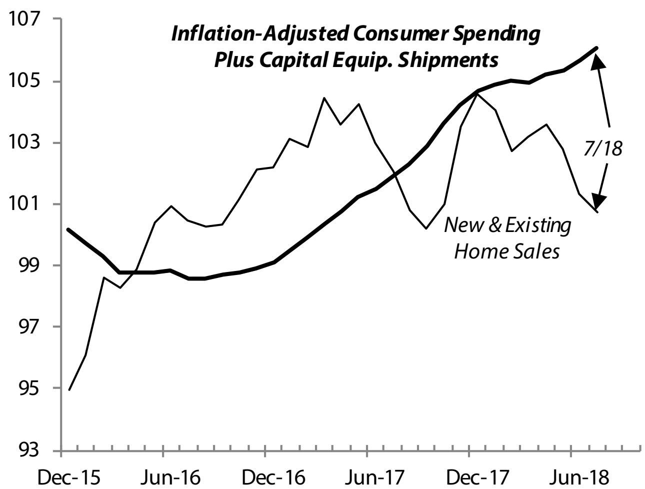
Market strengths in the weeks ahead will be tested by what historically has been the most challenging month for stocks. September is the only month of the year suffering losses, on average, since 1960, a threat compounded by above-average volatility. Adding to the drama this year will be several potentially market-moving events during the period. Among them: Friday's employment report for August, unsettled emerging market conditions, another rate increase by the Fed at the September 26 FOMC meeting, Italy's budget negotiations posing an existential threat to the European Union, and looming tariffs on $200 billion in U.S. imports from China capable of turning a bilateral skirmish into a full-blown trade war.

A late-cycle paradox. Skepticism over the growth cycle's staying power is building even as the economy's momentum continues to hold up surprisingly well. Doubts rest on a temporary, sugar-high view of recent fiscal stimulus, strength overstated by catch-up from years of subpar growth, supported by unusually high consumer and business confidence levels. Added concern is coming from recent interest rate increases converging with levels viewed as threatening a narrowing growth cycle. Faltering economic growth supporting an early pullback in rate increases by the Fed could create its own offset to associated weakness in earnings gains by supercharging a liquidity-driven rally in stocks and other financial investments. Ultimately, however, that would risk a more wrenching adjustment later by stoking asset-price inflation.

For now, real-time estimates of 3% to 4% third-quarter growth are more than adequate to support rate increases by the Fed later this month and into 2019, even with a modest further loss of momentum, as business and consumer spending fill the void left by recent declines in home sales. Economic growth continues to hold up well despite the recent slowing of big-ticket auto and home sales typically at the heart of pent-up demand. Credit some of that resilience to high confidence levels limiting the slowdown in household spending growth during the three months to July. And outsized increases in July wholesale and retail inventories signaled a second wind for manufacturing growth supported by a rebuilding of stocks depleted by brisk second-quarter sales.

A growth cycle centered increasingly on consumer and investment spending

Index: Dec. 2015=100; 3-month moving averages



Sources: U.S. Commerce Department; National Association of Realtors.

Elsewhere, reports last week of slowing home-price increases through June and a further decline in late-August mortgage applications were the latest signs of housing's lost momentum. Still, housing and other credit-sensitive sectors of the economy can take some comfort from inflation-adjusted mortgage, corporate-borrowing, and other rates still running below their rolling 10-year average, a period dominated by fragile, below-average economic growth dependent on low borrowing costs. That suggests more room for rate increases before they become an even more serious threat to big-ticket spending.

Investors returning from the long holiday weekend face a heavy flow of top-tier economic data, capped by Friday's jobs report for August and extending to the highly visible August purchasing managers' reports for manufacturing and nonmanufacturing Tuesday and Thursday, respectively. These and other data will be scrutinized for fresh signs of slowing growth midway through the third quarter, as they vie for the market's attention with trade negotiations and news on emerging market conditions.