Marketing Communication

Market comment for the period through September 10, 2018

Separation Anxiety

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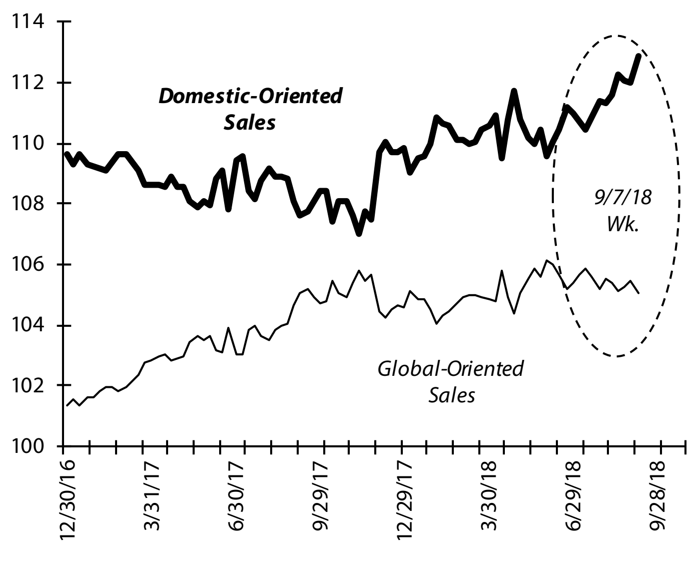
Rolling thunder. Successive declines in a holiday-shortened week left the S&P 500 Index at an August 23 low on body blows from worries over emerging markets, trade policy, and the tech-sector outlook before staging a partial recovery Monday. It was news Friday of a jump in wages that struck at the heart of the market's strength, threatening to shave earnings growth beyond a cut of more than one-half as the boost from lower taxes washes out of year-ago comparisons. Energy and tech bore the brunt of the declines since the end of August. Energy stocks have been hurt by price declines in a losing tug of war between worries over future supply shortages and concern over the outlook for global oil demand amid signs of slowing overseas economic growth. Tech has suffered from a confluence of worries over trade protectionism, regulation, and doubts over the pricing sector's outlook. Dual-purpose utilities and consumer staples have been wearing their defensive sector caps in outperforming the S&P 500 Index despite rising yields on competing bonds normally weighing on interest-sensitive sectors.

"Home body" domestic-oreinted stocks well ahead of their global counterparts

Index vs. S&P 500; Nov. 21, 2014 Week=100



Source: Goldman Sachs, Inc.; Bloomberg Fin'l News, Inc.

Even more impressive has been the relative performance of domestic-oriented stocks, extending a prolonged, at times irregular, rally, leaving them at least at their highest level against the S&P 500 Index since 1999 according to Goldman Sachs style-group indices. Domestic-oriented small caps have bucked that trend to some extent, lately hurt by the backup in interest rates. Elsewhere, international stocks continued to bear the brunt of U.S.-inspired trade protectionism and increased emerging market contagion, aggravated by higher U.S. interest rates and by dollar strength. The U.S. locomotive role as a global growth engine, historically so effective in leading the international out of (and into) recessions has been short-circuited by U.S. protectionist threats and the Fed's leading-edge normalization compared with more tentative moves by central banks in other more fragile economies abroad.

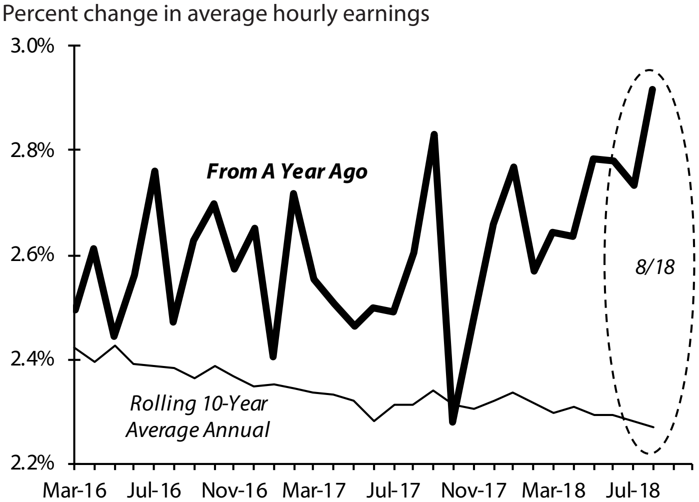
Increased momentum in the second quarter's world trade growth—a reflection of that U.S. economic pull and a growth engine in its own right—was overstated by accelerated shipments ahead of a first wave of U.S. tariffs and retaliation in July. More current indications of tariffs' impact are apparent from back-to-back U.S. export declines in the June–July period and from unexpected slippage in the trade-oriented German economy's July factory orders and output. At issue is the U.S. economy's ability to detach itself from a de facto stress test it imposes on the global economy through higher interest rates and associated dollar strength capable of aggravating international market turbulence and weakness. The benefit of a strengthening dollar to our trading partners' export competitiveness is being outweighed by the debilitating effect on commodity prices, dollar debt burdens, and liquidity in local financial markets, risking the sort of disorderly market conditions forcing delay in the Fed's rate increases in 1998 and again in 2016. The dollar's key currency role may confer significant advantages on the U.S. financial market, but it often adds a complicating international dimension to policy considerations that is difficult to ignore.

A lesson learned? Noteworthy dates in what has been the most difficult month of the year for stocks include a likely eighth rate increase by at the Fed's September 26 Federal Open Market Committee meeting; a reconstituted S&P 500 Index after the market's close on September 28, creating a new communications sector similar only in name to the telecommunication services sector that it is replacing; and a mid-September expiration of the old 35% tax rate applied to pension-fund funding write-offs spurring fund investments in longer-dated Treasury securities helping to suppress bond yields. Mid-September also will mark the 10th anniversary of the Lehman Brothers bankruptcy filing, ushering in the near meltdown of the financial markets and a decade-long adjustment shaping economic and investment performance. Much has been written about the causes of the financial crisis and its human and economic toll. A long, slow economic adjustment from the deep recession that followed rightly was anticipated by students of earlier financial crises.

Adjustment has taken a few unexpected turns, and it's a safe bet that any future turbulence from today's financial excesses will flow through channels different from housing, over-leveraged consumer and bank balance sheets at the heart of the last crisis. Among the potential flashpoints in any future turbulence are nontraditional financing venues, including private equity exchange-traded funds plus a potentially unsettling role for rapidly growing passive investments. All could be coming to a head, as the Fed continues to raise rates in pursuit of its mandated full-employment growth and price stability. Often overlooked in the discussion of past crises and the risk of future ones is an economic environment of low inflation and subdued interest rates conducive to asset-price inflation; leveraging; and, ultimately, disruptions to market liquidity. The tendency of the Fed and foreign central banks to attach a higher priority to growth plus goods and services (i.e., consumer price) inflation at the expense of asset-price stability fosters the kind of market behavior giving rise to financial excesses in highly charged trading activity ultimately risking disruptions to the availability of financing often far more serious and far reaching than changes to its cost.

Breaking free: average hourly earnings accelerating away from their long-term average

Percent change in average hourly earnings



Source: U.S. Labor Department Data.

Front and center for wage inflation. Fresh signs of brisk but narrowing growth on the week were overshadowed by long-awaited seepage of tight labor market conditions into wage inflation, climbing to a 9.5-year high on an outsized August increase. For now, the economy is benefiting both from the lift to household purchasing power supporting consumer spending and, at the same time, avoiding margin pressure from productivity gains strong enough actually to lower unit labor costs. That happy combination is not likely to last if, as expected, an economy slowing to a more sustainable pace lowers productivity growth with it. Consequently, the buildup of wage pressures strengthens the case for multiple rate increases by the Fed into 2020, economic growth and financial stability permitting.

For now, real-time gross domestic product growth estimates of about 3% to the nearly 4.5% are more than adequate for multiple rate increases through the end of this year. An unexpectedly strong increase to a 14-year high in the August purchasing managers' index for manufacturing was followed by a stronger-than-expected rise in the month's dominant nonmanufacturing sector consistent with strong growth there. Equally impressive was news of a decline in initial jobless claims to a 49-year low in the final week of August. Other data showed strength centering increasingly on consumer spending and investment. Disappointing auto sales slipped to a 3.5-year low, joining early-cycle housing in a long-overdue slowdown. However, much of the void was filled by non-auto spending, judging from the rise in weekly chain-store sales to a 12-year high in the latest 4 weeks, supported, in part, by added income from the slower pace of auto sales and lower gasoline prices. Equipment spending weighed in with support from an upward revision to double-digit growth of capital goods orders in an advance report of the prior week, countering a wind-down of usually supportive, late-cycle commercial construction spending through July. Foreign trade weighed on economic growth through mid-summer, as well. Payback for earlier strength spurred by looming tariffs triggered back-to-back declines in June–July exports and the widest trade deficit in five months.

Looking ahead, another full, back-loaded calendar will feature August updates on top-tier producer and consumer price reports, retail sales, and industrial production for the month, and the mid-week release of the Fed's Beige Book survey of regional economic conditions for a good top-down view of economic conditions in the Fed districts around the country. The Treasury will be making its presence known with a $73 billion three-part sale of 3-, 10- and 30-year securities Tuesday through Thursday. At center stage for investors splitting their attention between economic reports, fallout from recent emerging market turbulence and the latest U.S. protectionist will be August consumer and producer price reports for signs of follow-through to the accelerated rise in wages signaled in Friday's jobs report. Consumer price inflation already has been accelerating to a 6-year high in the 12 months to July.