Marketing Communication

Market comment for the week of September 21, 2018

Distant Drums

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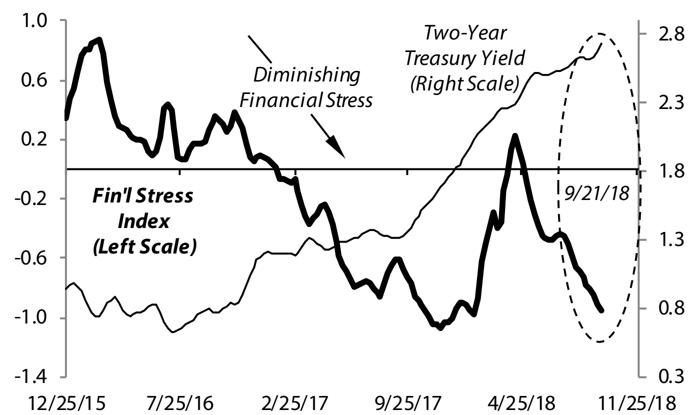
… and full speed ahead. Stocks are plowing through a historically difficult month in climbing to record highs on economic and earnings optimism reinforced by a more upbeat spin to an escalating trade war between the U.S. and China. Risk-on trading has given added support to a fairly typical rally into the early and middle stages of an interest rate up cycle, drawing on safe-haven demand suppressing bond yields enough to lift the S&P 500 Index's price/earnings (P/E) multiple back to a February 2018 high of over 17 times projected 12-month earnings. Market optimism also has helped propel a narrow portfolio of risk assets to a seven-week high against their more conservative, safe-haven counterparts, paced by solid gains in U.S. and emerging market stocks. The tug-of-war between stock market positives and negatives has combined with still-ample market liquidity to suppress volatility, much like early this year. A below-average VIX index of implied volatility more recently has been accompanied by a reversal from a historically high level in the skew index, a VIX cousin, effectively measuring the chances for outsized declines by stocks.

Diminishing financial stress, even as interest rates rise



Source: Bloomberg Financial News, Inc.

As impressive as the stock market's late-cycle rally has been, the sector rotation sustaining it, moving to utilities and other yield-oriented sectors when high-flying tech stumbled on worries over heightened regulation, trade protectionism, and revenue gains in parts of the sector, then on to energy stocks as interest rates rose and oil prices regained momentum. Second-place telecommunication services has been the exception to interest-related weakness across most high-dividend stocks, a fitting end for a sector to be absorbed beginning Monday into a broader, more dynamic communications services sector that includes social media and high-tech consumer-oriented companies. Rebalancing has been all the more impressive within the confines of seemingly uniform sector returns signaled by elevated correlation and diminishing returns dispersion.

Still-ample market liquidity conditions have supported the rotation toward riskier assets, punctuated by a decline in financial stress indices (based on yield spreads and volatility, among other things) back to their reading on the eve of the market correction in early February despite ongoing increases in Treasury interest rates. So-called quality spreads have responded, sending the risk premium on U.S. non-investment-grade securities to their leanest in nearly a decade amid oversubscribed offerings with diminishing investor restrictions on loan and bond issues.

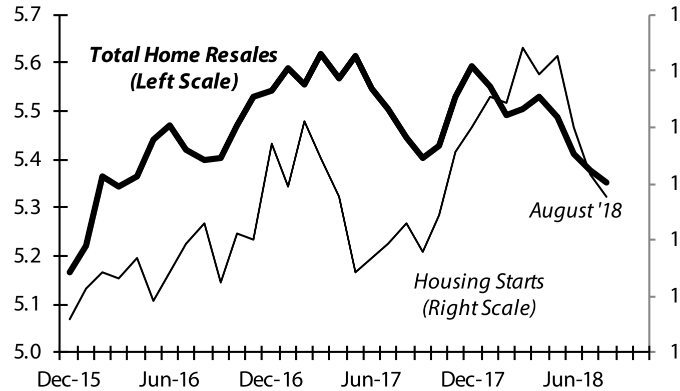
At issue, however, is the ability of market liquidity to survive the latest backup in interest rates, leaving the benchmark 10-year Treasury yield at a 4-month high of nearly 3.1%. More important than the seemingly short-lived pressures behind the rise—ranging from hedging-related sales to accommodate a heavy corporate bond calendar, a tax-related decline in pension fund purchases, and an unwinding of overseas flight capital—has been an increase in investor inflation expectations and real or inflation-adjusted rates better measuring their bite to economic activity. For example, the so-called breakeven rate for a 10-year Treasury inflation-indexed (or TIPS) security—a gauge of investors' inflation expectations—is at an early-June high and its stated yield of over 0.9% is back to a level not seen since early 2011. Added pressure on rates could come from worsening supply/demand technicals, including increased budget deficits, the Fed's balance sheet wind-down, and the risk of more subdued institutional demand at home and abroad.

Historically low yields still haven't climbed enough to pose a systemic threat to the asset markets. However, recent increases already may have helped lift yield premiums on non-investment-grade, emerging market government securities to a three-year high against U.S. high-yield counterparts. Moreover, sizable increases in U.S. bond yields have produced the steepest 4-week loss on the 10-year Treasury note in 7 months, aggravated by unusually high sensitivity to given interest rate changes in an unusually low yield environment. Investors' rising inflation expectations pose a double-barrel threat to bonds, strengthening the case for multiple rate increases by the Fed and directly pressuring inflation-sensitive yields higher. Emerging and global market stability could, in turn, face a more systemic test from deflation pressures should the dollar follow interest rates higher. Stocks face their own double-barrel threat from rising rates, leaving rich valuations exposed and earnings growth vulnerable to an economically debilitating rise in inflation-adjusted interest rates. The market also will be tested by the loss of nearly half S&P 500 Index earnings growth as higher corporate tax rates wash out of easy year-earlier comparisons in 2019, aggravated, perhaps, by a shift to more moderate economic and corporate revenue growth.

A different kind of tapering. A shift to sustainable, more narrowly based economic growth has been the message from the economic data since early September. Record small-business optimism in August left little doubt that the economy maintained a good head of steam midway through the third quarter. And solid gains in real average weekly earnings (a proxy for household purchasing power) plus an unusually high reading for early-September consumer sentiment point toward more consumer-led growth during the closing months of the year.

Still unclear, however, is the extent to which high-flying manufacturing is relying on closed-end inventory building from lean midyear levels rather than more open-ended support from underlying domestic and foreign demand. A disappointing August retail-sales report left rolling, three-month growth of underlying sales (excluding gasoline stations and building supply stores) at a first-quarter low during the summer, striking at the heart of the economy's core strength. And the pace of housing activity continued its gradual descent through August, judging from new-home construction and resales, risking a vicious circle from increased construction and remodeling costs adding to interest-related pressure on affordability. The specter of last year's surprising bout of disinflation surfaced recently, as well, as an unexpectedly modest rise in August consumer prices broke a string of year-to-year increases in inflation dating back to December.

Housing's gradual descent extends through August
Millions of units



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

Economic policy will contend with the economy's strengths as a key outlook issue during the balance of this year and into 2019. Front and center are the Fed's rate hikes and their effect on financial market stability, as the increases weigh on the economy's credit-sensitive sectors. Fiscal policy will remain in the forefront as stimulus winds down in the coming year, too, absent a postelection "tax cut 2.0." Moreover, asset-market complacency over recent and prospective rounds of tariff increases won't be tested fully until they work their way through the global supply chain, initially lifting inflation and ultimately squeezing incomes, spending, and global economic growth next year.

Capping a full events calendar in the coming week will be the long-awaited Federal Open Market Committee meeting Tuesday and Wednesday, top-tier consumer confidence for September, along with durable goods orders, new-home sales, and advance foreign trade for August. The Treasury also will be weighing in with a $123 billion three-part offering of 2-, 5-, and 7-year Treasury notes Monday through Wednesday. Investors looking beyond another quarter-point increase in the federal funds target rate, seemingly baked in the cake at Wednesday's policy meeting, will key on Fed Chair Powell's press conference remarks for clues to the timing and trajectory of future rate increases into 2019. Economic data will be scrutinized for a loss of economic momentum or for signs of another sustained bout of disinflation similar to last year's episode affecting the outlook for multiple rate increases by the Fed this year and next.