Marketing Communication

# Market comment for the week of October 1, 2018

## "It's the Economy, Stupid"

Gary Schlossberg

**Fed riven, Fed driven.** U.S. stocks are on a roll coming off the best quarter for the S&P 500 Index since late 2013 in a rally supercharged by news of a North American Free Trade Agreement replacement agreement raising hopes for an early end to the trade wars with China. Bedrock support for stocks and other risk assets also is coming from ongoing optimism over the economic and earnings outlook propelling the S&P 500 Index's valuation to a 7-month high of over 17 times forecasted earnings during the next 12 months, 15.5% above its long-term average. Investors have shrugged off worries over extended interest rate hikes by the Federal Reserve (Fed), keying, instead, on improving financial stress indices (based on risk premiums and market volatility) approaching those during the late-January melt-up on the eve of the market's correction. Yields in the final week of the third quarter steadied enough to support a first gain across the bond market in over a month, paced by foreign developed and emerging market securities and, here in the U.S., by investment-grade corporate issues. It was the rebound in emerging market debt issues that led the rise in a narrow group of risk assets to a record high against their safe-haven counterparts as the quarter came to an end, overcoming slippage in U.S. stocks.

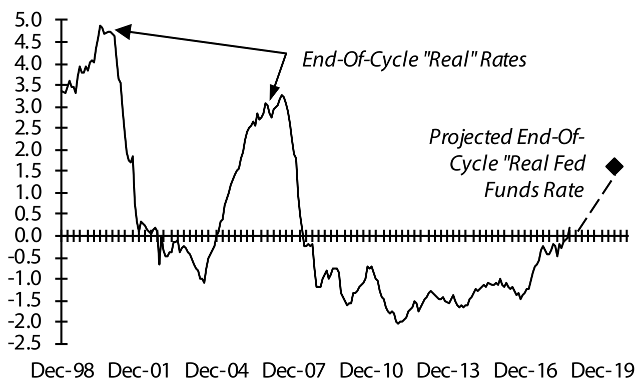
Investors are counting on earnings growth of more than 20% in the third and fourth quarters to sustain the stock market's rally through the end of the year. Macro forces filling the void ahead of the unofficial start, in a week, of the third-quarter reporting season included a supply-driven rally in oil prices to a new four-year high, propelling energy stocks to the top of the sector performance rankings. Dollar strength and worsening trade tensions with China pummeled bottom-ranked materials producers on the week. And lower yields late in the period helped send financial services into the red while lifting utilities and the market's other bond-like sectors.

Temporary yield declines supporting the stock market's interest-sensitive sectors and, to some extent, its rich market valuation were an unexpected response to the Fed's hawkish tilt at the midweek Federal Open Market Committee (FOMC) meeting. At the meeting, it raised the federal funds target range to 2.00% to 2.25%, dropped accommodative from its description of Fed policy, and coalesced around a December rate increase and similar steps into 2020. Safe-haven demand may have played a supporting role in the late-week rally, responding to a looming showdown between the European Union and Italy following that country's release of an aggressive budget exceeding deficit caps. More important was the Fed's latest policy slant, combined with signs of moderating economic growth and reduced price pressures slowing inflation and capping investors' inflation expectations at a four-month high on the eve of Wednesday's policy meeting.

Lost in the debate over the Fed's current policy stance was an important milestone in its rate normalization process raising the federal fund's target rate moving above inflation—a gauge of policy tightness—for the first time in over a decade. Future rate increases likely widening the gap with inflation through 2020 will weigh increasingly on the economy, much like Fed policy has during past tightening cycles. Rate increases amid historically low and subdued inflation have been justified as giving the Fed greater leeway to maneuver rates during any future economic slowdown without resorting to the distorting effects of negative interest rates more common abroad.

**An unusually "lean" end-of-cycle forecast For the inflation-adjusted Fed funds rate**

Fed funds rate less year-ago % change "core" PCE deflator




Sources: Federal Reserve Baord; U.S. Commerce Department.

As seen in the chart above, however, even the multiple rate increases outlined in the FOMC's official forecast through 2020, to less than 3.5%, imply a peak inflation-adjusted funds rate to just a fraction of those during the last few major interest rate cycles. That unusually low end point may be too optimistic, even adjusting for subdued inflation and for a fragile financial market lessening the need for an overly restrictive policy stance. A more pragmatic Powell Fed more likely will be guided by prevailing economic conditions in the run-up to each remaining policy meeting in this rate cycle, raising interest rates until economic growth and inflation stabilize at satisfactory rates and financial market overheating cools.

Navigating an appropriate glide path for monetary policy is complicated in this cycle both by the threat of latent wage-price pressures abruptly responding to dwindling spare capacity and by financial market excesses vulnerable to rising interest rates. An overly cautious Fed risks falling behind the curve both for goods and services (or Consumer Price Index) and asset-price inflation, ultimately forcing policy catch-up through aggressive rate increases putting at risk both the economy and a still-fragile financial market. Moving too aggressively risks an asset bust and de-leveraging serious enough to affect the smooth flow of liquidity and credit availability, potentially more disruptive to economic growth than rising borrowing costs. Twin uncertainties complicate formulation of an appropriate neutral rate for the economy that is both economically neutral and capable of unwinding financial market distortions in a manageable way.

**Past its prime?** Economic data stayed on message in the latest week, portraying moderating but still-respectable growth accompanied by fresh signs of subdued inflation. Real-time growth estimates converged around the 2.75% to 3.75% range on data judged as disappointing from a worsening, still-negative Citigroup Economic Surprise Index (measuring actual against expected data results) in the final week of September. Weakening housing activity and worsening foreign trade have accounted for most of the slowdown, countered by strength centered on consumer spending and business investment. September's regional and U.S. purchasing managers' surveys showed strong manufacturing growth still on track but propelled as much by seemingly closed-end inventory gains, rebuilding depleted second-quarter stocks, as by more open-ended strength in underlying sales.

Consumer and investment spending did lose momentum in August, though neither showed signs of unwinding. Consumer spending's inflation-adjusted growth in the latest three months (akin to a trend at the margin) did slow to a rate of less than 3%, but solid gains in household purchasing power and wealth along with historically high confidence levels bode well for a rebound during the balance of the year. And an unexpected decline in equipment orders on the month followed solid gains earlier in the summer that left three-month growth at an impressive double-digit pace. By contrast, moderating home-price increases and news of a fourth straight decline in the rolling average of new-home sales in the latest three months showed housing continuing to struggle, responding to recent pressure on affordability from rising mortgage rates. Trade protectionism began to make its mark on U.S. foreign trade, too, judging from steepening, broad-based export declines during the summer.

A shift to a more sustainable, late-cycle pace of activity lessens the threat of bottlenecks and overheating capable of growth-threatening increases in inflation and interest rates. The more subtle, less traditional threat to growth in this asset-fueled cycle ironically is from renewed disinflation beginning to emerge from the latest price data. Slowing inflation typically is growth-supportive through its lift to purchasing power and its restraining effect on interest rates. In this cycle, however, a repeat of last year's unexpected decline of inflation, lower interest rates, and delayed rate increases by the Fed risks overwhelming those advantages by aggravating asset-price inflation, leveraging, and other financial market distortions enough to affect the smooth flow of liquidity fueling economic activity.

Top-tier jobs data for September will headline the remaining data calendar, accompanied by Fed Chair Powell's Tuesday and Wednesday appearances at the annual conference of the National Association for Business Economists and at a Washington, D.C., panel discussion. Investors will be scrutinizing the data for its strength and composition amid signs of moderating, narrowing growth in the third quarter. Look for a downward bias to September data, hurt by the effects of Hurricane Florence, that should be reversed by a typical reconstruction-related rebound during the closing months of 2018. Also noteworthy will be Friday's wage increase in the September jobs report for signs of follow-through to the labor-cost pickup in August. Moderating growth still should be strong enough to support a seemingly hawkish tilt to policy in last Wednesday's FOMC communique, in its dot-plot interest rate forecast, and in comments by Fed Chair Powell at the post-meeting press conference.