Marketing Communication

Market comment for the week of October 5, 2018

"Normalizing!"

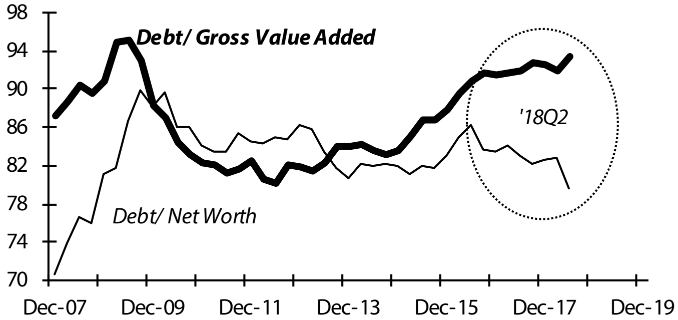
Gary Schlossberg

October blues. Stocks' two-day sell-off had investors eyeing the calendar in a reminder of October's reputation as a market with above-average returns but notorious for steep declines. The S&P 500 Index's 1.50% drop from its record high just over a week ago pales in comparison to the month's deep dives in 1929, 1987, 1998, and 2009. However, the latest setback was jarring enough for a market coming off another in a series of seemingly one-way rallies leaving its rich valuations all the more vulnerable to a reversal.

Market vulnerability has been aggravated by uneven adjustment compared with an economy closer to normalization than either interest rates or asset prices. Dwindling excess capacity and the slow turn from disinflation—both supported by a return to more satisfactory and resilient economic growth—stand in contrast to financial conditions still liquid enough to encourage a reach for yield and return in riskier, still-inflated assets and excessive leveraging despite last week's setback. That's left stocks and other risk assets exposed to the kind of broad-based interest rate rise of the past few days, led by those on longer-dated securities, sending the benchmark yield on the 10-year Treasury note to a 7-year high of nearly 3.25%. This so-called bull-market steepening of the Treasury yield curve, signaling a vote of investor confidence in the economic outlook, has moved it away from a feared inversion (in which short-term rates rise above longer-dated maturities) associated with a recession.

Adding to an unsettled link between the economy and asset markets have been rapid increases in more volatile equity values inflating corporate balance sheets, household net worth, and associated increases in borrowing power. While the midyear debt net worth ratio of nonfinancial corporations still was slightly below its long-term average, leverage based on more stable output value added was more than 25% above its norm. And the share of household net worth in equities, at an 18-year high of over 27% at midyear, exceeded that of homes by a wider margin than it did in the run-up to the financial crisis a decade ago.

Is corporate leverage understated by elevated equity values?
Non-financial corporations; In percent



Source: Federal Reserve Board.

Triggering the past week's interest rate rise were strong economic reports plus a hawkish spin to Federal Reserve Chair Powell's remarks, encouraging investors to look past a sanguine view of the wage-price outlook in keying on his upbeat view of the economy and scope for further increases to or beyond a still-to-be-determined neutral interest rate.

Rate increases centered less on inflation expectations than on their real or inflation-adjusted component are keyed more to economic strength, reduced safe haven, Fed and other demand, or increased debt supply. The positive spin to increases tied to inflation-adjusted rates is that they are driven by the same economic strength supporting corporate earnings growth. Moreover, such increases help allocate capital more effectively by removing distortions in yields aligning with economic growth and inflation fundamentals. The downside is two-fold. First, real interest rates, a gauge of monetary policy's bite to economic activity, create a potential headwind to economic and earnings growth as they continue to rise. And rising yields, regardless of their driver, typically weigh on rich stock and other risk-asset valuations by cheapening competing bonds. Friday's S&P 500 Index price/earnings (P/E) multiple of 16.7 times forecasted earnings in the next 12 months still is nearly 13% above its long-term norm. Inflation-adjusted yields of 1.1 percentage points—still just a fraction of their average 1.8 percentage points, based on the stated yield for the 10-year Treasury Inflation-Protected Securities since its inception in 1997—have room to squeeze valuations before they weigh materially on economic activity.

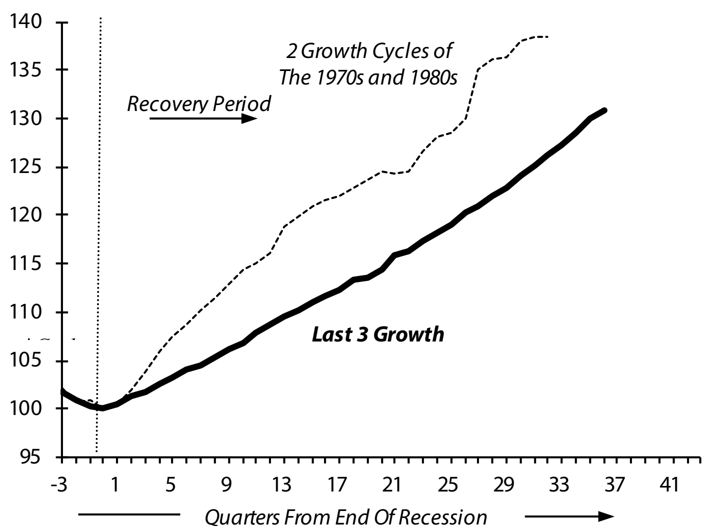
Less clear is the outlook for inflation, the other interest-rate component. Strong economic growth threatens inflation directly, through pressure on dwindling excess capacity, and indirectly, through increased pricing power. Among strong growth's counterweights to a more rapid inflation buildup are healthier gains in productivity, easing pressure on unit labor costs, profit margins, and selling prices. Higher interest rates also support dollar gains dampening import-price increases and, ultimately, pressure on capacity. The global economy's moderating growth acts as a restraint, too, by easing pressure on capacity worldwide, adding to restraint on import prices directly and indirectly, by supporting the dollar. And then there are the exogenous shocks from higher oil prices and from tariff increases working their way through the economy, less affected by U.S. economic strength or weakness and capable of early cost-induced pressure on growth. Beyond that are inflation's structural restraints contributing to prolonged disinflation, including heightened global competition; weaker labor unions; an aging, slower growing population; cumulative deregulation; and market-disruptive innovations.

High flyer. Solid economic reports out much of the week countered earlier signs of moderating growth at the end of the third quarter, lifting the Citigroup Economic Surprise Index (measuring actual versus expected economic data) into the black for the first time since mid-July. Clear from the data, however, is narrowing support for this growth cycle from housing and foreign trade, leaving consumer spending and investment to do most of the heavy lifting. Real-time third-quarter growth estimates still are clustered in the 2.75%–3.75% range, with the Atlanta Fed's highly regarded GDPNow estimate an outlier at 4.1%.

This is the third straight growth cycle showing some of its best strength years after its start, forgoing the usual burst of economic activity in favor of less highly charged gains better-suited to an extended economic expansion. Decades-long disinflation has fostered this pattern of activity, contributing to mild recessions in 1990–1991 and in 2001, limiting pent-up demand powering strong growth early in the rebound. Prolonged balance sheet rebuilding after the deep meltdown-induced slump in 2008–2009 had much the same effect on the economy's trajectory during this decade-long recovery. Prospects for gradual reinflation could dampen future economic cycles even as they leave the economy exposed to a highly charged financial market capable of disruptions similar to a decade ago.

Slower, but steadier growth cycles since 1990

Real GDP, end of recession=100



Source: U.S. Commerce Department.

Capping the past week's upbeat economic reports and setting up the stock and bond market for a late-week decline were Thursday's outsized increases in the September purchasing managers' report for dominant nonmanufacturing and in private sector employment estimated by ADP Corp. A positive spin to the September jobs report had investors looking past hurricane-distorted employment numbers to the unemployment rate's decline to a 48-year low as a sign that still-subdued wage inflation soon will be turning the corner. Elsewhere, consumer-led growth maintained a good head of steam into the fourth quarter with solid weekly chain-store sales throughout September reinforced by a reported increase in the seasonally adjusted auto-sales pace on the month to a November 2017 high. And downward-revised capital goods orders for August still left three-month growth at a double-digit rate. By contrast, a wider-than-expected trade deficit, hurt by another monthly decline in exports, added to the drag on economic growth from worsening foreign trade.

Inflation will move to center stage in this week's thinner events calendar as investors eye fall-out from solid activity data on key September price reports out Wednesday and Thursday. Bracketing that news will be Tuesday's Small Business Optimism Index for September plus Friday's updates on the month's export-import prices and early-October consumer sentiment from the University of Michigan. Also on tap will be a $74 billion three-part sale of 3-, 10-, and 30-year Treasury securities Wednesday and Thursday. An outsized increase in September Consumer Price Index inflation, reversing August's equally unexpected decline, risks adding to investors' inflation expectations and increasingly less sanguine view of monetary policy aggravated by last week's batch of strong activity data.