Marketing Communication

Market comment for the week of October 12, 2018

A Fall Classic

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Rope burn. Welcome to October, a month known for above-average returns but notorious for top-ranked volatility punctuated by some of the deepest slumps in the market's history. The month hasn't disappointed this year with two weeks still to go. The S&P 500 Index's 5.5% decline from its September 20 peak (over 4% of which was in the latest week) is well short of the near-11% correction early this year and pales by comparison with the month's deep dives in 1929, 1987, 1998, and 2008. The setback in stocks helped lift investment-grade bonds on the week, accompanied by a decline in high-yield securities of just a fraction of the S&P 500 Index's slump.

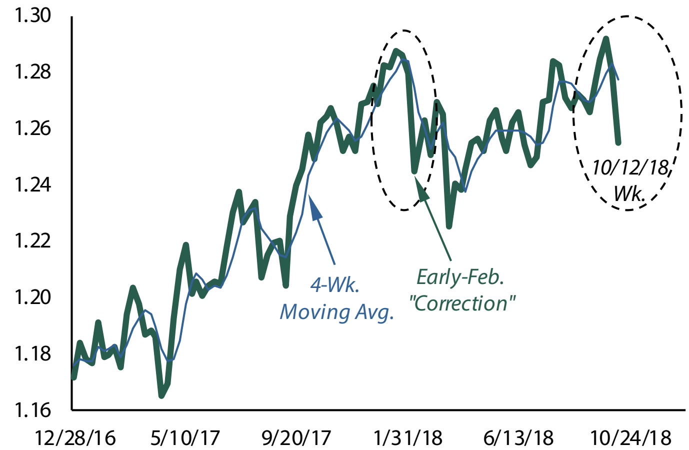
Rising interest rates were the catalyst for the stock market's latest setback, a by-product of the strong economic growth underpinning stock-friendly earnings performance. That, plus Federal Reserve (Fed) Chair Powell's upbeat view of the economic outlook, interpreted as a hint of aggressive rate increases to come, lifted the 10-year Treasury yield to a 7-year high that left rich valuations all the more vulnerable. Friday's price/earnings (P/E) multiple of 16 times forward earnings for the S&P 500 Index, though at a September 2015 low, was well above its 12.1 times reading when yields last were this high in May 2011, even after adjusting for stronger long-term earnings-growth expectations embodied in the so-called PEG ratio (or valuations adjusted for long-term earnings-growth expectations).

Interest rates may not be high enough to threaten the economic growth cycle or corporate earnings performance, but they already are attractive enough to draw income-oriented investors away from stocks. Yields across the Treasury maturity spectrum (including Treasury bills) exceeded the S&P 500 Index dividend yield, even after its lift to a four-month high from the latest slump in stock prices. That includes an advantage favoring the 10-year Treasury yield, at over 3.15% Friday, of more than 1.25%. Only bond-like utilities sport a dividend yield exceeding any in the Treasury sector.

Yields aside, doubts already have been creeping into an extraordinarily bullish earnings outlook beyond another solid, 20% rise expected to be reported for the third quarter. Earnings growth will lose about half its strength as easy year-earlier comparisons with pre-tax-cut incomes wash out early next year. Beyond that are worries over margin pressure from rising oil prices and interest rates, latent wage pressure from a tight labor market, and the still-unknown impact on costs of proliferating tariffs just beginning to work their way through the economy—all aggravated by uneasiness over moderating growth abroad, Italy's fiscal confrontation with the European Union, and ongoing geopolitical strains. For that reason, stocks during the current reporting season may be influenced as much by company comments on the outlook as by profits relative to expectations.

"Risk" assets on the comeback trail against their "safe-haven" counterparts

Ratio of total return indexes, risk/ safe haven portfolios, 12/21/05=1.00



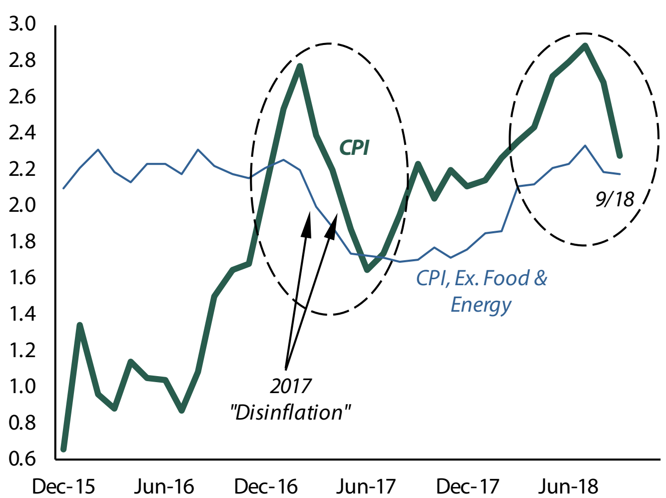
Source: Data from BofA Merrill Lynch, Inc; Bloomberg Fin'l News, Inc.

Like the much steeper decline in early February, last week's setback had plenty of conviction in extending across all 11 S&P 500 Index sectors and all but 7 of its 125 constituent industry groups. Now, like then, more highly charged risk assets—including emerging market stocks and bonds, corporate and high-yield debt, and U.S. stocks—have borne the brunt of the decline, falling to a 3-month low in the latest setback compared with a 4.5-month low in early February. Interest-sensitive and defensive (or less economically sensitive) utilities have been the most resilient in both down markets, accompanied by other interest-sensitive sectors despite surprisingly moderate declines in bond yields. However, trade-sensitive materials producers and industrials have replaced energy stocks at the bottom of the S&P 500 Index performance rankings on protectionist concerns and slowing growth abroad. Small caps have been hit harder than large-company stocks in the past week than they were early this year on worries over exposure to higher interest rates, while Russell 1000 Value stocks have done better against growth this time on attractive valuations and recent signs of U.S. economic strength.

It may be too early to gauge the lasting effects of the market's latest setback from its worst weekly setback since March. However, the S&P 500's pullback has all the markings of a reaction to an overstated rise carrying the benchmark index nearly 11.5% from its most recent low in early May. Support is coming from solid economic growth underpinning the earnings outlook, for now, despite rising oil prices, higher interest rates, and looming headwinds from diminishing fiscal stimulus in the coming year. Moreover, early signs of reduced price pressure, if sustained, could short-circuit increases in bond yields and, perhaps, slow the pace of Fed rate increases in much the same way that inflation's decline did last year. However, stocks likely will face added bouts of turbulence as interest rates eventually align with economic growth and inflation fundamentals after years of financial suppression, exposing levered balance sheets to higher borrowing costs and encouraging a rotation by conservative investors into higher-quality securities aligned more closely with risk tolerance after years of reaching for yield.

Disinflation's long goodbye. A potentially far-reaching message from the past week's economic data was a possible drawn-out transition from low and declining inflation, despite solid economic growth and adjustment to post-meltdown weaknesses. Subdued inflation constraining market-driven interest rates and rate hikes by the Fed could sustain the reach-for-yield mentality of investors dissatisfied with historically low returns on high-quality assets, fostering ample liquidity inflating leverage and asset values.

Will another bout of "disinflation" sidetrack interest-rate increases?
Year-ago percent changes



Source: U.S. Labor Department.

A modest rise in the September CPI, the week's main event, lowered top-line inflation for a second straight month, to 2.3%, and the core rate (excluding food and energy) to a five-month low of less than 2.2%. Inflation's latest decline, though considerably more modest than the unexpected drop between February and June of last year, nonetheless has been impressive amid stronger economic growth and less excess capacity. Adding to the good news on inflation was reduced wholesale price pressures in September to a five-month low. A first slippage in import prices for manufactured goods since May was especially significant in signaling little impact, thus far, of tariffs on U.S. inflation.

Elsewhere, a light calendar of activity data added to the evidence of moderating but still respectable growth despite weakness in housing and foreign trade. Real-time estimates of third-quarter growth continue to center on a healthy 3.0% to 3.5%, with the highly regarded Atlanta Fed's estimate still above 4%. Sentiment in the labor-intensive small business sector slipped a bit in September but remained within striking distance of its record high in August—good news for an already tight labor market. An unexpected rise in jobless claims during the October 6 week was taken with a grain of salt amid hurricane-related distortions that still left the rate historically low. And consumer-led growth was on display with another solid gain in weekly chain-store sales in early October, overcoming high and rising gasoline prices with inflation-adjusted income's healthiest rise in over two years during September.

The spotlight shifts to activity data in the coming week, with a moderately full calendar capped by September retail sales and industrial production, regional manufacturing reports for early October, the forward-looking index of leading indicators, and home resales for September. At issue is the extent to which hurricanes in the Southeast will distort upcoming September and October data, likely depressing the numbers, to some extent, then inflating them as reconstruction gathers momentum during the balance of the year.