Marketing Communication

Market comment for the week ending November 30, 2018

Destiny Delayed

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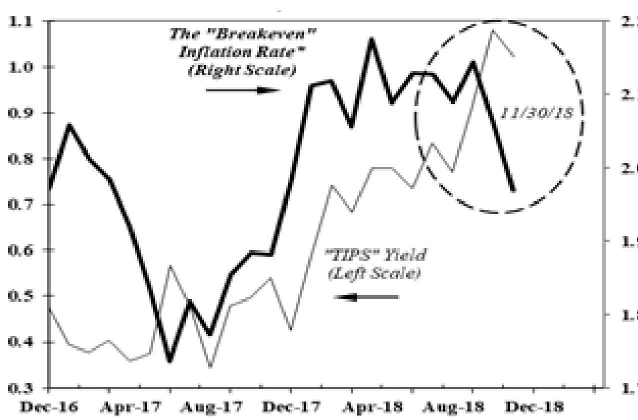
A Powell "put"? Stocks posted their best weekly rally in seven years on Federal Reserve Chair Powell's seemingly dovish policy tilt, reinforced by optimism over prospects for a trade truce ahead of critical talks between Presidents Trump and Xi on Saturday. The S&P 500 Index closed Friday at a three-week high in a broad, deep rally across all 11 sectors and 118 of 125 constituent industry groups, taking some of the edge off red October's 6.8% loss. The benchmark's forward price/earnings multiple ended at a 2.5-year low of less than 16 times next year's projected earnings despite lower interest rates elevating prices, providing an opening for further market gains despite next year's more subdued earnings outlook. The S&P 500 Index paced a rebound from the previous week's decline in a narrow group of risk assets against their safe-haven counterparts, largely reversing the previous week's decline.

Lowered inflation expectations drive Treasury yields lower
The yield and "breakeven" inflation rate* on a 10-year "TIPS", in %



*Needed to equate TIPS yield with a conventional, 10-year yield. Source: Bloomberg Financial News, Inc.

Risk-on trading didn't prevent safe-haven Treasury securities from joining the rally, however, driven by an oil-led decline in investors' inflation expectations leaving the so-called breakeven rate on the 10-year Treasury at a December 2017 low of less than 3% on Friday. Yields on corporate investment- and non-investment-grade bonds bucked the Treasury declines, lifting yield premiums in both markets to a two-year high against comparable government debt as yields bucked the late-week decline in Treasury interest rates. The corporate bond retreat has been attributed by some to less-ample funds in the market amid the Fed's balance sheet wind-down, though still easy financial stress indices are mitigating the pressure.

Powell's implied support to risk assets—via an effective put, or price floor—came from his view that interest rates were closer to neutral in their effect on the economy than they were in a statement by him just a few weeks ago, bringing the Fed's outlook closer to a more cautious futures market now priced for just two rate increases between now and the end of 2019. The chair's seemingly conflicting views in the past two months were a reminder of just how elusive is the concept of the neutral interest rate, or the rate level consistent with the Fed's twin mandates of full employment growth and price stability. Arguably adding to the concept's complexity is the varying impact of a given interest rate level, seemingly beyond neutral, at the moment, in housing, but still low enough to foster more than adequate liquidity and a further reach for yield inflating asset values. Economic justification for the policy tilt could be found in gathering signs of slowing U.S. growth and inflation. Still, the timing of that tilt prompted speculation by some of a Fed capitulation to White House pressure against further rate increases. Presidential kowtowing or not, the timing of the chair's latest policy comments likely will make the market that much warier when the Fed next is confronted with pressure to raise interest rates.

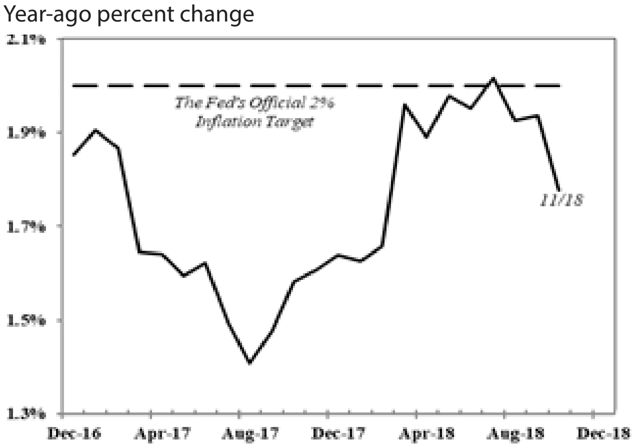
The Fed likely will continue to key on the U.S. economy as a policy guidepost in the coming months, downplaying signs of slowing global growth or international financial turbulence unless they trigger disorderly market conditions threatening the smooth flow of global credit. Placing signs of moderating growth ahead of an earlier stated need to re-establish an interest rate cushion ahead of the next recession is a sound one as far as it goes, given the risk of a self-fulfilling prophecy from premature rate hikes. However, the decision to key policy more closely to the latest economic data leaves monetary policy and the financial market all the more vulnerable to whipsawing from the data's inevitable ebb and flow. And more drawn-out rate increases risk aggravating asset-market distortions fostered by the reach for return in more highly charged assets and by leveraging stoked by historically low funding costs. The silver lining to a flatter interest rate trajectory is reduced pressure on housing and other credit-sensitive sectors of the economy. It also likely will take some of the wind out of the dollar's sails, easing pressure on U.S. exporters; multinationals' translated income from abroad; and, more broadly, deflationary pressure on global liquidity.

The U.S.-China G-20 trade truce was the expected result just ahead of the event, capable of providing residual support to the asset markets this week. Unlike similar arrangements with Europe and Japan, the ninety-day truce between China and the U.S. establishes a March 1 deadline for a negotiated settlement and potential source of market turbulence ahead of that date. A thorough-going agreement, if one can be arranged, likely would have China agreeing to international norms for technology transfers plus arbitration of theft claims and forced multinational handovers. This would be in exchange for lowered tariffs on Chinese exports; renewed access by Chinese telecom companies to U.S. and other foreign markets through closely monitored subsidiaries; and, perhaps, the promise of an early coveted designation of China as a market economy by its trading partners.

December could provide some clarification of remaining threats to financial stability from oil-price uncertainties, the Brexit outcome, and the Italian budget's threat to the European Union's (EU's) cohesion. A likely Russia-OPEC agreement at the December 6 Vienna meeting to cut output would be a first step toward stanching recent oil-price declines, leaving future U.S. output, global oil demand, and prospects for de-embargoed Iranian oil as potential sources of market turbulence. The British parliament's Brexit vote remains a cliffhanger, perhaps leaving the country facing the threat of a hard Brexit crash-out or a politically unsettling second referendum. A "no" vote on the Brexit accord risks compounding uncertainties within the EU ahead of the group's decision this month on an Italian budget with an unacceptably high deficit.

Recent and prospective developments in the U.S. economy, trade, and Fed policy plus unsettled global conditions risk a delayed return to sustained, respectable economic growth, re-inflation's cyclical and secular turn, interest rates more in line with the economy's fundamentals, and less highly charged asset markets. Whether this latest twist is nothing more than a short delay in the transition to a more normal investment environment or something more fundamental could be shaped by a combination of the internal workings of the growth cycle, outside exogenous forces—notably tariffs and global oil prices—along with the Fed's reaction to them.

Is "core" inflation heading for another bout of "disinflation"?
Year-ago percent change



Source: U.S. Commerce Department.

More lamb than lion at the end of 2018? Economic data stayed on message during the final week of November, signaling moderate but narrowly based consumer-led growth. Growth's shift to a more sustainable 2.6% rate from 4.2% in the second quarter and 3.5% in the third quarter was accompanied by an erosion in its pattern, driven increasingly by an inventory buildup through October, masking the weakest growth of underlying demand—1.2% in the third quarter—in nearly two years. Still-solid income and spending growth through October was accompanied by the report's core inflation estimate of 1.8% in the past 12 months, a February low. Healthy income growth and subdued inflation supports the economy through increased purchasing power and by interest rates subdued enough to kindle household wealth and borrowing power, housing, and other credit-sensitive sectors of the economy.

Weaknesses beyond an encouraging personal income and spending report were responsible for a first negative reading in the Citigroup Economic Surprise Index (measuring actual versus expected data results) in a month. Housing is the economy's most visible soft spot, with home-price increases continuing to slow through September and the pace of new and pending home sales slipping more than expected. The foreign trade deficit continued to widen, as well, to a level not seen in 10 years based on October's advance report. This unusually long growth cycle is well positioned for an assault on the record if growth is sustained through June 2019. Signs of moderation, understandable after a decade-long expansion—roughly double the norm—lessens the risk of overheating in a fully employed economy, igniting inflation and interest rates and upending the economy's credit-sensitive sectors. The biggest risk at the moment is of another disruption in the financial market triggering a credit squeeze that sinks the economy.