Marketing Communication

Market comment for the week ending January 4, 2019

Whiplashed!

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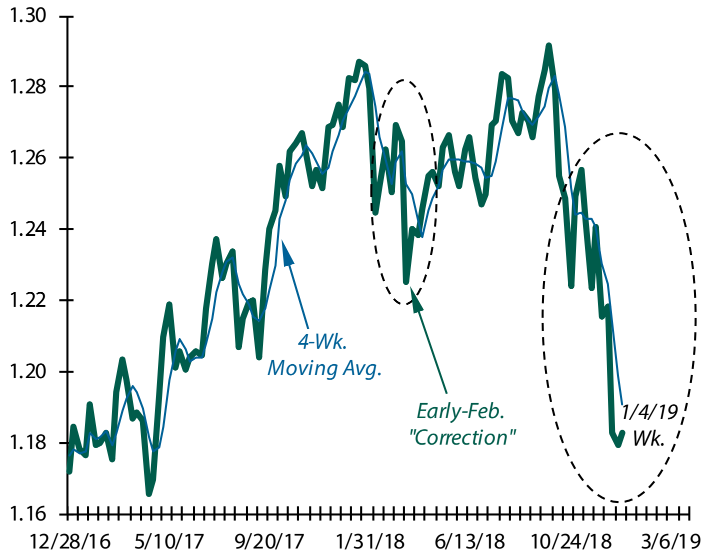
A Hail Mary! Fed Chairman Powell and the Labor Department joined forces for an eleventh-hour save, turning a near-certain relapse by S&P 500 stocks into a second straight weekly rise. Friday's rally, leaving the benchmark with broad, deep gains on the week across 9 of 11 S&P 500 sectors and 100 of its 125 constituent industry groups, triggered a rotation out of Treasury securities that lifted the yield on the benchmark ten-year note from a January 2018 low of little more than 2.55% the day before—not enough, however, to prevent its third straight weekly decline—to 2.67%, that left the yield nearly a quarter percentage point below its average since peaking in early November. The dollar followed yields lower, contributing to broad-based gains in commodity prices with the important exception of economically sensitive copper still vulnerable to global growth concerns. The rally in a narrow group of risk assets—paced by S&P 500 stocks, high-yield and emerging-market bonds—produced a first weekly rise against their safe-haven counterpart in three, lifting the relative value ratio from an April 2017 low.

Powell, the December jobs data stem a deep dive by "risk" assets in the fourth quarter

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



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

Double-barrel support from Powell and the latest jobs report staunched gathering expectations of an early recession this year seemingly out-running the data. An unexpectedly weak purchasing managers' survey of December manufacturing still left the composite consistent with modest-moderate growth. Additionally, Apple Inc.'s more sober revenue outlook, fingering hot-button China trade and a China-led global growth slowdown as causes, reflected company-specific issues, as well. Nonetheless, worries aggravated by the two reports carried investors' inflation expectations down to an 18-month low of less than 1.7% before recovering modestly at the end of the week. Equally striking was the change in policy expectations captured in the Fed funds futures market, shifting from a 95% probability of a rate increase by the December 2019 FOMC meeting on December 3 to no chance of a hike and a 45% probability of a rate cut a month later. Likewise, the Treasury yield curve (the path traced by interest rates at various maturities) was flashing yellow for the Fed policy outlook and its effect on the economy, with a curve inversion, punctuated by diminishing yields between one- and five-year maturities and a drop in those yields below the Fed funds target ceiling.

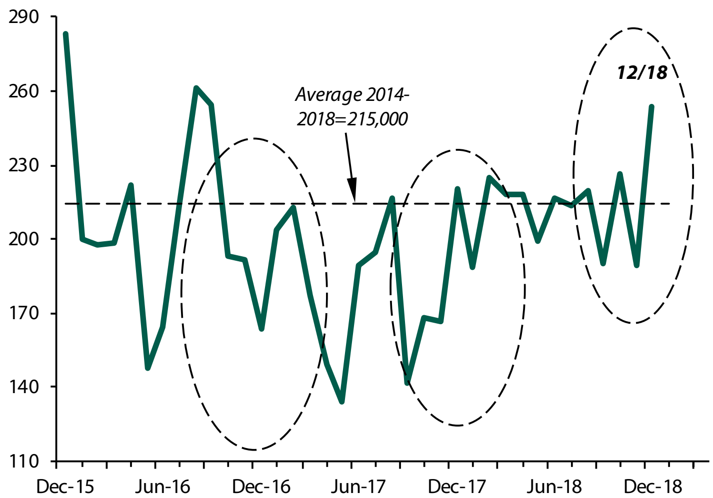
Arguably, the defining event for the market in a tumultuous week was Powell's decision effectively to blink in the Fed's confrontation with market vigilantes, driving rates lower, by expressing flexibility both in the timing and extent of the Fed's short-term rate hikes and (breaking new ground) in the pace of the Fed's balance-sheet wind down. A second stand-down on short-term rate hikes by the Fed in the past four years could turn out to be one of at least two dogs that didn't bark in 2019. A second, helping to drive the first, may be inflation's failure to sustain its rise despite the gradual, but steady buildup of wage pressures. Ironically, the White House may achieve its goal of forestalling further action this year by the Fed less through direct political pressure and more by contributing to turbulence approaching the tripwire creating disorderly market conditions for policy makers.

A decision by the Fed to delay rate increases could defer what was shaping up as a central issue this year—the collision between normalizing interest rates and a levered, inflated asset market. Reduced financial stress and a more benign Fed could counter ongoing uncertainties over trade policy, the government shutdown and the global growth slowdown, shoring up support for risk assets sensitive to rising interest rates in much the same way that they did earlier in this economic cycle by fostering increased valuations. The S&P 500's valuation is at a 5½-year low—measured by its forward price-earnings multiple, even conservatively based on half the consensus earnings forecast of over 7%—with some room for expansion. Attention, therefore, could focus on the response to the Fed's market-friendly remarks by measures of financial stress, credit availability and volatility, whose improvement is capable of soothing investor jitters still sensitive to economic crosswinds clouding the outlook. Most have turned the corner but remain elevated by recent standards. Notable has been the continued rise to a 2½-year high in investment-grade corporate yield premiums to comparable Treasury securities, even as non-investment-grade premiums narrowed with the rally in stocks, and the steepest decline since early 2017 in the monetary base (i.e., currency and bank reserves, the raw material for money-supply growth).

A split decision. Investors whipsawed by a two-part data calendar exited the week wondering which economy best guided strategy. Disappointing economic reports, capped by Thursday's December purchasing managers' survey, left the Citigroup Economic Surprise Index (measuring actual against expected data results) at a September 2017 low, only to be propelled noticeably higher the following day by one of the best jobs reports of the year. Sorting out seemingly contradictory reports on the week shows the economy posting respectable, but narrowly based growth in the 2½%-3% range during the closing months of the year, centered on the dominant consumer and with a supporting role from state and local government spending.

Strong fourth-quarter job growth keeps the economic expansion on track

Average monthly job gains, in thousands; 3-month moving averages



Source: U.S. Labor Department.

Data on the week confirmed that consumer-based strength, underpinned by a solid labor market. Accelerated year-over-year growth of 9.3% in weekly chain-store sales during the December 29 period was at a record high dating back to 1996 (covering periods of considerably higher inflation), pointing to the best Christmas selling season in years. Auto sales continued to defy expectations of sustained slowing with a better-than-expected pace in December. Behind that strength have been steady declines in fuel costs (freeing up income for other spending) and a still-solid jobs market. The showstopper of a December jobs report had payrolls up by their largest amount since February and the three-month moving average well above its norm of the past five years. Equally encouraging was an increase in so-called discouraged workers coming off the sidelines to look for work (and accounting for at least a temporary uptick in the unemployment rate) plus a solid gain in wages needed to sustain income growth's supportive role for consumer spending. Accelerated wage growth has been a mixed blessing for investors concerned about margin pressure from rising expenses and about the incentive for the Fed to revert to more hawkish rate increases if cost pressures ultimately spill over to inflation.

The link between wages and inflation is just one of several questions shaping this year's economic outlook for moderate but sustained growth. First, will economic growth broaden to include a revitalized housing industry, supported by the recent decline in mortgage rates to a four-month low? Second, how will oil-industry cross currents affect the outlook for fuel costs and inflation? And third, how vulnerable is the traditionally closed U.S. economy, historically driven more by domestic spending, to an extended trade war with China and to an associated slowing in global growth?

Bracketing a full, upcoming events calendar will be Monday's purchasing-manager December report for dominant non-manufacturing and Friday's release of consumer prices for the month. Sandwiched between will be a Thursday speech by Fed Chairman Powell at the Economic Club of Washington, D.C., minutes of the December 18-19 FOMC meeting at mid-week and a $78 billion three-part sale of 3-, 10- and 30-year Treasury securities Tuesday through Thursday. Investors here and abroad also will be monitoring the start of mid-level trade talks between the U.S. and China, the first since the early December meeting between Presidents Trump and Xi. Holes in the data calendar will persist until the end of the government's partial shutdown keeping Commerce Department data—including November foreign trade, plus wholesale sales and inventories for the month—on hold with earlier construction spending and housing releases. The Powell speech and FOMC minutes will be scrutinized closely for any follow-through and added color to the Chair's dovish remarks Friday on an American Economics Association panel with former Fed chairs Bernanke and Yellen. Investors also will be monitoring closely upcoming data for guidance after news Friday of an unusually strong December jobs report countered worries over an early recession.