Market comment for the week of January 5, 2018

A rendezvous with destiny?

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A fast start. Stocks burst out of the starting block in the opening week of the year, never looking back (or down) in posting successive highs throughout a holiday-shortened week. Impressive performance by the second-longest stock-market rally on record continued to draw support from the economy's seemingly ageless expansion, fresh tax cuts, and from synchronized growth abroad—all just ahead of fourth-quarter earnings reports centered on a likely double-digit rise in S&P 500 Index profits from a year ago. The market's rendezvous with destiny either will have it breaking the rally's 1990–2000 longevity record (by avoiding a correction through August) or colliding with rising interest rates in a worst-case market correction.

In fact, missing thus far from this year's rally has been last year's yield declines underpinning rich stock valuations. Increases in the benchmark 10-year and policy-sensitive 2-year yields left the former near the upper end of its narrow trading range of recent months and the latter at a level not seen since the market meltdown in September 2008, as investors continued to price-in multiple rate increases by the Federal Reserve this year. Recent economic data have been strong enough to lift the probability of a sixth rate hike by the Fed in this cycle to nearly 82% in the Fed funds futures market, with the chances of a follow-on move at the June 13 meeting approaching 50%. Investors are beginning to take note of the less sanguine backdrop for longer-term rates in lifting long-term inflation expectations (based on the 10-year breakeven rate in the market for Treasury Inflation-Protected Securities, or TIPS) above the Fed's 2% target rate for the first time since last March.

Yields have yet to respond fully to those increases, providing a path for expanded price-earnings (P/E) multiples and other valuation measures. By Friday, the S&P 500's forward P/E multiple was at a new 14-year high of just under 19 times next year's expected earnings, nearly 29% above its long-term average, and up from an already lofty P/E of 17.1 a year ago. Rising valuations, atop the market's earnings-driven gains, are one indication of greater reliance on low bond yields to support the rally. Are yields set for a more sustained rise? Already-low financial stress indexes are rolling over, again, after showing signs of firming late last year, a sign of investor caution in translating less-sanguine inflation expectations into higher bond yields. While some linkages have yet to begin normalizing, others could provide more of a back-door threat to interest rates and to the stock market by re-linking monetary policy to economic growth. The so-called money multiplier—the ratio of bank lending to the funds created by the Federal Reserve—was at a one-year high on banks' greater willingness to lend. And money velocity—effectively, the number of times money courses through the economy to finance a given level of transactions—is showing signs of stabilizing after a secular decline pre-dating the last recession.

A sustainable dollar-U.S. yield de-coupling?

Source: Bloomberg Financial News, Inc., as of December 30, 2017.

The modest back-up in yields last week may have done little to blunt the stock market's powerful rally, but it did help shape sector performance. Bond-like utilities were buoyed, at times, by industry restructuring news, but not by enough to prevent them, along with yield-sensitive telecommunications services, real estate, and consumer staples, from falling to the bottom of the performance rankings. U.S. investors in international stocks benefited from currency-related gains lifted by dollar weakness, continuing a trend that added ten percentage points to the dollar-based EAFE benchmark last year in pushing it past the S&P 500's near-22% total return. Dollar weakness, retreating toward its 2017 low, has been a surprise amid a widening U.S. yield premium over European and other interest rates. (See the chart at left.) Support for the euro against the dollar, despite a yield advantage for U.S. securities at an April 2017 high, may be based on investor optimism over European growth and inflation prospects upbeat enough to trigger an earlier and, perhaps, more aggressive wind down of the European Central Bank's quantitative easing. That may be a weak link in the outlook for foreign and U.S. multinationals' stocks, commodities, and even central-bank policies shaping the trajectory of foreign interest rates, however, if the dollar-U.S. interest-rate link is restored amid a turn toward higher wage-price inflation here.

Not your parents' economic cycle. The growth cycle may have lost a step at the end of last year, but not by enough to undercut support for stocks and other risk assets. The Citigroup Economic Surprise Index showed data still running well ahead of expectations, though slippage from the previous week's peak hints at investors' expectations converging with reality. Moreover, the latest real-time estimates of fourth-quarter economic growth have gravitated toward the 2¼%–2½% range, down from the 3%–3¼% pace during the middle quarters of last year. With the economy still firing on virtually all cylinders, recent slippage likely signals a shift to more sustainable growth rather than a steady wind-down of activity. Strength in December auto and chain-store sales supported consumer-led growth through the end of last year, and single-family construction spending was on the leading edge of a solid gain in the month's building activity.

Even weak spots in the latest data were stronger than they appeared. December's disappointing job growth still was strong enough, atop solid gains in October and November, to lift the rolling 3-month average to a 15-month high. Likewise with a modest rise in aggregate weekly hours (combining the average workweek with employment to form a proxy for monthly economic activity), contributing to the strongest 3-month gain in 3½ years. Additionally, an unexpectedly large increase in the November trade deficit, weighing on fourth-quarter growth, was due to a sizable increase in imports out-weighing still solid export growth in a sign of domestic-spending strength.

No two economic cycles are the same, but this one's unusually large number of peculiarities began with an upside-down housing recovery, led by apartment activity instead of the usual strength in the dominant single-family sector, and with early support from late-cycle commercial construction. Enduring strength of early-cycle auto sales, other big-ticket spending, and housing has been another stand-out feature, along with the rotation from dominant non-manufacturing to manufacturing on the leading edge of this growth cycle. Remarkable, late-cycle strength in manufacturing was on display in the December purchasing-manager reports, showing an increase to near boom-like conditions amid an unexpected decline in the non-manufacturing index to a 4-month low. Much of this cycle's uniqueness—including its length, disappointing strength, and pattern—can be tied to the enduring legacy of disinflation, aggravated by the damage from the financial meltdown in 2008–2009. Household purchasing power, wealth, housing, and other credit-sensitive sectors have benefited from subdued inflation and historically low interest rates. Its dark side has been weak business pricing power, threatening profit margins, and financial markets prone to asset-price inflation capable of triggering abrupt economic setbacks with a decline in asset values and, in the extreme, a disruption of credit flows.

Now the economy is being confronted with the added challenge of an unusual, late-cycle tax cut designed to lift after-tax profits, household incomes and, hopefully, consumer and business spending, but forced to navigate a tightening labor market, rising corporate debt, and interest-rate normalization by the Federal Reserve. One of tax reform's more immediate issues is its ability to support an investment recovery. Tax-cut expectations likely contributed to the near-18% burst of equipment orders in the three months to November, a 5-year high, and to the most upbeat capital-spending survey by a few Fed districts since at least 2004. Stepped-up investment spending ultimately could lessen the threat of stimulus to inflation by boosting labor productivity. The more immediate issue, however, is the inflation threat of tax-related increases in business and consumer spending in an economy at, or near, full employment.

Another back-loaded calendar in the coming week will feature the December CPI and retail sales, Friday, close behind Thursday's wholesale-price report for the month. Also on tap will be a three-part, $56 billion offering of 3-, 10- and 30-year Treasury securities Tuesday through Thursday. Friday's CPI release has taken on added significance after its slowing through much of 2017 helped uncouple the Fed's three rate increases last year from inflation-sensitive, longer-term rates. Investors are awaiting evidence of inflation's turn higher, validating recent economic strength in re-linking the Fed's policy moves with market-driven interest rates. Retail sales and other activity reports will be taking on added importance after the loss of momentum signaled by December employment and other data Friday. Investors are anticipating more encouraging news from December retail sales atop November's out-sized increase, based on related reports covering unit auto sales and Christmas receipts by the nation's retailers.