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Market comment for the week of January 19, 2018

"High-wire" investing?

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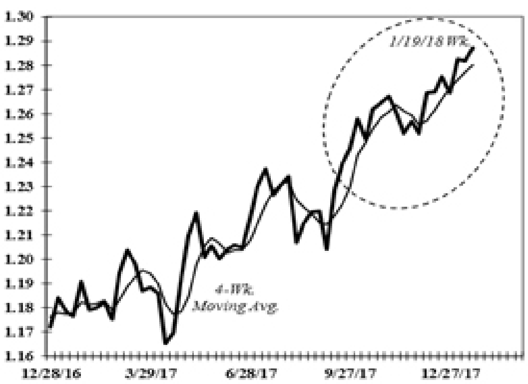
Parting company. Asset markets largely treated a looming government shutdown as a sideshow in moving stocks to yet another record high, contributing to further gains in a portfolio of highly charged assets against their safe-haven counterparts. Market complacency stems from the limited impact of past shutdown-related disruptions to the economy, because of non-essential spending's small—roughly 15%—share affected by the move and tempered further by subsequent catch-up spending when the disruption ends. Troubling this time is the degree of partisanship risking a more prolonged and damaging shutdown, perhaps setting the stage for a potentially disruptive debt-ceiling impasse when the limit is reached as early as March. Ironically, the safe-haven role of Treasury securities—ground zero for a debt impasse's default risk—made it one of the chief beneficiaries when the issue was at its most visible in August 2011.

"Risk" on a roll against "safe-haven" assets

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



Sources: Data from ICE BofA Merrill Lynch, Inc.; Bloomberg Financial News.

Off to their best start since 1987's double-digit gain, stocks are drawing on optimism over the synchronized global expansion, tax cuts, and their effect on U.S. economic and earnings growth. That's out-weighing, for now, rich valuations made increasingly vulnerable by the rise in interest rates to a May 2014 high on the 10-year Treasury note. Gains across 7 of 11 S&P 500 Index sectors and 84 of 125 constituent industries weren't overly broad or deep last week, paced by defensive consumer staples and health care—a pattern belying the market's gathering euphoria. Treasury securities failed to capitalize on their safe-haven role ahead of the government shutdown at the end of the week, suffering, instead, a setback on investors' rising inflation expectations. For the benchmark 10-year Treasury note, its sizable, 4¼% loss since yields bottomed early last September has been aggravated by a heightened sensitivity to rate changes (measured by duration) at these unusually low yield levels. Increases in bond yields were enough to stem the trade-weighted dollar's decline to a three-year low early in the week. Resulting currency gains continued to lift dollar-based returns on international EAFE stocks past the S&P 500, even as local-currency returns lagged the U.S. market.

A widening gap between stock and bond performance, like that experienced recently, is fairly typical early in an interest-rate up-cycle, when stock valuations are insulated by earnings growth supported by the same economic strength boosting interest rates. Stock-market rallies don't typically end because of elevated stock valuations alone (much like economic growth cycles not dying of old age). Only when interest rates begin to weigh on economic and earnings growth do stock prices begin to falter. Before then, however, rich valuations do leave the market increasingly vulnerable to shocks or to other changes in the investment environment as interest rates move higher.

Investors in this cycle also have to be mindful of a potential sea change in the investment environment propelling financial assets during the past decade's adjustment to the financial meltdown and, in fact, much of the time since the early 1980s. Rising stock valuations out-pacing double-digit earnings-growth projections are an indication that the rally there and in risk assets extending out to crypto-currencies still is being supported by ample financial liquidity characteristic of the past decade's meltdown adjustment. The S&P 500's price-earnings multiple has broken new ground in climbing to a 2002 high of nearly 19.5 times projected earnings over the next 12 months, or 32% above its long-term average, and made increasingly vulnerable by the recent rise in interest rates and declines in competing bond prices.

At issue is whether the bond market's latest sell-off signals a change in disinflation's tailwind propelling financial assets over the past few decades. Investors' inflation expectations, measured by the breakeven rate in the market for 10-year Treasury inflation-protected securities (or TIPS), has climbed to a September 2014 high of nearly 2.1%, converging with households' higher, but more stable inflation expectations included in the monthly consumer-sentiment reports and accompanied by signs of manufacturers' improved pricing power. However, key wage-price barometers have yet to show a sustained rise consistent with recent economic strength and dwindling excess capacity. Core, or underlying, inflation has percolated since September, but the 12-month rate of 1.8% still is short of the Fed's official 2% target. Average hourly earnings haven't shown signs of a break-out, either, with the Atlanta Fed's wage tracker index slowing a third straight month in December, to an October 2015 low of less than 3%.

An added uncertainty is the tipping point for interest rates to slow the economy and earnings growth enough to weigh on stock and other risk-asset prices. A decade of subdued inflation, ultra-low borrowing costs, and inflated asset values may have left these markets and the economy more sensitive to even modest rate increases, even at these historically low levels. The counter to that argument is the importance of non-interest factors propelling growth (like tax cuts, strengthening economic conditions abroad, and improved confidence among businesses and households) and of still subdued real (inflation-adjusted) interest rates in supporting economic activity.

A third, emerging issue centers on Fed policy. Interest-rate normalization—lifting artificially low interest rates back in line with economic growth and inflation fundamentals—has always implied less sensitivity by the Fed to prevailing economic conditions in raising interest rates. Added weight more recently has been given to a parallel argument favoring earlier rate increases and other liquidity-draining measures to boost the Fed's firepower ahead of the next economic slowdown, justified, perhaps, by lowering or softening its inflation target. Beyond the obvious risk of accelerating the very slow down the Fed seeks to counter is one of repeating last year's decline in longer-term yields stoking asset-price inflation by dampening inflation expectations.

Ageless? Economic growth may have lost a step at the turn of the year, leaving its still-respectable pace nonetheless on track to make this the second longest growth cycle on record. The Citigroup Economic Surprise Index remained high through the January 19 week, despite a fourth straight decline, as once guarded data expectations converged further with reality. Despite occasional disappointments in the economic releases—some due to harsh weather—their overall tone supported an upward adjustment in the fourth quarter's real-time growth estimates centered in the 3%-3½% range from an earlier 2½%-3%—strong enough to support the consensus forecast of double-digit earnings growth for a second year. The Fed's Beige Book survey of regional conditions pointed up the dilemma facing policy makers, inclined to tether rate changes even loosely to economic conditions, by characterizing growth as "modest to moderate" in virtually all districts but with little sign of increased wage-price pressures supporting more aggressive rate increases.

Slippage in December's weather-sensitive housing starts wasn't enough to prevent its rolling, three-month average from climbing to a February 2017 high, with added resilience signaled by increased December permit activity and from still-solid home-builder sentiment early this month. Likewise, December's modest rise in manufacturing output still left three-month growth at a 7½-year high and the operating rate at a post-recession peak, helping to explain the historically high capital-spending plans through early January in several Federal Reserve bank surveys. Harsh weather likely contributed to slippage in early-January output in those same surveys, but to a still-respectable level. And the drop in initial jobless claims to a new 44-year low in the January 13 week left little doubt that labor-market strength remains intact. The big surprise on the week was the decline in early January consumer sentiment to a six-month low, centered on current conditions, and was all the more surprising amid recent increases in the weekly measure.

A full, back-loaded events calendar in the coming week will include a first look at fourth-quarter GDP, updates on manufacturing and housing, along with the forward looking index of leading economic indicators for December. Also on tap will be an $88 billion sale of conventional 2-, 5-, and 7-year Treasury notes Tuesday through Thursday, accompanied by a $15 billion offering of 2-year floating-rate notes at mid-week. Weather-related distortions aside, investors will be looking for more evidence of economic momentum sufficient to keep growth at or near 3% through the opening months of this year. Policy announcements Tuesday and Thursday by the Bank of Japan and by the European Central Bank, respectively, likely will be the main event in overseas markets, as investors await a clearer picture of the outlook for Japanese and eurozone quantitative easing (QE) after recent hints of an early and, perhaps, more aggressive wind down of policy stimulus.