

Market comment for the week of May 19, 2017

Stress tested!

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That '70s show? Washington elbowed aside Main Street and Wall Street with Watergate-like intrigue, triggering a mid-week drubbing of stocks just days after another record high. Also stirring the pot were ongoing tensions in North Asia, a fresh confrontation between China and the U.S. in the skies over the East China Sea and Brazil's second presidential corruption scandal in a year. Market "bulls" had the final word, however, retracing much of the decline in a two-day rally that left the S&P 500 with a second moderate setback in as many weeks. Caution bordering on confusion was apparent from the pattern of performance across markets and market sectors. The narrowly based sell-off within the S&P 500—across just 7 of 11 sectors and 80 of 143 industry groups—suggested a lack of "risk-off" conviction, as did an end-of-week ratio of "risk"- to "haven"-asset prices still hovering near its highest level in over 12 years. That said, lingering caution also was visible in the solid gains by haven gold, Swiss francs, Japanese yen and, to a lesser extent, U.S. government bonds.

Market turbulence had a varying impact on themes and stock indexes tied to them. The "EAFE" benchmark for international stocks bucked the U.S. market decline, but only because of currency-related gains associated with a weaker dollar. Local-currency declines in emerging-market stocks still translated to dollar losses for U.S. investors, by contrast, because of a firmer exchange rate against most currencies there. Disruptions to the U.S. high-yield market were more of a speed bump, leaving yield premiums to comparable Treasury issues unchanged on the week after a short-lived "spike." Multinationals and yield-oriented (mostly "defensive") stocks were the big winners, propelled by declines in interest rates and the dollar. Multinationals ended the week at an August 2014 high against more domestic-oriented companies, extending dollar-driven support to large- over small-cap tech companies. And low yields helped reverse four straight weekly declines in defensive, yield-driven sectors against tech and more economically sensitive segments, even as they failed to lift buyback, takeover, and other "restructuring" stocks as they did during much of 2016.

The same defensive, yield-oriented stocks dominating the S&P 500 Low Volatility Index helped propel it to a four-week high against the broader benchmark. In fact, the retreat by VIX implied, and S&P 500 realized volatility from a mid-week, but still historically low, mini-spike kept it at the forefront of the debate over key market drivers during the balance of the year. The popularity of low-volatility exchange traded funds (ETFs) and the sizable futures-market bets on a rebound in market volatility both point up investor anxiety over an abrupt increase. Fall-out from unusually low volatility on returns can range from increased asset and sub-market correlation and reduced dispersion, plus inflated risk-adjusted returns encouraging a rotation into more highly charged assets.

Awareness of the historically short-lived impact of political and geo-political developments on market performance may help explain their muted effect on the market in the latest week. Threats ultimately could be more enduring this time for two reasons. First, Asia tensions are built around the risk of a nuclear conflagration risking a horrific loss of life, not to mention the loss of a significant and dynamic part of the global economy. And homegrown U.S. distractions are coming at a crucial point in the policy cycle, threatening to derail the debate over health-care reform, tax and other fiscal stimulus. Tax-exempt munis would benefit most from a "no-go" on corporate and individual tax cuts, adding to ironic support from revenue shortfalls restraining supply of new securities that lifted the sector's year-to-date return, at 3.25%, to more than a percentage point above that of the U.S. Aggregate Index of investment-grade taxable issues. Stocks' resilience to incessant, potentially high-stakes disruptions much of the week likely rests, in part, on more satisfactory global growth contributing to an impressive, mid-teen increase in first-quarter earnings for the 473 companies reporting through Friday, according to Bloomberg Financial News.

Added support continues to come from ample "liquidity" and from the latest decline in U.S. interest rates, lifting bond prices enough to support "rich" valuations in the stock market. The turn from "disinflation" is the last of three broad adjustments to be made to the financial "meltdown" nearly a decade ago and to its aftermath. Balance sheets of banks and households—principal trouble spots in 2008-09—long since have been restored enough to foster growth-supportive re-leveraging. Household debt breached its September 2008 peak of nearly \$12.7 trillion in this year's first quarter, though it was still well below peak readings after normalizing for after-tax income or net worth. Asset-price inflation in housing, certain other tangible and other financial assets is being underpinned by historically low interest rates restrained by subdued inflation. Re-inflation is the third—but still missing—ingredient for a full-fledged return to a more normal, post-meltdown economic, financial and investment environment, restraining asset-price increases by lifting interest rates. Instead, subdued inflation and historically low (and recently declining) interest rates have supported above-average valuations—at 17.6 times forward S&P 500 earnings Friday nearly 20% above its long-term average.

An "up-for-grabs" quarter? Mixed economic data of recent weeks has sketched a confusing mosaic of early second-quarter activity, leaving investors guessing about the strength of the growth recovery imbedded in recent asset returns. Real-time estimates by the Atlanta Fed's "GDP Now" model show the growth recovery firmly on track in accelerating to an impressive 4.1% rate thus far in the April-June period from less than 1% in the opening months of the year. A glass-half-empty view from the Citigroup Economic Surprise Index—

measuring actual versus expected data results—has painted a less upbeat picture of a riches to rags decline in the index from a three-year high in mid-March to a one-year low in the latest week.

The truth may lie somewhere in between. Above-average growth often follows the kind of overstated weakness experienced in the first quarter. Still, recent data have been mixed, featuring ongoing strength in housing, manufacturing and the labor market countered by ongoing uncertainty over dominant, consumer-led growth. Disappointing housing starts for April, centered on a sizable decline in the volatile apartment segment, masked an increase to an 8.5-year high in the larger single-family sector. Likewise, solid gains in the Philadelphia Fed's regional manufacturing survey for early May—atop a solid, albeit auto-led rise in April industrial output—out-weighed an unexpected decline in the Empire State regional survey early this month.

Little fresh information on consumer spending was available in the latest period, leaving investors to stew over a wind down in consumer spending growth through April that culminated in the first three-month decline in inflation-adjusted receipts (including internet sales) in nearly five years. However, April's weakening spending was accompanied by a rebound in inflation-adjusted weekly earnings (a proxy for changes in household spending power). Other indicators were equally mixed. Overall lending activity is regaining momentum after stalling in late March for the first time in six years. However, a "flattening yield curve," or narrowing gap between shorter and longer-term interest rates—one of 10 components in the index of leading indicators—continues to flash "yellow," as does broadening "disinflation."

Much is riding on a second-quarter growth recovery for Fed policy expectations. The Fed funds futures market remains firmly "priced" for a rate hike at the June FOMC policy meeting despite mixed economic and financial signals, a potential bind created by the Fed's transparent comments earlier this year about the need for interest-rate "normalization." Barring worsening geo-political strains or a Watergate-style scenario playing out in Washington, a significant change in the economic environment likely would be needed for the Fed to risk its credibility by delaying the move next month, as it did during much of 2015 and 2016. Less clear is the outlook beyond that, where rate-increase probabilities drop off to less than 33% through—what many view—as "primetime" for a third rate increase in September.

The calendar fills out in the coming week, still dominated by housing and manufacturing data at the center of the past week's releases. Consumer-related reports will be confined to Friday's University of Michigan's bi-weekly update on consumer sentiment for late May. Much of the market's attention will be on April new and existing home sales, Tuesday and Wednesday, Thursday's advance report on April merchandise trade, along with advance durable-goods orders for the month at the end of the week. Friday's calendar also will include a first revision to first-quarter GDP, expected to be nudged higher to a still sub-1% rate. Also on tap during the week will be an \$88 billion sale of conventional two-, five- and seven-year Treasury notes Tuesday through Thursday, accompanied by a \$13 billion mid-week sale of Treasury two-year floating-rate notes. Investors will be counting on confirmation of housing and manufacturing support to the growth recovery from the next round of the economic data, while they await updated reports on the consumer the following week.

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