Market comment for the week of May 26, 2017

Stress tested!

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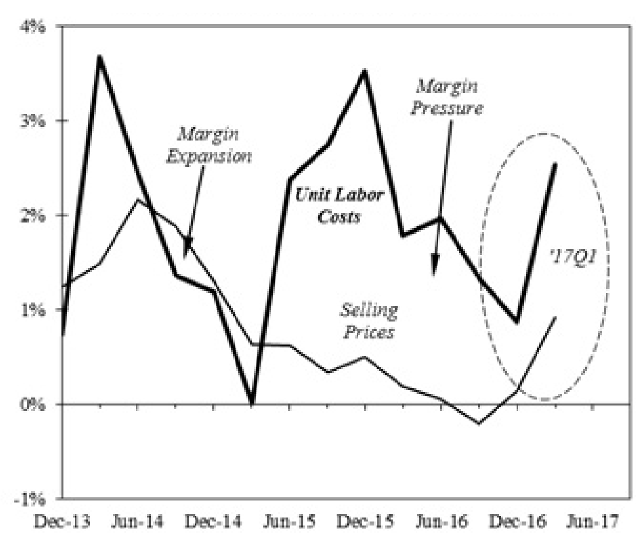
Back on top! The stock market's seven-day rally was a reminder of why political disturbances, like the most recent D.C. follies, are viewed by investors more as distractions than as enduring threats. Largely overlooked in the latest run up of stocks and other risk assets were tremors from a China sovereign-debt downgrade, the U.K. bombing, a less-than-cordial meeting between President Trump and other G-7 leaders plus unexpected oil-price uncertainties tied to oil producers' extended production-sharing agreement. Investors opted, instead, to key on strong earnings growth and a positive spin to the interest-rate outlook in sending the S&P 500 to successive highs in a broad, but not overly deep rally across 9 of its 11 sectors but just 90 of the 143 constituent industry groups. High and rising investor confidence in the rally's strength also brought the VIX "fear gauge" of implied market volatility to within shouting distance of its multi-decade low earlier this month.

Stocks have continued to draw strength from solid earnings growth, the fundamental driver of market performance. The Commerce Department's take on first-quarter profits highlighted strengths and weaknesses likely shaping the trajectory of corporate income during the balance of the year. Reported after-tax profits overcame a quarter-to-quarter decline to post double-digit growth from a year ago, fully consistent with the gain by the 489 S&P 500 companies reporting through Thursday. Strength centered on overseas earnings, over-shadowing a decline in domestic-based profits and a reminder of the support to large-cap multinationals from a typical late-cycle rotation of U.S. economic strength to the rest of the world.

Figure 1: Margin pressure from unit labor-cost increaes out-running slowly improving "pricing power"
Year-ago percent change; Non-financial corporations



Source: U.S. Commerce Department

Figure 1 shows margins squeezed to a six-year low by gains in labor costs exceeding still-subdued corporate "pricing power." Efforts to keep a lid on cost increases, amid selling-price "disinflation," help explain the muted response by wages to a tightening labor market. Unit-sales and revenue growth will be the main support for earnings gains in coming quarters if margin pressure is sustained, with a modest "leavening" of profits from above average operating leverage—revenue per dollar of costs—allowing a larger share of those receipts to pass directly to the bottom line.

The silver lining to weak domestic-driven earnings and to economic-outlook uncertainties is the "safety net" of a more sanguine interest-rate outlook, another by-product of recent CPI "disinflation" and of doubts over the growth recovery's strength. Low interest rates have allowed the stock market to accommodate still higher valuations, lifting the S&P 500's forward price-earnings (P/E) multiple to a new 13-year high of 17.9 times projected earnings. Tell-tale signs of disinflation's impact have extended beyond the bond market to the rotation by investors from economically sensitive to more resilient sectors of the asset markets. Last week's stalled bond rally still left yields at the lower end of their recent trading range on a positive spin to the minutes of the Fed's early-May FOMC meeting, signaling policy caution beyond a likely rate increase in mid-June. That was "priced" into Fed funds futures rates, showing a noticeable decline in rate-change probabilities after a near-certain move at the June policy meeting. Investor caution also was apparent from the narrowing gap between two- and 10-year Treasury yields, dubbed a "flattening yield curve" and often signaling slower growth ahead. Low interest rates also had an "echo" effect on gains in other so-called "haven" assets, including a gold rally lifting prices there to a one-month high.

Economic-growth uncertainties and subdued interest rates also contributed importantly to the top-ranked performance by utilities and tech stocks on the week. The rotation into leading-edge utilities was a reminder of the support by bond-like (yield-oriented) stocks to any market rally propelled by disappointing growth and subdued interest rates. The premium on earnings resilience during periods of sub-par growth added to this year's strong performance by tech stocks, lifting their near-20% year-to-date return to more than double that of the S&P 500 and contributing to Growth's 16-year high against the indexes' Value counterpart. Doubts over the growth outlook also weighed on economically sensitive small caps, down a second straight week against the larger-cap S&P 500 boosted by multinationals' strong overseas earnings growth. Support for "risk" assets from low interest rates and a weak dollar allowed emerging-market stocks to out-perform the U.S. benchmark, easing dollar-debt repayment burdens and propelling commodity-price increases across oil, precious and industrial metals, corn, and wheat.

Grounded! Another week, another batch of disappointing economic data, taking the Citigroup Economic Surprise Index (measuring actual versus expected data results) to a one-year low. Second-quarter growth estimates were lowered by shortfalls in April home sales, wholesale and retail inventories plus a larger-than-expected foreign-trade deficit for the month. However, a wide, 2%-4% range of second-quarter growth estimates pointed up the still uncertain outlook midway through the period, left unresolved by Friday's revised first-quarter GDP data. The upward revision to first-quarter growth, to a still-modest 1.2% from 0.7% in the initial estimate, may have drawn potential strength from the spring period. That may help explain "flat" back-to-back capital goods orders for March and April after unsustainable, double-digit growth of first-quarter investment. However, the pattern of first-quarter changes—upward revisions to consumer spending, investment and other components of underlying demand combined with lowered inventories—positioned the economy for stronger, manufacturing-led growth in the months ahead. A revival of consumer spending—critical to growth strong enough to reduce unemployment and to support interest-rate "normalization" by the Fed—is being supported by a recent pick up in households' real income, or "purchasing power," from subdued inflation and from a gradual buildup of wage pressures. Added support to that recovery may come from consumer sentiment, still elevated despite a larger-than-expected decline in late May.

Investors are bracing for a full calendar of top-tier economic data in next week's holiday-shortened session, capped by the May purchasing manager report for manufacturing Thursday and the month's all-important employment release the following day. Preceding those reports will be updates on May consumer confidence, April personal income and consumer spending, March home prices from S&P/Case Shiller, the Fed's Beige Book regional survey at mid-week, and a first look at June consumer spending from Thursday's auto sales report for May. Upcoming data could be critical to reshaping the growth and inflation outlook affecting stocks, bonds and other asset values. Markets geared toward slow growth and low inflation risk being upended by unexpectedly strong data altering currently subdued inflation expectations and interest rates. Stocks are, perhaps, best insulated among the major asset classes from data surprises, because of dual support, at the moment, from low interest rates and earnings growth positioned to benefit further from surprisingly strong data. Even stocks are vulnerable to unexpectedly strong growth, however, through an unsettling rotation from yield-oriented sectors and earnings-resilient tech, to the market's more economically sensitive consumer cyclicals, industrials, and materials producers.

Low "vol's" bad vibes. Investors struggling to make sense of a second assault on record low volatility in less than a month are grappling with the implications for asset diversification and the risk of unraveling distortions created by unusually calm conditions across the asset markets. Big swings in market volatility haven't been associated with expected changes in stock-bond correlations encouraging diversification. For example, the correlation between changes in S&P 500 stock and Treasury bond prices temporarily increased during some of the worst months of the financial crisis in late 2008, lessening incentives to diversify. More recently, diversification has been encouraged by an increasingly negative correlation between stock and bond returns, even as the VIX periodically has approached a record low. That's surprising, because the same ample "liquidity" suppressing volatility has supported both stock and bond rallies. Reduced volatility cutting across asset classes has been greater for stocks and other more highly charged assets than for more stable investments, aggravating market distortions by encouraging a tilt by investors toward riskier securities. This "coiled spring" effect risks aggravating future increases in volatility caused by interest-rate "normalization" or by other enduring "shocks" to the market.