Wells Capital Management

Market comment for the week of September 22, 2017

Sea change redux?

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A not-so-boring high-wire act. Muted asset-price reaction to seemingly far reaching policy developments in the latest week had less to do with lethargy than it did with cross currents hemming in prices. Seeming calm was the result of a stand-off between a less market-"friendly" Federal Reserve and the latest "spike" in North Korea tensions versus prospects for still ample market "liquidity" plus optimism on economic growth, inflation and third-quarter profits ahead of the early-October start to the earnings-reporting season. Outlook positives out-weighed negatives in producing another big week for risk over broadly declining safe-haven assets, lifting risk's total return index to its highest against safe-haven in at least the last 16.5 years on gains paced by commodities and emerging-market stocks. Market strengths also boosted confidence enough to nudge the VIX volatility gauge down toward its late-July low for the year. Even the CBOE "SKEW" index in the options market—effectively measuring so-called "tail" risk of a significant market "shock"—converged with its historic norm from a red-zone level the week before.

Eleventh-hour support nudged S&P 500 stocks to a second straight weekly gain in a fitting end to a period starting with rapid-fire highs, leaving the benchmark well within striking distance of Wednesday's record close. Market caution was apparent from narrow and shallow gains across just 5 of 11 sectors and a mere 68 of the 125 constituent industry groups. Hard-pressed telecommunications services led the way for a second straight week on talk of industry restructuring. More pervasive on stocks was the lift to yields from a muted sell off in a bond market over-bought by "flight"-related demand early in the month, leaving the benchmark 10-year Treasury yield at a still-subdued 2.25%. The modest rise still propelled financial services, benefiting from banks' increased net interest margins and insurance company investment income, while keeping the S&P 500's bond-like utilities, consumer staples and similar sectors at the bottom of the performance rankings. Elsewhere, small caps extended their rally against the S&P 500 through a second week on fresh hopes for tax cuts (perhaps in doubt, again, after the latest failed effort at health-care reform) and on encouraging U.S. economic data favoring smaller, more domestically oriented companies.

Market optimism has been built on a positive "spin" to a seemingly "hawkish" outcome at Wednesday's FOMC policy meeting. Reaction to the Fed's "dot plot" forecast of a December rate increase has been mixed, upping the Bloomberg probability in the Fed funds futures market of a year-end rate rise to nearly 63% from less than 22% in early-September amid an unusually narrow yield premium on the policy-sensitive two-year Treasury note to Fed funds for this stage of an interest-rate "up cycle." The futures market greeted the Fed's 2018 and 2019 forecasts with even greater skepticism, pricing the December 2018 Fed funds rate at less than 1.6% versus the Fed's projected 2.1% and at less than 1.75% against the Fed's 2.7% in 2019. The market's ability to ride out a potential sea-change in Fed policy and in the investment environment has had much to do with a still-sanguine inflation outlook, despite last month's uptick. Investors' long-term inflation expectations, measured by the 10-year "breakeven" rate in the market for Treasury inflation-protected securities (TIPS) is up, but has yet to make a sustained rise toward the Fed's 2% target rate. And a stubborn discount on the 10-year Treasury note's "term premium" suggests longer-term expectations of still lower interest rates. All this is contributing to increasingly relaxed financial stress indexes, despite the announced start of a balance-sheet wind down at the latest policy meeting, providing an increasingly supportive backdrop for risk and other financial assets.

Accounting for subdued inflation in an unusually long growth cycle, with historically low unemployment, draws less on a "silver bullet" than on a laundry list of explanations. Some are cyclical, including the reduced risk of recession-inducing bottlenecks from modest growth, through its effect on inflation and interest rates. Others are quasi-cyclical, notably the post-"meltdown" adjustment phase during this cycle's early and middle stages, discouraging debt-supported increases in consumer spending in favor of a buildup of cash and other balance-sheet rebuilding. The dollar's earlier rise combined with extended global economic sluggishness to deflate manufactured-goods import costs and trade-sensitive goods prices in the CPI. Also at work have been structural changes, ranging from an aging population, technological change and innovation, along with "globalization" holding down wage costs and business "pricing power."

Whether or not August's uptick marks the start of inflation's more sustained rise or is just a blip could determine if a true policy sea change is at hand after numerous false starts, both by shaping the Fed's interest-rate "normalization" and the market's response to it. This interest-rate cycle has been driven by efforts to bring credit conditions in line with prevailing growth and inflation "fundamentals," not by a need to restrain a buildup of price pressures. Subdued inflation expectations help explain why inflation-sensitive longer-term rates have been unusually resilient to rate increases by the Fed in recent years, largely coming full circle after four rate increases by the Fed since December 2015. It also explains the perverse response by bond yields to "QE on" and "QE off" between November 2008 and October 2014, when intermittent pullbacks signaled weaker growth and reduced price pressures. Likewise, perverse yield increases during QE's three rounds were supported by rising inflation expectations associated with the stimulus. Interest-rate normalization amid subdued inflation further complicates efforts to resolve the new "unholy trinity" of three often contradictory policy goals, balancing satisfactory growth, acceptable goods and services inflation and reasonable asset-price increases, by loosening the link between policy, market-driven interest rates, and asset prices.

Breathing room? Encouraging economic data in the latest week show the economy having the Fed's back in its pullback from aggressive stimulus. Timely data show the economy holding up reasonably well in the hurricanes' disruptive aftermath. Jobless claims already are retreating, regional manufacturing surveys were holding up well in early September as did a weekly sales survey by Evercore/ISI, and wholesale gasoline prices have stabilized at a pre-storm level as refinery output is restored. In all, economic data's improved tone sustained the recovery in the Citigroup Economic Surprise Index—still in the "red," but with its best reading since late April. Storm-related activity will shift from a "drag" to a potent tail wind in coming months, as reconstruction, deferred and replacement demand gather momentum.

Beyond the storm's impact, there's the issue of growth supports in this ninth year of economic growth. Faltering housing and "big-ticket" consumer spending is drawing support from wealth's accelerated rise through the second quarter, countering modest income growth by adding to borrowing capacity and allowing households to lower saving rates. Also at issue is whether inflation's August uptick was just a temporary break from recent "disinflation" or the start of a sustained rise interest rates. Evidence of more permanent increases comes from a fifth monthly rise in six by August import prices for manufactured goods, pointing toward a turn from deflation in trade-sensitive goods prices weighing domestic inflation, and from September regional surveys showing manufacturers' strengthened "pricing power."

Looking ahead, there's something for everyone in the upcoming events calendar, cutting across consumer income, spending and confidence data, July home prices, August durable-goods orders and advance foreign trade, plus a final look at second-quarter GDP. Accompanying a heavy data line-up will be an $101 billion, three-part sale of two-, five-, and seven-year Treasury securities Tuesday through Thursday, including a mid-week auction of $13 billion in two-year Treasury floating-rate notes. Accompanying a Tuesday address by the Fed's Yellen will be speeches by Fed bank presidents throughout the week, all drawing added interest by investors seeking color to the Fed's FOMC communique and subsequent press conference by the Chairwoman last Wednesday. Upcoming activity and, particularly, price data will take on added importance in shaping the odds for this cycle's fifth rate hike at the December 13 FOMC meeting.

A QE retrospective on the stock market. There were more than a few surprises during the three rounds of quantitative easing in the six years to October 2014. Dollar behavior was as unexpected as the response by interest rates, falling in two of the three rounds despite rate increases and rising amid rate declines during the other. Dollar weakness during much of QE helps explain the relatively strong performance by multinationals and by internationally oriented stocks, sensitive to currency-related gains and to improvement in international competitiveness. Perhaps more surprising was the relatively strong performance during QE by the interest-sensitive Dividend Aristocrats Index and by REITs. Less surprising was the stock market's ability to overcome rising interest rates during two of the three QE phases, a reminder of the market's ability to rally and even to expand P/E multiples when optimism is building with a recovery of corporate earnings. Lastly, relatively strong performance by smaller cap and other economically sensitive stocks during QE intervals pointed up investor confidence in the policy's ability to reinforce the growth recovery during its early and middle stages.