Wells Capital Management

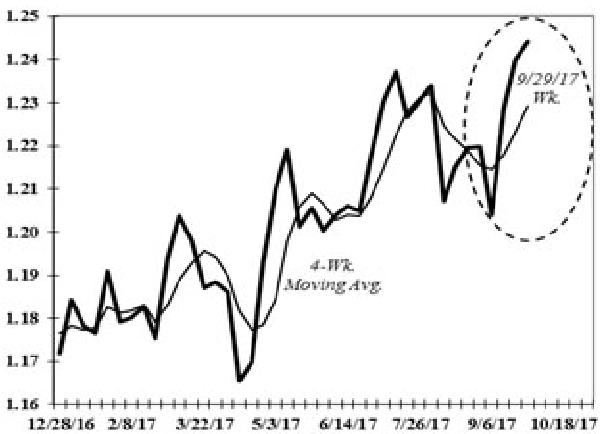
Market comment for the week of September 29, 2017

Reflation's déjà vu

Gary Schlossberg

Transitioning? Tax-cut talk's "reflation II" provided an added wrinkle to the sea change slowly enveloping the asset markets, atop the pivot by the Fed and other major central banks from aggressive stimulus. Events of the past week also were a reminder that the transition likely won't be a smooth one, disrupted by fresh North Korea tensions, Germany's muddled election result pointing toward a weak governing coalition, and by fresh signs of subdued inflation. The net effect was a further uncoupling by stocks and other risk assets from historically low, but rising interest rates in a down-and-up week, lifting the S&P 500 to back-to-back record highs late in the period and powering risk assets to a third strong weekly gain against their "safe haven" counterparts.

"Risk powers past "safe-haven" assets in September
Ratio of total return indexes, risk/safe haven portfolios, 12/21/05=1.00



Sources: BofA Merrill Lynch, Inc., Bloomberg Financial News, Inc.

Stock "friendly" tax proposals, capped by a cut in the corporate rate to 20% from the 35%, touched off a pattern of gains similar to those just after the November election, most noticeably adding to support for Russell 2000 small-cap and other high-tax stocks, plus economically and (in the case of financial services) interest-sensitive Russell 1000 Value stocks against their Russell 1000 Growth counterpart.

The breadth of the rally bode well for its staying power, covering 9 of 11 S&P 500 sectors despite less impressive depth across just 87 of 125 constituent industry groups. Less fortunate bonds suffered multiple blows from Yellen's "hawkish" speech on the policy outlook early in the week, the tax proposal's implications for budget deficits and Treasury financing needs, a $101 billion, three-day auction last week of intermediate securities and from a presidential interview with at least one "hawkish" candidate for the Fed Chairmanship.

September's 2.1% gain for S&P 500 stocks was far better than the month's average losses over the past 56 years, though it was in keeping with the more upbeat performance subset in years when the market is doing well. Beyond the tilt toward the market's more tax-sensitive sectors was a September leadership rotation from top-ranked tech and utilities to energy and financials, among the bottomed-ranked sectors during the July-August period, supported by the rebound in oil prices and by the lift to banks' net interest margins and to insurance-company interest income from higher interest rates. Also noteworthy in recent weeks has been a more challenging environment for active managers created by a decline in returns dispersion, or differences across the S&P 500's 11 sectors amid bouts of "risk-on/risk-off" trading, despite a manager-"friendly" decline in sector correlation, or the extent to which they move together.

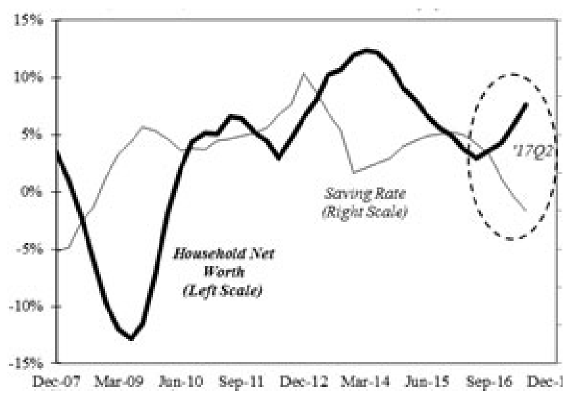
Dispersion could increase in October, with a better returns record than September but with the highest average volatility of any month of the year. An early test to market stability could come from this week's start to the third-quarter earnings reporting season for S&P 500 companies, expected to post growth half the second quarter's double-digit pace as year-earlier comparisons become more challenging. Another threat comes from the monetary-policy debate here and abroad. European markets are bracing for an announced wind down of "quantitative easing" by the region's central bank, whose impact could spill over to the U.S. In the U.S., round two of the tax debate adds another layer of uncertainty to Fed policy already grappling with the effects of stubbornly low inflation on interest-rate "normalization" and its effect on a financial market distorted by years of artificially low rates. The Fed's intention to press ahead with a December rate increase—producing a noticeable rise in Fed funds futures probabilities—leaves the Fed walking a fine line between falling behind an inflation curve yet to be established fully by recent price data and unsettling the market by moving too aggressively.

Post-election tax talk's "sizzle to fizzle" effect on stocks at the turn of the year was a reminder of policy's needed follow-through for any sustainable market impact. Tax reform's immediate issue is providing substance to a framework only modestly more detailed than the one-pager distributed in April by the president, bridging hot-button issues before the clock runs out with the start of mid-term election campaigning next spring or early summer. The second is the fundamental threat to investor inflation expectations and to financial stability from unusual late-cycle tax cuts, adding to a budget deficit already set to rise at an accelerated pace as Social Security and other entitlements spending rise with an aging population. A tax-induced boost to growth could become a victim of its own success, now that an unusually long growth cycle has left excess capacity at a nine-year low.

Just winded. Economic data increasingly are coming under the shadow of late-summer hurricanes, complicating efforts to get an accurate reading of the economy's true strength in the run-up to a promised December rate increase. The good news is that the overall tone to the latest economic data continued to improve, judging from a twelfth increase by the Citigroup Economic Surprise Index in the last 15 weeks. Moreover, third-quarter growth estimates of 2%-2.5% leave the economy positioned for a rebound to a healthy 3% rate as reconstruction plus replacement and deferred spending gather momentum in coming months.

Changes in household net worth a substitute for personal savings

Year-ago percent change* Percent of after-tax income*



*Four-quarter moving averages. Sources: Federal Reserve Board, U.S. Commerce Department.

Several conclusions can be drawn from last week's economic reports. First, leading-edge housing still is providing surprising support to a maturing growth cycle, even as "affordability" and other "fundamentals" come under pressure, judging from still-vibrant home-price increases countering the storms' more recent impact on sales and construction data. Second, more evidence that growth is broadening to include business investment has come from an upbeat report on August capital-goods orders. Third, accelerating growth in household net worth through the mid-year, propelled by strong gains in home prices and by the stock market's rally, has allowed households to channel more income growth into consumer spending, keeping the saving rate at a historically low level through August. Fourth, export growth has become more supportive, for now, accelerating to a February high amid a synchronized global recovery and dollar weakness lifting U.S. competitiveness to a June 2015 high. And fifth, Yellen's "hawkish" remarks on inflation and the policy outlook have come amid a steady 12-month rise in the August PCE deflator—the Fed's preferred inflation gauge—and a "core" rate (i.e., excluding food and energy) slipping to a November 2015 low.

Yellen's Wednesday speech and comments throughout the week by Fed officials will vie for the market's attention with key, top-tier economic data likely consistent with the consensus third-quarter growth estimate. Friday's jobs report for September will headline next week's releases, probably saying more about the impact of the two hurricanes hitting the Gulf area than about the economy's underlying strength or weakness. Other highly visible reports during the period include Tuesday's auto sales for the month—also understated by the hurricanes' impact in Florida and in Texas—along with September purchasing-manager reports for manufacturing and non-manufacturing, out Monday and Wednesday, respectively. Remarks Wednesday by the Fed's Yellen likely will maintain the "hawkish" tone of her speech last Tuesday pointing toward another rate increase in December, but perhaps clouded by milder comments from other officials emboldened by inflation's latest "soft" number.