Market comment for the week of October 6, 2017

Between juggernaut and market "melt-up?"

Gary Schlossberg

Transitioning with a show of strength. The stock-market rally seemed to take on a life of its own in the latest week, including six straight record highs for the first time in 20 years despite erosion of market supports from downward revisions to third-quarter earnings estimates on the eve of the reporting season, a less sanguine interest-rate outlook and aggravated by talk of a more "hawkish" replacement for the Fed's Yellen. That still left the market with considerable support from economic growth at home, synchronized with the best global growth prospects in six years. Third-quarter earnings growth for S&P 500 companies has been revised down below 5% on the eve of the reporting season from 6.5% at the beginning of September, according to Thomson Reuters consensus estimates, leaving "rich" valuations all the more vulnerable to higher interest rates. The S&P 500's price-earnings (P/E) multiple of 18.1 times earnings in the next 12 months is at a 14-year high and 22% above its long-term average.

The rally's and depth within the S&P 500 on the week was respectable but not overwhelming, spread across 8 of 11 sectors and 89 of 125 reporting industry groups. Market confidence could be found elsewhere, starting with "VIX"-based volatility falling, at one point, to a record low and, in a confusing combination for "active" managers, sector dispersion (measuring the range of returns) squeezed by "risk-on" trading, even as sector correlation (the extent to which those returns move in the same direction) fell to a level not seen in the last 16 years. Economically—and tax—sensitive small caps led the S&P 500 benchmark a fourth straight week, reinforced by the tax-cut debate gaining momentum in Washington. More broadly, another good week for "risk" assets lifted our sample portfolio to a fourth straight record high on the week against their "safe-haven" counterparts, paced by emerging-market and U.S. stocks in broad-based gains contrasted with broad-based losses by the more conservative asset basket.

Strength of risk assets here and abroad is signaling the end of post-"meltdown" adjustment, led by the U.S. but more recently extending globally and marked by fundamental changes in the economic and financial environment for portfolio management. The transition, first signaled in the U.S. by an end to balance-sheet consolidation and re-leveraging by businesses and households, set the stage for interest-rate "normalization" gathering momentum here and in Canada, and on the verge of being extended to markets abroad by the European Central Bank (ECB) and by the Bank of England.

The turn from "disinflation" (or slowing inflation) likely is the next chapter in transitioning from the post-meltdown phase of secular adjustment to the "Great Unwind" of 2008-09. Where we are in that transition is critical to the outlook for monetary policy, interest rates, asset values, and, ultimately, economic growth. Controversy surrounding this year's inflation slowdown has revolved around its causes and consequences. Lower inflation much of this year has extended beyond one-time factors to imported "deflation" for trade-sensitive goods prices to ongoing disruptions from technological change and globalization. Recent dollar declines, adequate growth, and tightening labor markets are creating conditions for a more sustained buildup of price pressures. Added to that are chances for more sustained energy-price increases caused by shale output's slow response to improving market conditions lifting prices. Inflation's next big test will come from September wholesale and consumer price reports later this week. Inflation's rebound would vindicate the Fed's interest-rate normalization strategy—safeguarding against unacceptable goods and services inflation and, of greater investor concern, protecting against a full-blown "bubble" in asset values.

How the Fed executes policy in the coming year could well depend as much on politics as it does on economic and financial conditions. First, there's the issue of Fed vacancies—as many as four, including the vice chairman and, perhaps the chair position itself. Campaign statements to the contrary, nearly all front-runners for the chairmanship are more "hawkish" on policy than the incumbent, raising questions about policy formulation and execution during a critical transition in the economic and financial environment if the positions are filled, or leaving the Board sorely stretched and, perhaps, lacking a quorum to deal with potentially sensitive issues if some or all of the positions remain vacant. The more "dovish" candidates for the Fed's top position are current board members Yellen and Jerome Powell, the latter perhaps occupying the pole position because of his lighter-touch bias toward financial regulation. A second Fed-related political issue deals with the institution itself. Criticism of the Fed extends beyond its failure to anticipate the financial crisis of 2008 to aggressive stimulus inflating asset values and widening the gap between wealthy and less wealthy households. The two issues risk encouraging more aggressive normalization of interest rates, roiling a market made all the more vulnerable by financial distortions and by the Fed's balance-sheet wind down.

Another potential complication is that changes at the Fed could come amid tax-driven fiscal stimulus, adding to deficit-related increases in government securities and a wind down of demand extending beyond the Fed to U.S. and foreign investors responding to less aggressive stimulus by central banks abroad. Tax reform's effect on asset prices extends beyond budget deficits to specific proposals in the plan. Corporate bonds are among those sectors with the most to gain or lose, depending on the tax changes. Lower corporate tax rates and the full or partial end to interest deductibility could discourage new-issue activity, supportive of the market and of narrow yield premiums after a potential "drying-out" period for highly leveraged firms bearing increased financing costs or relying more heavily on profits to pay down liabilities. Tax reform's added support to the corporate bond market could come from relief on multinationals' overseas earnings, encouraging funds' repatriation channeled toward investment, "financial engineering" (via buy backs, special dividends, and takeovers, for example) and other previously debt-financed activity.

Tax reform's benefit to the corporate bond market would provide a timely counterweight to the market's increased sensitivity to higher rates and their effect on performance. First, "real" (inflation-adjusted) interest rates—essentially the risk premium above inflation and susceptible to changes in economic growth, among other things—are well below historic norms and capable of adding to bond-debilitating rate increases if growth strengthens with tax reform or other supports. And second, bond-market "duration"—essentially its price sensitivity to a given interest-rate change—has increased noticeably in recent years, keyed partly to duration's inevitable extension with declining interest rates and partly to a rotation into longer-dated debt by firms locking in historically low interest rates.

Above the storm. The economy showed its mettle in providing data strong enough to lift the Citigroup Economic Surprise Index (measuring actual against expected reports) into positive territory for the first time since the April 22 week. The message from the latest numbers: broad-based economic strength, supported, remarkably, by early-cycle manufacturing and already feeling the effects of post-hurricane reconstruction, replacement demand and deferred spending by businesses and by consumers. Close on the heels of an increase in the September purchasing-managers' composite manufacturing index, to a 13-year high, was an unexpectedly strong, companion report on dominant non-manufacturing activity. Even a September jobs report muddled by the storms showed enough underlying strength to keep the Fed firmly on track for a December FOMC rate increase. Overshadowing a first decline in headline non-farm payrolls in seven years was an out-sized increase in the companion household-based jobs estimate, conceptually unaffected by weather-related disruptions that brought the unemployment rate down to a February 2001 low of 4.2%. The month's wage increase was overstated by storm-related work disruptions to lower-paid food and hospitality workers, but upward revisions to earlier months still suggested a long-awaited response by earnings to a tightening labor market.

Post-hurricane support to the economy was most apparent in September auto sales, soaring to a 10-year high in a first step toward replacing several hundred thousand autos lost to the two Gulf storms. Beyond consumer spending, the economy continues to enjoy good support from investment and foreign trade compensating for housing's lost momentum. Both may lose some steam in coming months—from a rebound in declining imports in the first instance and depending on the outcome of the tax debate in the second—but continue to support respectable late-cycle growth.

September retail sales will share the spotlight with the month's key producer and consumer price reports in a largely back-loaded data calendar. The warmup for the key reports will be provided Tuesday and Wednesday by September small-business optimism and by the Labor Department's "JOLTS" report detailing the anatomy of August employment changes in hiring and in layoffs. Investors also will be eyeing a $56 billion, three-part sale of three-, 10- and 30-year Treasury securities Wednesday and Thursday. Price reports have become increasingly important as guidance for the timing and pace of interest-rate "normalization," beyond a likely fifth rate hike in this cycle at the December FOMC. "Disinflation" during much of this year has been the remaining argument by policy "doves" against a quick return to hikes by the Fed in short-term interest rates.