Wells Capital Management

Market comment for the week of October 13, 2017

Early tricking and treating

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A potent brew. Stocks chalked up a fifth straight week of gains and another record high at mid-week on fresh interest-rate optimism and a strong start to third-quarter earnings reports in breezing through what, historically, has been the most difficult time of the year for the market. Third-quarter earnings were up more than 8% for the 32 S&P 500 companies reporting through Friday, according to estimates by Bloomberg Financial News, Inc. Even more important support, at this early stage of the earnings-reporting cycle, came from a bond rally sending the benchmark 10-year Treasury yield to a two-week low, accommodating S&P 500 valuations at a 13-year high. Propelling the bond market was the mid-week release of the September 20 FOMC minutes revealing unexpectedly deep divisions over policy implications of subdued inflation and news Friday of another month of surprisingly modest inflation in the CPI's "core" component (i.e., excluding food and energy). The latest interest-rate decline triggered a rotation of strength toward yield-sensitive real estate, consumer staples and utilities from more highly charged materials, financial services and economically sensitive, "big-ticket" consumer goods during the early part of the month, amid prospects for stronger growth, higher inflation and a less sanguine interest-rate outlook. The bond rally also encouraged an added move along the bond market's credit-risk "curve," leaving the yield premium on investment-grade corporate issues to comparable Treasury securities at a 10-year low.

Lingering caution, despite mounting investor optimism and a historically low and declining "VIX" index of market volatility most of the week, was apparent from the narrow and shallow S&P 500 rally across just 6 of 11 sectors and 78 of 125 industry groups. Investors counting on an improved backdrop for "active" management, deviating from "passive" indexes, continued to get half a loaf from an encouraging decline in S&P 500 sector correlations (measuring the extent to which sector returns move together) countered by diminishing sector dispersion (or the extent to which returns vary). Elsewhere, small-cap stocks bucked the rally in the larger-cap S&P 500 on a more guarded outlook for economic growth and tax reform. Overseas, the most synchronized global growth recovery in decades made its mark on international stocks in developed and emerging markets, whose performance advantage over the S&P 500 was enhanced for U.S. investors by currency-related gains from a weaker dollar.

This year's unexpected changes in the dollar's exchange rate, though highly visible, have nonetheless provided a modest contribution to dollar-denominated returns by historic standards. However, an end to the currency's four-week rally, on lower interest rates, helped lift commodity prices and ease dollar debt burdens of overseas borrowers still further, contributing to the strong performance of emerging-market countries. Moreover, the dollar ultimately could be important to the U.S. interest-rate outlook directly, by influencing demand for U.S. versus foreign securities, and indirectly, through its effect on inflation.

The latest leg of this eight-year rally in stocks has come as a pleasant surprise to investors bracing at the start of the year for market headwinds from rich valuations, higher interest rates, geo-political uncertainties plus disappointing progress toward growth "friendly" tax cuts and increased spending. What's changed is less those working assumptions than the backdrop supporting stocks and other risk assets. The decade-long adjustment to a post-"meltdown" economy has brought enough healing to lift U.S. and global growth back to a more satisfactory level even as adjustment to "disinflation" (or slowing inflation) remains incomplete, strengthening the "goldilocks" environment supporting asset markets. Lowered inflation expectations accompanying stubbornly subdued price pressures kept financial stress indexes unusually "easy" and the Treasury "term premium" on longer-dated securities negative through mid-October, a combination threatening to undercut efforts by the Fed to "normalize" market-driven yields through successive increases in short-term interest rates.

Recent economic data have done little to change the outlook for a December rate increase by the Federal Reserve, whose probability in the Fed funds futures market remains over 73%, according to estimates by Bloomberg Financial News, Inc. The September price report and the FOMC minutes have added to market skepticism over prospects for multiple rate increases in 2018, whose probabilities in the futures market drop off noticeably from well below 50%. Two alternative scenarios for next year to the Fed's "dot-plot" forecast are coming into view. A divided Board over the inflation outlook could defer or stretch out rate hikes scheduled for 2018, risking heightened asset-price stability to boost goods and services inflation. Alternatively, more "hawkish" Trump-nominated Board members could force multiple rate increases amid still-subdued inflation, increasing the risk of a "flatter" or even "inverted" yield curve (in which short-term rates rise above those on longer-term maturities) often associated with a slowing economy.

"Conundrumed!" Last week's economic activity data signaled a swift rebound from Gulf-Coast hurricanes, likely overstating economic growth in the next few quarters after a third-quarter dip now estimated at 2.25%-2.50% according to "real-time" estimates, as housing and commercial reconstruction adds to support already coming from auto and other replacement or deferred demand. Even with storm-related strength, the latest reports were mixed enough to keep the Citigroup Economic Surprise Index (measuring actual data results from expected levels) virtually unchanged from the previous week's modestly positive level. The big news continued to center on inflation's muted response to diminishing economic slack. More important than the temporary, energy-led increase in the CPI's overall rate, associated with storm disruptions, was a core rate stuck at a below-target, 1.7% rise over the past twelve months. Most worrisome for Fed officials was a steepening decline in trade-sensitive "goods" prices, already responding to a strengthening dollar early in the month. More encouraging was a second straight increase in labor-intensive, wage-sensitive services prices, likely nudged higher by a third straight monthly increase in wage inflation (as measured by the 12-month percent change in the comprehensive Atlanta Fed "Wage-Tracker" index).

Investors will be facing another full events calendar in the coming week, capped by the Fed's Beige Book survey of regional economic conditions, a Friday speech by Chairwoman Yellen and top-tier reports on September industrial output, housing starts and the month's forward-looking index of leading indicators. Accompanying those reports will be a first look at October manufacturing activity from the Empire State and Philadelphia Fed regional surveys and at September export and import prices. Rounding out a full weekly calendar will be a $5 billion sale, Thursday, of 30-year Treasury inflation-protected securities (TIPS). Activity data will be parsed for clues to the economy's underlying strength net of hurricane-related distortions, atop fresh evidence of a quick, hurricane-related bounce atop last Friday's jump in September retail sales. Economic growth still appears adequate for the December rate hike firmly imbedded into market expectations. The main issue for the Fed—and for investor expectations—is what to make of inflation's failure to respond to the usual late-cycle pressure on the labor markets along with the outlook for the dollar and global economic growth affecting the CPI's goods component.

Cutting the stock market's rally down to size. On the face of it, this stock-market rally has been long and powerful from its trough on March 9, 2009, ranked second in strength and longevity to the rise between the market's low in December 1987 and its peak in March 2000 among the rallies after the S&P 500 finally breached its pre-1929 peak in the mid-1950s. However, a few adjustments putting the latest rally in perspective portray a more ordinary rise. First, the market's rebound had too much of a running start from the unusually deep, overstated slump that preceded it. Looking at the S&P 500's cumulative change from its previous peak in early October 2007 drops the rise from second to fourth in the post-1950s rankings. Taking the comparison a step further and adjusting for the rally's length leaves it with a middling, 5% average annual gain, trailing the average annual 6% of the 10 market rises in the last 65 years. The rally does move up in the rankings a notch when the market's gains are adjusted for earnings growth, the most fundamental of the market's drivers, ranking behind five of the last 10 rallies. Surprisingly, however, support from expanded price-earnings (P/E) valuations hasn't provided unusually strong support to the market atop earnings growth. Of the seven rallies since the 1950s in which P/E multiples have expanded, four showed a more sizable contribution to stock-price increases than the current one.