Wells Capital Management

Market comment for the week of October 27, 2017

Immovable force, unstoppable object?

Gary Schlossberg

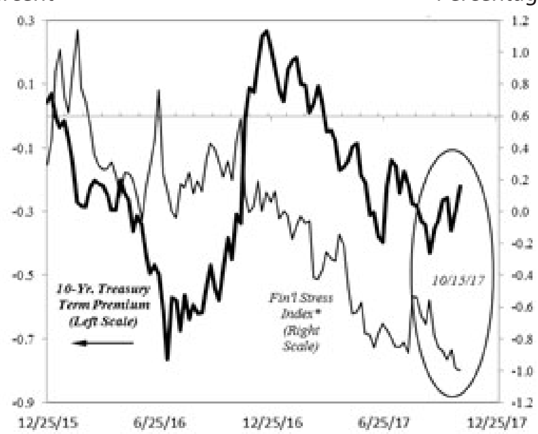
A fistful of issues. S&P 500 stocks were lifted to a seventh straight weekly high—capped by yet another record Friday—by a potent combination of better-than-expected corporate earnings, market "friendly" policy developments and by economic data solid enough to validate investor optimism. Earnings-growth expectations for the third quarter were bested by a procession of upbeat company results into the heart of the reporting season, lifting the Bloomberg Financial News tally of year-to-year increases to just over 8% for the 272 companies with results through Friday—nearly double expectations on the eve of the reporting season. Earnings growth has been accompanied by a healthy 6.2% gain in revenues, raising hopes for sustained, top-line-driven increases in profits favored by investors. Difficult negotiations over revenue offsets to proposed tax cuts failed to dim optimism over a reform package before year-end. Underscoring market support from the latest economic data was the biggest weekly improvement in the Citigroup Economic Surprise Index (measuring actual versus expected data results) in five years, leaving the measure at its healthiest since mid-April. Icing on the cake came from a tilt in the nomination sweepstakes for a new Fed chairman toward "dovish" insider Powell, increasing the chances for policy continuity during interest-rate "normalization." Support also came from an announced pullback from quantitative easing by the European Central Bank (ECB) gradual enough to support a bond rally spilling over to the U.S. market.

The latest leg of the stock-market rally was narrowly based in the latest week across just 5 of 11 S&P 500 sectors and 62 of 125 constituent industry groups. Tech's earnings-driven rally led the way, followed by economically sensitive consumer "cyclicals" and materials producers. The telecom services sector brought up the rear, hurt by a more competitive pricing environment contributing to a drop in third-quarter profits from a year ago. More generally, "risk on" trading was at work in propelling a simple basket of highly charged assets past its "safe haven" counterpart for a second straight week, supported by gains in U.S. stocks and commodity prices countering declines elsewhere. Deeper and more broad-based "haven" declines across U.S. Treasury securities, gold, Swiss francs, and Japanese yen masked gains in German government bonds supported by the ECB's surprisingly modest tapering announcement. As important as the backup in Treasury yields in the bond market—to a mid-March high by the benchmark 10-year note at one point—has been the widening gap between inflation-sensitive, longer-term rates and those on policy-sensitive shorter-intermediate securities in what is dubbed a "bear-market steepening" of the Treasury yield curve, typically associated with strengthening economic growth and rising inflation expectations.

Investors' inflation expectations among investors, measured by the 10-year "breakeven" rate in the market for Treasury inflation-protected securities (TIPS), was at a two-week high Friday despite prospects for a rate hike by the Fed at its December FOMC meeting. Unsurprising, nonetheless, is the reversal of spring-summer rate declines on a more upbeat economic outlook, lessening fears of "disinflation" producing perverse declines in market-driven interest rates responding to the Fed's normalization of short-term rates. Higher interest rates have yet to discourage a "reach for yield" by investors, judging from the market's mixed "liquidity" measures.

"Easy" liquidity conditions turning a bit more mixed

In percent — Percentage points

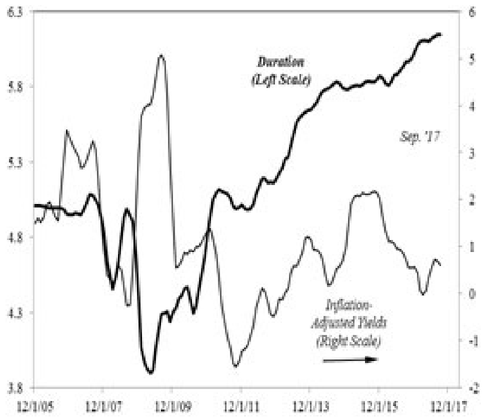


*Standard deviation from a 1992-2008 average.

A diminished discount on the "term premium" for bond yields, suggesting a less cautious longer-term outlook for interest rates, is being countered by liquidity conditions eased further by investors pumping cash into riskier investments in search of return despite the shift from aggressive stimulus by major central banks. Financial stress indexes capturing liquidity conditions likely will turn less "easy" once inflation moves higher. Labor-cost increases have been accelerating from a mid-year low, by one measure, pressuring wage-sensitive services prices. Financing restraint ultimately could lift fuel costs by capping investment in the U.S. shale industry, now the swing producer in the global energy market. Prospects for trade-sensitive "goods" prices are more of a toss-up after years of declines, now that the dollar has resumed its rise, though stronger growth abroad still could discourage price cuts by foreign firms selling into the U.S. market.

At issue is the stock market's ability to transition smoothly from a liquidity-led to an earnings-driven rally. The market's ability to rise through the early stages of past interest-rate "up cycles" bodes well for a similar transition in this one. Uncertainty centers on potentially greater interest sensitivity of economic growth and of asset prices to a given rate increase, due to increased leverage and unusually "rich" market valuations.

Duration in years Percent



Source: Via Bloomberg Financial News, Inc.

Bond exposure to higher interest rates has been aggravated over the years by the effect on market-wide "duration" (or a bond's price sensitivity to a given change in interest rates) of the rotation toward longer-term securities and of historically low interest. Adding to the bond market's exposure are historically low "real," or inflation-adjusted interest rates, partly the result of sub-par growth since the financial "meltdown" in 2008-09 and vulnerable to increases with any improvement in the economy's performance.

A good fit. The economic data's improved tone on the week fit nicely with the bullish-stock/bearish-bond narrative generated by favorable earnings reports, the gathering tax reform debate and the less sanguine outlook for monetary policy. A full data calendar provided fresh insight to several key issues shaping the growth and inflation outlook. First, healthy preliminary estimates of October purchasing-manager indexes for manufacturing and non-manufacturing signaled well-balanced growth early in the fourth quarter. Second, the economy is recovering quickly from hurricane-related disruptions. Respectable third-quarter growth of 3% was overstated by an inventory buildup, masking a modest rise in underlying demand. However, declines in weekly jobless claims through late October added to earlier reports of a jump in September auto sales in signaling an early, brisk rebound in the Gulf area, with even more of a tailwind likely from housing and commercial reconstruction. And third, double-digit growth of equipment orders during the July-September period showed the economy's rotation toward late-cycle investment spending still intact, increasing the odds of expansion continuing into 2018.

Capping another full events calendar in the coming week will be the president's announced nomination for Federal Reserve chairman and, perhaps, vice chairman before departing for his Asia trip late in the week. Also vying for attention will be Wednesday's FOMC policy announcement and Friday's October jobs report, in a week laced with other potentially market moving data. Among them: September personal income and spending, out Monday, Tuesday's consumer confidence report for October plus that month's purchasing-manager reports for manufacturing and non-manufacturing out Wednesday and Friday, respectively. Data will provide fresh insights to key outlook issues tied to the strength and breadth of the economy's recovery, between manufacturing and non-manufacturing, and the rebound from late-summer storms in the Gulf area. Price data in the September personal income and spending report, used by the Fed as its official inflation target, also will be eyed for signs of an end to disinflation complicating policy decisions since the spring.