Wells Capital Management

Market comment for the week of November 3, 2017

Taxing times!

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A crowded field. Policy, profits and a full data calendar propelled the S&P 500 to an eighth straight weekly rise and to another in a succession of record highs. Gains on largely market friendly news were part of a broader rally in riskier, or more highly charged asset groups, besting an equally narrow "safe-haven" portfolio a third straight week on broad based gains across all components except emerging-market bonds. Adding to support from better-than-expected economic data and earnings reports was the market-supportive Powell nomination to replace Janet Yellen as Fed Chair and release of the House's market "friendly" tax reform bill—paramount in the latest leg of the rally nearly a year after the president's surprise election victory touched off a similar market response on much the same theme.

As impressive as third-quarter profits growth, now projected at 8% by Thomson Reuters from less than 6% on the eve of the reporting season at the start of October, has been the growing importance of more investor friendly, sales-driven gains triggering a knock-on "leavening" of earnings through relatively high operating leverage (effectively measuring the extent to which sales gains flow right to the bottom line). Support to revenue-driven earnings growth from stronger unit sales is providing an important counter to margin pressure from increased unit labor costs and, in manufacturing, from higher materials prices. Support for the earnings outlook came from upbeat economic reports, best captured by yet another gain to a seven-month high in the Citigroup Economic Surprise Index measuring actual vs. expected data results. Capturing the economy's strong start to the fourth-quarter was a 3.3% growth estimate by the Atlanta Fed's real-time, GDP Now model—a third straight quarterly growth of over 3% if the pace holds up.

The House tax-reform bill was well received by the stock market because of the lift to corporate profits from the cut to 20% from the current 35% in the corporate tax rate, despite such proposed offsetting revenue enhancers as limits on corporate interest deductibility and a tax on multinationals' overseas income. Untouched, moreover, was the special carried-interest tax on hedge-fund income and the lower tax rates on capital gains and qualified dividends. Equally understandable is caution over the bill's outlook made all the more uncertain by the uneven impact of changes favoring manufacturers at the expense of home builders, higher education and many small businesses, plus cuts to such "birthright" deductions as mortgage interest plus state and local taxes. These and other revenue enhancers make the coming week critical to overcoming pushback on the bill's provisions and to maintaining the aggressive time table for late-2017 passage of tax reform. The tax debate is complicated by the size of needed revenue enhancers to hold the added deficit to $1.5 trillion over 10 years without entitlements reforms not even on the negotiating table.

As for the Fed, at least two things could up-end a seemingly safe gamble on nominee Jerome Powell: the Board's tendencies once as many as four vacancies are filled and performance by the new chairman during his first bout of market turbulence. More "hawkish" nominations by the president could serve as a counterweight to the more dovish Powell, increasing the chances of multiple hikes not yet priced into the Fed funds futures market. But for now, the Fed nominee brings several things to the table: 1) continuity, as a current member of the Fed, familiar with the Board's workings and with a similar policy stance to that of Yellen, 2) a lighter touch on financial regulation than the more "hawkish" Yellen, 3) a non-academic with a more eclectic approach to problem solving, 4) Wall Street and crisis-management experience, perhaps providing him with some of the insight, contacts and experience Fed Chairman Greenspan was able to bring to the 1987 stock market crash and to the 1998 bail-out of Long-Term Capital Management, and 5) a reputation as a behind-the-scenes consensus builder.

The narrow depth and breadth of last week's rally was hardly befitting an eighth straight weekly gain or the array of news supporting it, extending across just five of 11 S&P 500 sectors and fewer than half the 125 constituent industry groups. Narrowing support for the rally has been an issue throughout the year, leaving the top five S&P 500 companies accounting for more than half the gains since the start of the quarter compared to 25% in the year's first nine months and to less than 22% last year. Small caps drew short-lived support last week from announced tax cuts and from lower interest rates, finishing lower and at its cheapest against the S&P 500 since early September on relatively "rich" valuations plus strong overseas growth and lingering fall-out from dollar weakness earlier this year benefiting large-cap multinationals. By contrast, international stocks in both developed and in emerging markets out-performed the U.S. benchmark in local-currency and in dollar terms on favorable earnings reports, fresh signs of global economic strength, low European inflation supporting the "dovish" spin to central-bank shifts from aggressive stimulus and the latest rally in commodities. An improving supply-demand balance in markets for oil and industrial metals have helped make commodities one of the best performing asset classes thus far this quarter with a gain of more than 5.3% on the S&P-Goldman Sachs price index.

Looking back on October, the S&P 500's best monthly return in nearly a year may have been less significant than market stability in a month notorious for its volatility. Much of the calm stems from U.S. and foreign central-bank stimulus, still encouraging a reach for return in stocks and in other highly charged market segments despite the tilt toward interest "normalization" in the U.S. and, to a lesser extent in Europe. "Seasonals" will provide a market tailwind during the balance of the year, historically a performance sweet spot characterized by relatively high returns and by diminishing market volatility. Whether or not the market will oblige with that kind of performance this year depends, in part, on its ability to overcome tax reform's uncertain debate, a likely mid-December rate hike and the economy's uncertain post-hurricane trajectory. The market's big test will come with a turn toward higher inflation, anticipated by recent increases in the New York Fed's reliable Underlying Inflation Gauge, recent fuel-price increases, the lift to labor-intensive services from firmer wage increases and support to trade-sensitive "goods" prices from strengthening economic conditions abroad. For now, however, investors are content to key on recent "disinflation" in keeping interest rates restrained, providing the markets with ample cash through a reach for return and leaving liquidity conditions increasingly "easy."

A late-cycle "mini-burst?" At issue in the economy's best showing since 2014 is support from underlying vs. temporary, post-hurricane related strength. Storm-related disruptions distorted a mildly disappointing October jobs report, countered by more clear-cut strength in purchasing manager reports, factory orders, consumer confidence, and, in late-October, jobless claims. While not likely the start of an economic "boom" this late in the growth cycle, activity in coming months will enjoy a tail wind from hurricane-related reconstruction. Moreover, recent data validated themes likely to keep growth on track into the new year. First, October purchasing-manager surveys showed solid, well-balanced growth between manufacturing and non-manufacturing activity. Second, economic strength continues to broaden into late-cycle business investment, punctuated by double-digit growth in third-quarter equipment orders for the first time in three years. Third, there's been little let-up in the lift to U.S. exports from synchronized global growth, despite recent dollar strength. And an accelerated rise in third-quarter employment costs, affected less by hurricane-related distortions, added to the evidence of gathering wage-price pressures.

A light events calendar, including a wind down of third-quarter earnings reports, will allow investors to key on a critical phase of the tax-reform debate, almost certain to include push-back from groups affected by its revenue-raising proposals, plus lingering market reaction to the Powell nomination for Fed chairman and the recent batch of solid economic data. The data flow (or trickle) resumes Tuesday, with Labor's report on September job openings and labor turnover (JOLTS) and the Fed's consumer-credit report for the month. Attention then shifts Thursday to September wholesale trade and to weekly jobless claims for early November, ending the week with early-November consumer sentiment from the University of Michigan. Economic releases will be accompanied by a $62 billion three-part sale of three-, 10- and 30-year Treasury securities Tuesday through Thursday.

Not your father's (or mother's) bond market. Indexed-based investors have achieved a stealth move out along the "credit-risk" curve contemplated over the years by more active market participants. BBB-rated securities now account for over 51% of all investment-grade issues in the BofAML index of corporate bonds compared to less than 40% a decade ago and little more than a third in October 1997. The shift has increased investor exposure to a 12-month BBB return roughly double that of A and AA-rated issues with only a modest step-up in volatility. What comes next is open to debate. Yield spreads to comparable Treasury issues vs. their pre- and post-crisis average in the BBB segment aren't quite as "lean" as those in the higher quality segments. And while overall corporate finances are deteriorating with the recent buildup of debt, they are not overly exposed as a group for an economy likely to avoid a recession in the coming year. Historically, moreover, BBB-rated performance tends to hold its own against comparable Treasury issues during the early stages of an interest-rate up-cycle, arguably where we are now given the drawn-out increases of recent years.