

Market comment for the week of November 17, 2017

Giving thanks.

Gary Schlossberg

A glass half-full market. Stocks seesawed lower, leaving the benchmark S&P 500 Index with a rare, back-to-back weekly decline in trading unsettled enough to lift VIX-based volatility to an early-September high. The Treasury market took its cue from stocks throughout the week in its role as a haven investment, countering risk-asset moves, again demonstrating its diversification value in balanced portfolios. Still, chatter about an overdue reversal of an increasingly frothy market seemed premature. A simple portfolio of haven assets did out-perform its risk counterpart for a second straight week. However, risk-asset declines centered narrowly on the S&P 500 and on commodity prices (the latter on China's growth slowdown signs), masking gains in emerging markets stocks and other highly charged groups. Moreover, the S&P 500 ended the week little more than a half percentage point below its early-November high, in a fairly narrow and shallow decline across 7 of 11 sectors and only 53 of 125 industry groups. Big market moves up or down were contained by healthy economic and earnings growth, progress on tax reform, and still-ample liquidity conditions supporting rich valuations, countered by hints of firming inflation threatening supportive interest rates, China's credit-induced growth slowdown, and concern over market stability raised by the sell-off in the high-yield sector still centered disproportionately on ailing telecommunications services.

Asset markets will continue to face uncertainties in coming months during a critical phase of the tax debate and from the economic and financial-market implications of a narrowing gap between shorter- and longer-term rates—dubbed a flattening yield curve. Markets responded to more supportive news on tax reform with House approval of its version of the bill and the Senate Finance Committee's mark-up of its plan for a full vote as early as next week. At issue is the GOP's ability to draw on a narrow majority and its proposal's controversial features in winning a full Senate vote. Beyond that likely would be a difficult reconciliation between unexpectedly different House and Senate versions. Converging shorter- and longer-term rates left the gap between 2- and 10-year yields at a ten-year low last week in a move historically linked reliably enough to growth for inclusion in the Conference Board's index of leading indicators. Obscuring the yield curve's significance in this rate cycle, however, has been an unusual bull-market flattening of the yield curve, in which broad-based rate increases, paced by shorter-term yields and normally weighing on economic growth, have been supplanted much of the time by an often growth-friendly decline in longer-term yields suppressed by subdued inflation and by central-bank securities purchases. Adding to those distortions are the Treasury's planned rotation toward shorter-term securities in future deficit financing, narrowing the interest-rate gap more in response to technicals rather than to economically driven fundamentals.

Further muddling the outlook have been differing narratives on oil

prices and broader CPI inflation. Fuel costs have been propelled higher by Saudi political uncertainties, synchronized global growth supporting demand, and prospects for greater shale-output discipline on investor restraint and by market technicals (specifically a shift from rising to falling futures prices relative to those in the spot market, discouraging a market-supporting tilt by producers to futures sales), only to be undercut, recently, by lowered demand forecasts for next year and by reports of increased shale output bolstering excess inventories. Investors straining for insights to the inflation outlook have had to weigh signs of incremental pressure in several CPI components against persistent weakness in overall and core CPI inflation.

Crosswinds like these often create a vacuum, leaving asset markets vulnerable to a broadening array of setbacks like those buffeting stocks in the latest week. Adding to that sensitivity are stocks and other risk assets viewed by investors as priced to perfection, leaving them all the more vulnerable to future earnings disappointments or to other surprises. The challenge for investors is in distinguishing between short-lived, event-driven changes—like the tax debate's ebb and flow—versus more enduring changes in market fundamentals, including economic and earnings growth, inflation, interest rates, and the dollar. Still-friendly market conditions have eroded in recent weeks, but supportive fundamentals remain intact. Broadening economic growth is sufficient to support respectable, increasingly top-line-driven gains in corporate profits, even after stripping out support from hurricane-related distortions. Equally important has been the ongoing improvement in market liquidity conditions despite a likely fifth rate increase this cycle by the Federal Reserve next month, encouraging an ongoing reach for yield and return suppressing longer-dated yields and quality spreads on lower-rated issues. A more challenging 2018 awaits investors, but the scope of the change affecting risk versus haven assets still is unclear.

In the pink. There was less market confusion about the economy's strength after the latest batch of economic reports than about the implications for inflation. Upbeat data were captured by the solid rebound in the Citigroup Economic Surprise Index (comparing actual with expected economic-release results) to an 11-month high, consistent with a real-time growth estimate of nearly 3½% midway through the fourth quarter by the usually reliable Atlanta Fed's "GDPNow" model. Growth's thematic supports remain intact, including well-balanced manufacturing versus non-manufacturing growth, its broadening into late-cycle business investment, a post-hurricane lift extending out from autos and other consumer spending to housing and commercial construction, and support to U.S. foreign trade from solid growth abroad. Stand-out activity reports on the week included another month of accelerated growth in underlying retail sales in October, and a storm-related drop in auto inventories.

A fairly broad-based rise in October housing starts signaled improvement in this leading-edge sector extending beyond reconstruction in the Gulf area, bolstered by an increase in home-builder confidence to an eight-month high. Less clear were the implications of the latest price reports for the inflation outlook. The headline CPI was held down due to lower fuel costs. However, a seemingly modest rise still left the CPI's core inflation rate (excluding food and energy) up for the first time since January, supported, in part, by the biggest year-over-year increase in wage-sensitive services inflation since April. Less clear was the outlook for trade-sensitive goods prices, down, again, from a year ago, but with its first month-to-month increase since January amid further signs of stabilizing import prices for manufactured goods.

Looking ahead, potentially market-moving events in a Thanksgiving-shortened week include Fed Chair Yellen's Tuesday speech at the NYU business school, Wednesday's top-tier October durable-goods orders, late-November consumer sentiment, and the minutes of the Fed's October 31-November 1 FOMC policy meeting. Preceding that news will be Monday's forward looking index of leading indicators for October, last month's home resales, and the comprehensive Chicago Fed National Activity Index out the following day. Activity data will be scrutinized for fresh signs of respectable growth midway through the fourth quarter, supporting both the earnings recovery and multiple potential interest-rate hikes by the Fed in December and as early as March. Still at issue is the future trajectory of inflation—the missing ingredient this year for a more sustained rise in interest rates—after mixed reports this past week.

A different kind of value driven. Stronger corporate earnings growth has provided welcome support to this year's stock-market rally, piling an estimated third-quarter gain of just over 8% atop double-digit growth in the first half, and reinforced by talk of corporate tax cut potentially adding materially to cash flow. That said, this cycle of rising stock prices likely will be known as one driven more by price-earnings (P/E) multiple expansion than previous cycles. Nearly two-thirds of the S&P 500's rise from its most recent low in September 2015 has been driven by a rising P/E versus little more than a third by a direct increase in corporate earnings. During the last three extended stock-market rallies since the late 1990s, by contrast, rising P/E's accounted for about an average 25% of the rise in stock prices.

Behind the out-sized contribution of multiple expansion to this cycle's stock performance have been aggressive central-bank stimulus and ample market liquidity, driving down yields on competing bonds to unattractive levels while contributing to market-boosting growth of corporate earnings by lowering interest expenses. That tailwind has been supporting stocks throughout the secular decline in interest rates since the early 1980s, when a 10-year Treasury note yielding nearly 18% in March 1982 helped compress the P/E to 6.2 times projected, or forward earnings—little more than a third of its current multiple—boosted by a decline in the benchmark Treasury yield to less than 2.4%. However, dependence on low and declining interest cuts both ways, leaving stocks all the more vulnerable to a sustained backup of rates increasing financing costs and the allure of falling bond prices. Those bond prices are more sensitive to a given change in interest rates at these historically low yield levels because of an associated increase in duration, measuring the price sensitivity of bond prices to a given change in yields.

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