Wells Capital Management

Market comment for the week of December 22, 2017

Joy to the world!

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A tough act to follow. It has been a long time coming, but the global economy is on the cusp of a bona fide expansion last sighted briefly in the immediate aftermath of the deep, 2008-09 recession. The world economy is coming off its strongest and broadest expansion period since 2010-11, capped by a return of world trade as a growth engine and by double-digit earnings gains here and in many other parts of the world normally reserved for the strong "bounce" from a recession. Ongoing "disinflation," accentuated by the after-effects of the deep, "balance-sheet" recession, is the most visible legacy of that economically troubling time. Nonetheless, overall improvement has been supported by prolonged adjustment to the financial "meltdown," facilitated by extraordinary central-bank stimulus and, most recently, by positioning ahead of U.S. tax cuts set to go into effect next year. Economic conditions in 2017 have produced an unusually supportive, late-cycle combination of respectable growth, subdued inflation, historically low interest rates and a weak dollar contributing to a 22% return on the S&P 500 through late December and international (EAFE) stocks nudged past the U.S. gain by sizable currency gains from the dollar's depreciation.

In the latest week, the S&P 500's see-saw pattern after Monday's surge to its seventieth record high of the year may have signaled a hunkering down ahead of the long holiday and quasi-holiday period after impressive gains of recent weeks, or the start of a more fundamental consolidation phase as investors digest growth "friendly" tax reform and await the next "big thing." The test may not be long in coming, as investors are greeted early next month by, what is expected to be, double-digit growth of S&P 500 fourth-quarter profits, making it difficult to sell the "fact" of tax reform after buying the "rumor" of fiscal change. Lingering opportunities from the most far-reaching tax changes in thirty years make portfolio rotation out of stocks difficult, as well. Opportunities for "active" management created by the varying impact of tax changes at the industry and company level are yet to be "priced in" fully, for example. Also at issue is the volume and pattern of takeover activity, spurring combinations by lowering the after-tax cost of selling units and by freeing up cash for corporate acquisitions. More "strategic," company-to-company stock and cash deals will benefit relative to leveraged buy-outs because of the added cost of debt financing from lower tax rates and from reduced interest deductibility.

Bonds are ending the year on a less upbeat note, as "disinflation's" tailwind propelling the market much of this year shifts under the double-barrel "hit" to bonds from a likely increase in deficit-related supply and from growth "friendly" tax reform's effect on inflation expectations. Investors aren't waiting for inflation's actual rise, driving expectations (measured by the "breakeven" inflation rate on a 10-year Treasury Inflation-Protected Security [TIPS]), to an April 2017 high and, at 1.95%, within shouting distance of the Fed's 2% target rate. November's actual inflation, at a subdued 1.5% for the 12-month "core" rate (excluding food and energy) is stirring beneath the surface: the share of declining price components within the PCE deflator (the Fed's preferred inflation gauge) fell to a nine-month low, accompanied by an increase to a nine-month high in the share of components increasing at a rate of more than 3%.

Inflation, and how investors view its outlook, is critical to the future direction of interest rates and to the pattern of those changes. Disinflation this year has been the catalyst for a perverse interplay of Fed rate hikes and inflation-sensitive bond yields pulled down by central-bank moves lowering growth and inflation expectations in an unusual "bull-market flattening" of the Treasury yield curve (i.e., the path traced by interest rates at various maturities). Tax reform risks abrupt changes in the rate interest-outlook through higher inflation expectations providing a tailwind for higher bond yields and a "bear-market flattening" (or even a temporary, "bear steepening") of the yield curve more typical during the middle and late stages of an interest-rate "up cycle." Adding to the risk of higher interest rates are corporate bond portfolios made more interest-sensitive by the tilt toward longer-term debt by borrowers and by the "leavening" effect on "duration" (or the sensitivity of bond prices to a given change in interest rates) by historically low yields. The U.S. Treasury market could become more unsettled, as well, by a planned shift by the toward short-term financing in the coming year, making Treasury interest payments even more sensitive to rising interest rates than they already are.

Also at issue is the dollar's outlook after this year's unexpected decline, critical to determining U.S. investors' returns on international stocks and bonds along with multinationals' dollar-based income. The currency's setback, matching the unexpected decline in longer-dated Treasury yields between March and early September, continued during the back-up in U.S. interest rates this past week amid even more rapid increases in yields on German government rates, narrowing the still-sizable yield premium favoring the U.S. dollar strength should be supported in the coming year by a widening gap between U.S. and foreign interest rates lifted by a less sanguine inflation outlook and by a recoupling of U.S. yields with Fed policy on the leading-edge of the turn from aggressive central-bank stimulus.

Gift-wrapped for investors. The economy may not be leaving 2017 as a lion, but broad-based strength has supported respectable economic growth in the 2.5%-3.0% range, signaled in recent weeks by real-time" GDP estimates, and by earnings gains strong enough to overcome headwinds from higher interest rates in propelling stocks higher through the early part of the new year. Upbeat news raised the Citigroup Economic Surprise Index to a six-year high, despite an unexpected decline in late-December consumer sentiment and a disappointing gain in November's broad Chicago Fed National Activity Index. Elsewhere, however, housing's remarkable, late-cycle strength was on display with solid gains in November housing starts, new and existing home sales along with early-December home builder sentiment. Dominant consumer spending weighed in with its strongest 12-month, inflation-adjusted gain since May, confirming reports of an impressive rise in retail sales for the month. And both November durable goods orders and the early-December regional Philly Fed survey left little doubt over manufacturing's late-cycle strength as remarkable as that of housing.

November's forward-looking index of leading indicators built on the previous month's solid gain, accompanied by a rise in the ratio of coincident to leading indicators (often foreshadowing moves in the leaders) in signaling continued brisk growth in coming months. Even "soft" spots in the data contained strengths underscoring growth's broad-based support. A first decline in November capital-goods orders since June followed September and October gains strong enough to lift three month growth to an explosive, five-year high, a sign that investment-led growth is firmly on track ahead of tax cuts designed to sustain it. A sizable increase in the December 16 week's initial jobless claims still left the latest four-week average historically low and consistent with a tightening labor market. And a November personal saving rate of less than 3%—a 10-year low—may have been due as much to double-digit growth of household wealth, amid solidly rising home and stock prices, as it was to over-exuberant and unsustainable consumer spending.

A full events calendar midway through a holiday-shortened week will update housing activity, the dominant consumer sector, manufacturing and foreign trade. Also on tap is an $88 billion, three-part sale of conventional two-, five- and seven-year Treasury notes accompanied by a $13 billion mid-week sale of Treasury two-year floating-rate notes. Economic reports should be reasonably upbeat, showing economic momentum losing a bit of its edge but supporting still-respectable growth at the end of the year. At issue is tax reform's ability to build on that strength over the course of 2018. December consumer confidence, out Wednesday, and Thursday's purchasing-managers' index for Chicago-area manufacturing are the two potential market-movers during a normally quiet, inter-holiday period, with October S&P/ Case-Shiller home prices and November's advance foreign-trade report two potential "sleepers" in the line-up.

Testing this year's "hybrid" security in 2018. Paralleling this year's "Goldilocks" economy of respectable growth, subdued inflation and historically low interest rates has been an equally impressive mix of healthy returns and unusually low volatility in the stock market, effectively producing a bond-like, stock-like "hybrid" that combines two of their best features. The S&P 500's year-to-date return of just over 22% through Friday—nearly double its average of the past 92 years--has been accompanied by record low "realized" volatility (i.e., the standard deviation of month-to-month changes in total returns) of less than 2.5% above that on a long-term government bond versus a near-10% norm since the start of the "bull" market in 2009. Low "vol" has lifted this year's annual performance ranking from 31st over the past 92 years, based on nominal returns, to 15th on a risk-adjusted basis. Wedged between solid earnings growth and the absence of major economic "shocks" this year contributing to solid returns and subdued volatility, respectively, has been the role of interest rates subdued by ample "liquidity" in supporting both. However, the wind down of excess liquidity—among the market's most challenging events expected next year—likely will set the stage for a return by stocks to their traditional role as a highly charged "risk" asset.