Marketing Communication

Market comment for the week ending November 9, 2018

Divided We Stand

Gary Schlossberg

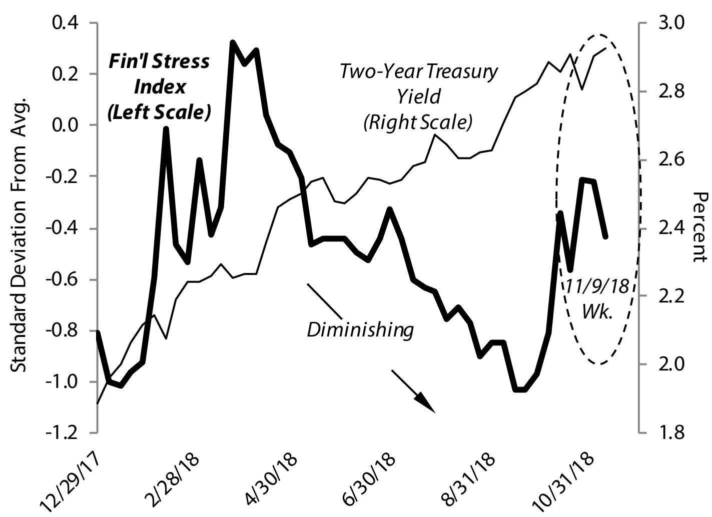
A déjà vu moment? A late-period reversal of an encouraging postelection rally—reminiscent, at times, of October's steep sell-off—wasn't enough to prevent a second straight up week for stocks, overcoming a hawkish spin to the Fed's latest policy announcement, plus fresh signs of a global growth slowdown seemingly confirmed by ongoing declines in oil prices to a six-month low from a near four-year high a little more than a month ago. Market valuation, based on the S&P 500 Index's forward price/earnings (P/E) multiple of 16 times projected 12-month earnings, was back to a 2.5-year low at the end of the week. This was still up from the worst of the October slump, however, and more than 8.5% above its long-term average despite the past year's surge in earnings. More broadly, a second straight weekly rally by risk against more conservative safe-haven assets was led by—but not confined to—U.S. stocks, leaving its value against the more conservative portfolio at its highest in more than a month.

The stock market's broad but fairly shallow rally on the week, across 10 of 11 S&P 500 Index sectors but only 88 of 125 industry groups, was paced by election-winner health care, benefiting from expanded Medicaid initiatives in several states and the Affordable Care Act's more secure position in a split Congress that outweighed potential bipartisan support for tougher drug-pricing regulation. Yield-sensitive real estate and other sectors followed, on lower interest rates late in the week propelled by safe-haven demand. Newly formed communications services—the week's only S&P 500 Index sector in the red—was hurt by a combination of disappointing earnings reports at a few social media companies, worries over tougher privacy regulations in the new Congress, rich valuations, plus dollar strength and slowing overseas growth weighing on the group's multinationals.

Interest rates continued to be driven mainly by their real (inflation-adjusted) component in sending the benchmark 10-year Treasury yield to a 2011 high Thursday, despite mounting inflation pressures up the pipeline from accelerating wage and wholesale cost increases. Behind the latest rise in real yields, more accurately measuring the bite to monetary policy on economic activity, were preelection jitters over added fiscal stimulus (and associated Treasury borrowing) and the hawkish spin to Thursday's Federal Open Market Committee (FOMC) communique still favoring multiple rate increases through 2019. Beyond the Fed, bonds risk a double dose of pressure from inflation's likely rebound from back-to-back summer declines and worsening supply-demand technical. The collision of increased Treasury debt supply and reduced demand from the Fed's balance sheet wind-down could pose a greater threat to interest rates than higher inflation, given investors' greater sensitivity recently to increased budget deficits.

The FOMC communique was as significant for what it didn't say as for what it did. No mention was made of recent market turbulence, slowing growth abroad and the potential impact of further restraint by the Fed on financial stability, a reminder that interruptions to future rate increases will require disturbances severe enough to disrupt the smooth flow of liquidity. Still, future rate increases by the Fed will have to strike a balance between the risk to financial stability and to a more interest-sensitive economy from aggressive increases against excessive increases in asset values and inflation if it moves too cautiously. For now, however, the Fed and investors still enjoy a safety net from still-easy liquidity conditions, signaled by historically low stress indices and recently narrowed quality spreads in the bond market, despite ongoing rate increases lifting the yield on the policy-sensitive two-year note and contributing to double-digit declines in the monetary base (the raw material for money creation).

Diminishing financial stress, even as interest rates rise



Source: Bloomberg Financial News, Inc.

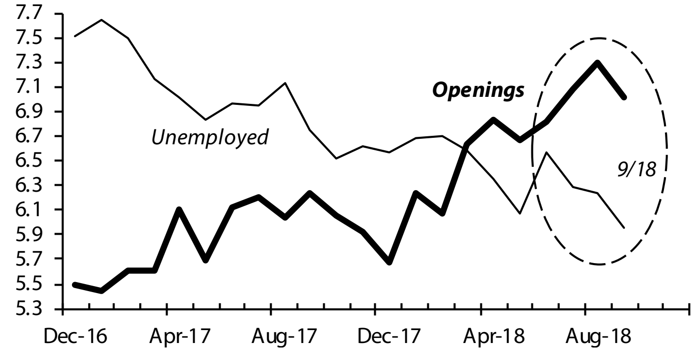
As for the stock market, history, if not economic fundamentals, is on the side of a market rally into 2019, as the market enters the sweet spot of the political cycle. Markets have risen after every midterm election since 1946, explaining why stocks tend to do best between the fourth quarter of a president's year two and the second quarter of year three (supported by the tendency to load up on fiscal stimulus, with or without the support of Congress, ahead of an election just two years away). Add to that the market's seasonal strength in the November–April period, plus likely aggressive stock purchases this year by active investors making up for October's steep decline, and ingredients for a politically driven rally are in place. There's also more to market support from split-Congress gridlock than stalled, potentially unfriendly legislation for the asset markets. Strong, postelection performance by policy-sensitive industries, including infrastructure and health care, highlight areas of opportunity for bipartisan legislation despite a seemingly deadlocked Congress.

Elsewhere lie potential election-related headwinds to market gains. Democratic control of the House virtually eliminates chances of Republican-inspired tax cuts, a relief to bonds avoiding still more government debt supply and the threat of added inflation, but disappointing to more growth-driven stocks. Budget stand-offs run the risk of renewed fiscal cliff disruptions to government spending. And passage of the new trade agreement with Canada and Mexico, though still likely, faces a more tortuous, market-unsettling path from Democratic demands for added labor and environmental concessions. Also capable of breaking that string of postelection market gains are slowing growth abroad and a late-cycle economy at home prone to higher inflation, rising interest rates, margin pressure from higher wage and financing costs, further translation losses on overseas income from a stronger dollar, and newly imposed tariffs likely having their peak effect next year.

A smooth reentry? A smooth transition to sustainable economic growth was the message from a light data calendar in the latest week. Real-time estimates based on early fourth-quarter data put growth just shy of 3% from the third quarter's 3.5% rate and 4.2% in the second period. Investors also could take heart from data results exceeding lowered expectations for a second week in lifting the Citigroup Economic Surprise Index to a four-month high. Hollowing growth still is the biggest concern at the moment, as lost momentum in housing; foreign trade; and, most recently, investment leave early-cycle consumer spending to provide disproportionate support for a seemingly interminable growth cycle headed for a record if sustained through next June.

Job openings widening the gap with the number of unemployed

Millions of jobs and jobless



Source: U.S. Labor Department.

Evidence of moderating, still-respectable growth in the fourth quarter came from October's purchasing managers' report for dominant nonmanufacturing. Tight labor market conditions, underpinning consumer-led growth, came from historically early-November jobless claims and from a widening gap between higher job openings and total unemployment. Added support for the consumer came from another solid reading on early-November consumer sentiment, along with a rebound to an early-October high in weekly chain-store sales during the November 3 week supported by added income available from a drop in retail gasoline costs to a seven-month low.

Fed Chair Powell's midweek appearance at a Dallas Federal Reserve conference will join October CPI and retail sales reports as this week's main events. Powell's remarks on the policy outlook will take on added significance after the FOMC communique left the market keying on inferences, not explicit guidance, to gauge the Fed's next moves. Friday's larger-than-expected rise in October wholesale prices will add to the drama surrounding Wednesday's CPI release, scrutinized closely for signs of reversal in the two-month inflation slowdown capable of stalling planned interest rate increases if the wind-down continues. Retail sales, capping the activity data, will be viewed for signs of continued momentum in an increasingly consumer-driven growth cycle. October and early-November data also will include updates on manufacturing, small business conditions, the Federal budget, plus export and import prices.