Marketing Communication

# Market comment for the week ending January 18, 2019

## Coming up roses?

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**Correction corrected.** A forgettable 2018 for stocks and other risk assets is giving way to a more promising start to 2019. Building on an encouraging December jobs report and the Federal Reserve's dovish policy shift early this month was optimism over a workable trade agreement with China ahead of next week's talks in Washington, D.C. Reinforcing market optimism have been stronger-than-expected fourth-quarter earnings numbers early in the reporting season and outlooks less worrisome than feared. Economic data truncated by the government shutdown still hinted at broadening strength beyond consumer-centric growth, easing concern over lost momentum midway through this tenth year of the growth cycle. Prevailing optimism lifted the benchmark S&P 500 out of correction territory with a fourth straight weekly gain in a broad, deep rally across 10 of 11 S&P 500 sectors and 112 of 126 industry groups, ending the week with the benchmark less than 9% below its September high. Still-subdued interest rates and the dollar's muted rise limited slippage in gold's price, to less than 1% below its most recent high on January 3. Nonetheless, our risk-asset portfolio was up a third straight week against its haven counterpart, to a late-November high.

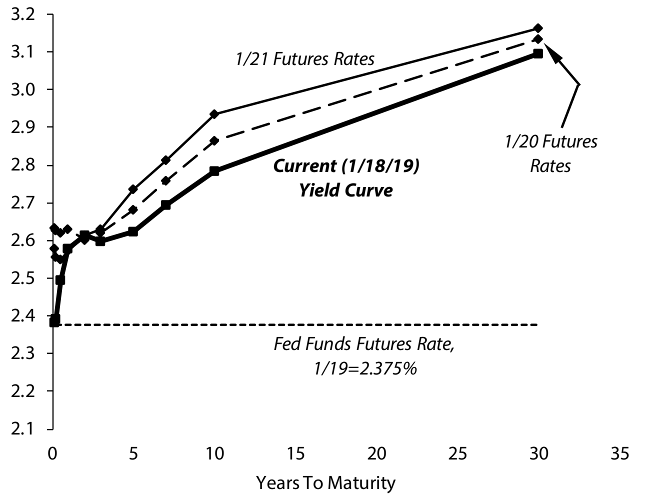
Challenges faced by the market early in the year include a record shutdown (partial or otherwise) with a still mild—but increasingly corrosive—effect on the economy, reversed only partially after the government's eventual reopening. Trade talks may be getting bogged down over the critical issue of intellectual property protection, despite optimism over their outcome. And mixed data are leaving investors guessing about the economy's ability to buffer an expected soft patch in first-half corporate profits expected to send first-half growth back to the low or mid-single digits during 2019's first half from over 14% in the fourth quarter, as the tax cut's statistical lift to year-over-year growth washes out, multinationals' revenues feel the effect of the growth slowdown abroad and margins are pressured by weak pricing power, elevated borrowing costs, wage pressures and, perhaps, losses on overseas income from a strengthening dollar.

The shutdown's economic impact is taking on a death-by-a-thousand cuts look, as consumer spending is nicked by the effective lay-off of nearly two million government workers and contractors, small-business and agricultural sectors face disruptions in government financing, while regulatory approval for drugs, airline routes, IPO clearance, plus other financial transactions and business needs are delayed. Estimates of a 0.1-0.2 percent haircut to first-quarter economic growth each week of the shutdown risks a perceptible impact on already moderate growth expected during the opening months of the year, potentially magnifying the impact through its effect on business and consumer confidence.

Nonetheless, key support for the strongest four-week rally in over seven years has come from a market still responsive to an improved outlook for interest rates and market liquidity. Valuations also are attractive at 15.4 times increasingly conservative S&P 500 earnings expectations for 2019, less than 4% above the long-term average and in line with the historic norm relative to bond yields. The 10-year Treasury yield, lifted to a one-month high of 2.78% by the rotation out of bonds and other haven assets, still is below its average since rates last peaked in early November. Credit that to investors' restrained inflation expectations, judging from a 10-year TIPS breakeven rate that ended the week still well below the Fed's official 2% inflation target at 1.82%.

**Backing away from the dreaded "flattening"—or "inversion"—of the Treasury yield curve?**

The Treasury yield curve vs. the Fed funds target; in percent



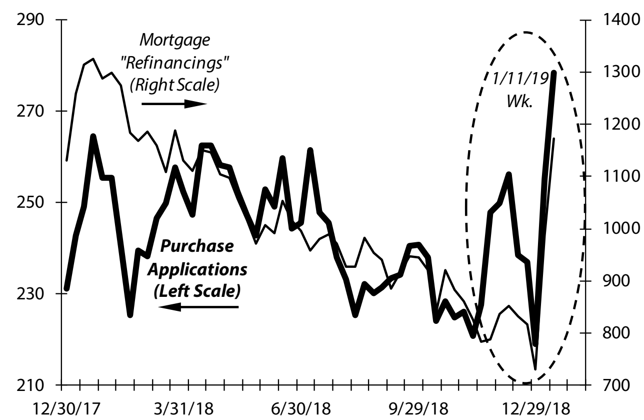

Source: Federal Reserve Board.

Subdued inflation encouraging the Fed's move to the sidelines perversely is contributing to a rise in longer-term rates by lessening the recession threat from multiple central-bank rate hikes. That, plus the return of risk-on trading, has benefited stocks at the expense of bonds, restoring a negative correlation (and associated diversification value) between the two asset classes missing during much of 2018 but typical when sufficient economic and earnings growth allow stocks to overcome the debilitating effect of rising bond yields late in a growth cycle. Equally important has been the effect of the Fed's more dovish policy tilt in fostering a typical, upward sloping Treasury yield curve (i.e., the path traced by interest rates at various maturities) priced into the futures market as illustrated in the chart above. Expected increases in short-term rates reduced materially by the policy stand down have lessened the risk of a dreaded inversion (in which short-term rates exceed those on longer-dated securities) associated with a recession. The brighter trade and Fed policy outlook supporting stocks and other risk assets has been reinforced by an associated easing of financial stress indicators accommodating a smoother flow of funds throughout the financial market, leaving conditions at their most favorable for the group in over two months.

**Beyond the shutdown.** Last week's abbreviated calendar nonetheless offered hints of broadening economic strength beyond consumer spending supporting moderate, sustainable growth. Capturing the data's tone was the Fed's Beige Book survey of regional economic conditions, characterizing growth as modest to moderate for a third straight time since October. The lengthening government shutdown made its mark on consumer sentiment, down sharply to an October 2016 low. Housing weighed in with support, however, responding to a decline in borrowing costs to an eight-month low with sizable increases in mortgage purchase and refinancing applications in the past two weeks, accompanied by a better-than-expected homebuilder sentiment index in early January.

**Mortgage applications "spike" higher on sizable mortgage-rate declines**

Index: March 16, 1990=100




Source: Source: Mortgage Bankers Assn.

Trade-sensitive manufacturing, hurt by uncertainties over U.S.-China trade and a revival of global trade and economic growth, suffered slippage in rolling three-month growth through December to its weakest pace since last July despite a solid gain at the end of the year. More current Empire State and Philadelphia Fed regional manufacturing reports for early January were equally mixed, leaving their average at a November 2016 low for a second month. Elsewhere, December export and import prices added to the evidence of price restraint coming from the month's wholesale and consumer prices, featuring another double-digit decline in imported oil costs accompanied by little change in the manufactured goods component affecting U.S. pricing power.

Economic prospects are set to improve beyond shutdown-related weakness, increasing the odds of 2%-2½% growth on the year. Mortgage rates suppressed by low inflation should sustain housing's mini-recovery in coming months. U.S. economic policy is set to remain as supportive of growth—if not more so—in 2019. Fiscal stimulus actually will increase this year, according to estimates by Strategas, an investment research firm, paced by individual tax savings and by disbursement of authorized spending hikes. Support from a U.S.-China trade agreement would extend beyond U.S. manufacturing to world trade's support to global growth. And the Fed likely will hew to its more dovish policy tilt until a more resilient economy is capable of navigating renewed financial volatility associated with future rate hikes. Ultimately, that could encourage the Fed's return to interest-rate normalization through multiple rate increases as early as this year's second half, exposing asset markets to renewed turbulence from a rotation back to safe-haven from risk assets plus another unwinding of leveraged portfolios and balance sheets in a more highly charged financial market.

Economic reports in a holiday-shortened, partially government shuttered week will pre-occupy the asset markets Tuesday through Thursday, accompanied by a growing focus on the worsening human toll and economic fall-out from Washington, D.C.'s partial shutdown. Available housing and manufacturing updates will keep the focus on prospects for broadening growth beyond its narrow consumer base in coming months. The Conference Board's forward looking index of leading economic indicators (LEI) for the end of the year also will attract more than the usual attention, for added clarity on the extent to which the government shutdown will be weighing on growth through the end of the first quarter. Overseas, Thursday's policy meeting of the European Central Bank (ECB) and January manufacturing and non-manufacturing purchasing manager reports will vie for investors' attention with the ongoing Brexit drama and progress toward a U.S.-China trade agreement.