Marketing Communication

Market comment for the week ending January 25, 2019

After the wall

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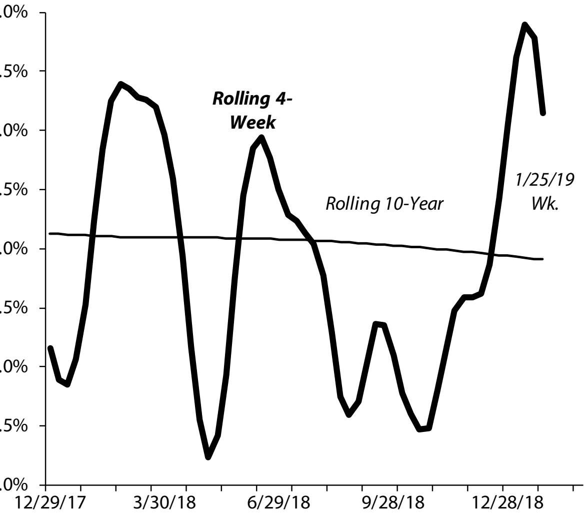
Taking stock. The stock market's assault on a fifth weekly gain in five fell short Friday, despite late-inning support from an announced truce in the government's 35-day partial shutdown. Investors nonetheless could take comfort in a gathering intra-week rally, overcoming deepening pessimism on conditions abroad and periodic disappointment in fourth-quarter earnings announcements that sent the market tumbling at the start of the holiday-shortened week. Optimism over prospects for a U.S.-China trade accord kindled subsequent strength, particularly after late-week news of senior Chinese officials packing the delegation to next week's round two of talks in Washington, D.C. Overlooked was threatened gridlock over still-material differences between the two sides on intellectual property-rights protection.

In addition, more fundamental help to the market came from reports of another dose of Fed dovishness on the policy outlook via an early end to the Fed's balance-sheet wind down, and from a strong start to the fourth quarter's earnings reporting season. Confirmation of the latest twist to Fed policy could come from Wednesday's post-FOMC communique and press conference. Better-than-expected company news kept the benchmark poised for earnings growth in the low to mid-teens on moderate revenue growth and margin expansion. The real challenge for the market will come from a likely slowdown in this year's earnings growth to the low- or mid-single digits, on rising costs, weak pricing power in many industries, and more difficult year-earlier comparisons as the lift from tax cuts washes out.

Trade policy, interest rates, and a more upbeat view of the U.S. economy have shaped S&P 500 sector performance during the market's rally from its most recent low in early January. Trade and economically sensitive tech and industrials have led the way on optimism over a U.S.-China trade agreement and with a helping hand from a less worrisome economic outlook here since release of the December jobs report. Financial services have been close behind, supported by economic optimism and firmer interest rates lifting banks' prospective loan demand and net interest margins (central to industry profitability). Cellar-dwelling utilities and consumer staples—yield sensitive but economically less so—have suffered a double whammy from higher interest rates on competing bonds and from the rotation toward the market's more highly charged sectors. Calmer conditions have allowed the benchmark's sector returns dispersion (measuring performance disparities) to edge down from a two-year high a few weeks ago, a potential headwind for active managers competing with indexing, if the trend continues.

Sector returns dispersion* off its peak in recent weeks
In percent



* Cross-sector standard deviation of rolling 13-week returns.
Source: Based on Standard & Poors, Inc. data, via Bloomberg Fin'l News, Inc.

Valuations, based on trailing price-earnings (P/E) multiples, support further rotation toward the market's highly charged sectors, economic growth and interest rates permitting. Current valuations on tech and industrials still are at a discount to their five-year average in absolute terms and relative to the S&P 500, while lagging utilities, at least, remain rich, by comparison. Among the deepest P/E discounts across other benchmark indexes are small-cap stocks in developed-country markets abroad, followed by their larger-cap EAFE brethren, emerging-market, Russell Midcaps and Russell 1000 Value indexes.

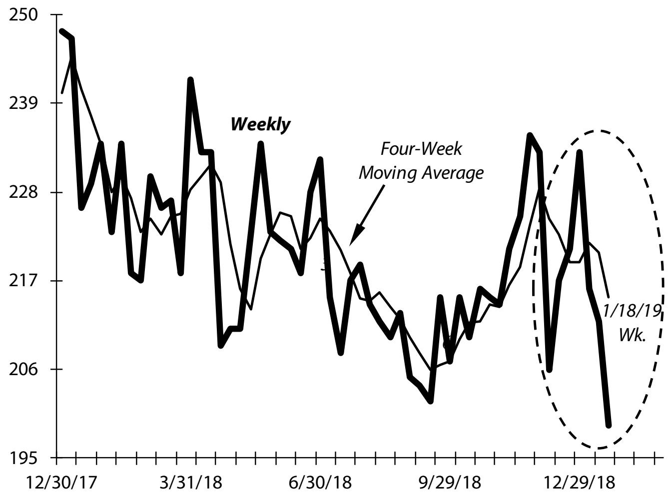
Risk-on trading has extended to the bond market, responding to reduced recession fears, a more dovish Fed-policy outlook, and resulting improvement in market liquidity conditions in reversing some of the run up of yield premiums to comparable Treasury securities between last October and early January in both the investment- and high-yield sectors. Lower-quality (A and BBB-rated) corporate securities are among the few sectors of the market with yield premiums to Treasury debt above their five-year average. Above-average quality spreads also are fairly common with the investment-grade and high-yield sectors, specifically between yields on A vs. AA, BBB and A, and, in the non-investment grade sector, the average yield on B vs BB rated issues.

At issue is the rally's staying power in stocks and other risks assets, tested in the coming week by a full events calendar that includes Friday's January jobs report, the mid-week FOMC policy communique and Powell press conference, round two of the U.S.-China trade talks, and a $113 billion sale of two-, five- and seven-year Treasury notes. Stocks also will be facing the heart of the fourth-quarter reporting season in coming weeks, beginning with several highly visible tech and industrial companies. The coming week's three key events are more vulnerable to disappointment than to pleasant surprises. The more modest employment gain expected in Friday's jobs report risks taking the edge off December's out-sized rise contributing to renewed risk-on trading by lessening recession worries. China trade talks likely will reveal a less ambitious road map to a thoroughgoing agreement on intellectual property rights than the one expected by the market, based differing positions of the two sides, leaving tariffs largely in place and becoming more of a market sore point. And, Wednesday's FOMC pronouncements risk an unfriendly downgrade to policy expectations by investors out in front of the Fed's dovish outlook, pricing rate cuts into the Fed funds futures market next year 2020.

Upside, downside…and sideways. A few pleasant and unpleasant surprises in the latest batch of data truncated by the Commerce Department shutdown netted to improvement sufficient to send the Citigroup Economic Surprise Index into the black (indicating better-than-expected reports on the week) for the first time in two months. The good news of an unexpectedly large drop in initial jobless claims to a 49-year low during the January 19 week—all the more remarkable because of a labor force double that of 1969—confirmed strong job-market conditions providing double-barrel support to consumer spending by signaling ongoing job growth while keeping the pressure on wages and household income.

The labor market's glad tidings just keep on coming

Initial jobless claims, in thousands



Source: U.S. Labor Department.

Less friendly was an unexpectedly steep decline in December home resales, to a three-year low. About the best that could be said of the report was that, based on closings, it reflected month-earlier demand saddled with a peak in mortgage rates the month before. Subsequent mortgage-rate declines, to a nine-month low in mid-January, powered a solid rise in mortgage applications for home purchases, responding to improved affordability, sustaining hopes for broadening growth beyond consumer spending to housing. Wedged between a disappointing housing report and more upbeat labor-market news were signs of stabilizing growth from preliminary purchasing-manager reports on January manufacturing and non-manufacturing activity. Better-than-expected news on the U.S. indexes contrasted to unwinding activity in major economies abroad.

The three-week reprieve from the economy's government-inspired slowdown, courtesy of Friday's compromise re-opening of affected departments, begs the question of the economic impact with or without another disruption after the agreement's February 15 expiration. The obvious threat of a shutdown restart may be more apparent than real, after the political and economic damage wrought by Partial Shutdown I. Cooler heads are more likely to prevail in agreeing to generalized Homeland Security funding, vulnerable to a subsequent carve-out for wall construction by a presidential national-emergency declaration. By the numbers, the month-long shutdown can be expected to shave ¼%-½% from first-quarter GDP if the government stays open after mid-February (and nearly eliminate first-quarter growth if it doesn't), adding nearly the same amount in catch-up spending during the spring.

Modest leakage from the first-quarter disruption could come from permanently lost wages of government contractors, tourism and certain other services receipts, plus the impact of food and other donations to government and contract workers undercutting re-stocking needs once income flows are restored. There's also the uncertain impact on business and consumer confidence, and associated spending, particularly in the fall run-up to likely deadlines on the debt ceiling and renegotiation of sequestration caps on government spending. The overall health of the economy, shaping the severity of any future fiscal-related disruption, will be confronted by an aging growth cycle countered by still-vibrant consumer spending supported by solid drivers and, perhaps, by broadening support from revitalized housing activity.