Wealth Management
U.S. Bank | U.S. Bancorp Investments

Market and economic update

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Current economic events

Just after the best week in seven years, U.S. markets were spooked last week by nagging trade fears, fears of yield curve inversions (longer-term interest rates lower than shorter-term interest rates) and weaker job growth. The S&P 500 declined 4.6 percent and gave back its entire gain from the prior week and more — and foreign markets fared just as badly. Investors looked to a G-20 meeting and potential trade deal between Presidents Trump and China's Xi Jinping to provide a lift to markets, and results looked promising initially on Monday. However, summary statements from the two countries showed very different takeaways from the meeting, to the point where it is unclear what sort of deal was made outside of a 90-day blackout of new tariffs to allow for high-level talks between the two nations. The arrest of the CFO of Huawei, a Chinese multinational telecom company, later in the week dampened hopes that the blackout would lead to meaningful progress on scaling back tariffs.

Mixed U.S. economic data did not help the poor market performance. Labor data continues to stand out for its strength, with the November payroll report revealing continued cycle highs in wage growth, multi-decade lows in unemployment and solid job growth. Purchasing manager surveys (PMIs) were mixed — readings from the Institute of Supply Management (ISM) showed the expansion in both manufacturing and services continuing in high gear while numbers from Markit depicted slowing growth. Markets also focused on the decline of the five-year U.S. Treasury yield below the two-year yield (a yield spread) as an omen of incoming recession. We much prefer to analyze yield spreads across the full maturity spectrum. Yields have generally been reasonable signals of recession somewhere between a year to a year and a half out, and most maturities are showing that there is still time left in this cycle. Despite generally worse sentiment in the United States in recent weeks, we continue to see the economy as strong, but no longer getting stronger.

PMI readings showed continued deterioration in developed foreign markets in November while ongoing Brexit developments added to market volatility. Manufacturing and services PMIs declined in Europe and Japan while the U.K. expansion looked nearly stagnant in the combined PMI reading. A change since last year in Japan's leading economic indicator also depicted a slowdown, shrinking by the most in two years. On the inflation front, annual

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change in European producer costs rose by the most since 2011, though other inflation measures, especially those that exclude commodities, have seen slower price increases. While the persistent worsening downtrend in many European economies is cause for some concern, we still see European growth as slightly above long-term averages. After declining data trends through September, we have seen a pickup in higher-frequency Japanese data in recent months, suggesting that the recent quarterly contraction in the gross domestic product (GDP) should likely not be repeated in the fourth quarter.

Emerging market data was mixed-to-positive last week despite sharp market declines. While official Chinese manufacturing PMI declined to a stagnant reading of 50, private estimates from Caixin were up in both the manufacturing and services sectors. India and Brazil also had pickups in both readings in November. Brazil also saw a return to growth in industrial production, as well as a tick down in consumer price inflation, a positive after near-stagflationary conditions had seemed to be developing. These slightly more optimistic data points are in the context of a broader slowdown across emerging markets, though growth in aggregate looks positive. Still, given the influence of the Chinese economy, the world's second largest, in many emerging countries it is difficult to see a longer-term pickup in emerging markets without the resurgence of China.

Equity markets

U.S. equities are off to the worst December start since 2008, following a tumultuous week of trading. The Dow Jones Industrial Average, S&P 500 and NASDAQ Composite declined between 4.5 percent and 4.9 percent last week while the small-cap oriented Russell 2000 retreated 5.6 percent. The sell-off was broad-based, with nine of 11 S&P 500 sectors posting losses. Only the interest-sensitive Utilities and Real Estate sectors posted gains for the week, advancing 1.3 percent and 0.3 percent, respectively. Last week's drawdown seems particularly noteworthy, since it occurred following more dovish comments from Federal Reserve (Fed) Chair Jerome Powell and President Trump and his Chinese counterpart, Xi Jinping, agreed to a short-term truce on escalation of additional tariffs. On balance, the near-term drivers of equity prices remain largely unchanged. The fundamental backdrop of rising earnings, restrained inflation and relatively low interest rates provides valuation support and serves as a catalyst for equities to trend higher. Conversely, sentiment is mixed and technical price-trend lines are under repair, suggesting time is still needed before concluding that a near-term bottom has been reached, with future returns likely to be more subdued.

The fundamental outlook for earnings remains mostly unchanged, with a downward revision bias. Consensus expectations remain for S&P 500 earnings of $161 per share in 2018 and $174 in 2019, reflecting moderating growth, albeit largely benign deceleration, because the effects of tax benefits are mostly factored into estimates. The pace of earnings growth is expected to normalize in 2019, and as long as earnings don't materially deteriorate, a moderate pace of earnings growth continues to provide valuation support. The fourth quarter earnings season unofficially begins during the week of January 14 when several money center banks, among others, are slated to release results.

Sentiment is mixed, with performance reflecting broad-based weakness and valuations trending within an acceptable zone near 25-year averages.

- Over the past three months there have been few places to hide. International and U.S. large- and small-cap indices are in negative territory. Six of 11 S&P 500 sectors have retreated 10 percent or more, with only three defensive or interest rate-sensitive sectors — Utilities, Real Estate and Consumer Staples — having advanced. It is hard to envision the broad market trending materially higher without the participation of Information Technology.

- Broad market valuations, in contrast, remain positive, with the S&P 500 ending December 7 trading at 18 times trailing 12-month earnings estimates compared to the 25-year average of 19.2 times earnings. The December 7 close was also roughly 15 times 2019 earnings estimates versus the longer-term average of 17.1 times earnings, according to Bloomberg.

The technical outlook is inconclusive, with recent widespread violation of key support levels. For the S&P 500, 2,823 is upside resistance, the recent high reached on October 16, while 2,603, the intraday low on October 29, is one level of downside support. The recent violation of key support levels suggests more time is needed before gleaning technical support. Conceptually, a pattern of higher highs and higher lows are needed to provide technical support.

Looking to 2019, volatility is likely to represent the norm versus exception. By many measures, the degree of investment difficulty is on the rise.

- The fundamental and technical trends are out of sync. The pace of earnings growth is slowing, pockets of inflation have become more prevalent, the risk of Fed policy error is heightened, trade tensions continue to linger, falling oil prices presents economic uncertainty both home and abroad and the aftermath of the midterm elections remains a work in progress. The list goes on. Importantly, bull markets don't die of old age — they tend to die of excesses or "bubbles" in valuation, inflation and euphoria indicators. At present, valuation, inflation and sentiment appear non-problematic, neither at high nor low extremes. These measures seemingly warrant a risk-on bias, suggesting that equities still have room to run.

Fixed income markets

U.S. Treasury yields remain under pressure, with investors seeking safety from riskier asset volatility. The 10-year U.S. Treasury yield is near 2.86 percent after reaching a peak near 3.25 percent in October and November. Domestic economic data remains relatively strong, albeit moderating somewhat, yet investor sentiment has faltered. Concerns center around trade, the slowing pace of economic activity and worries that monetary policy may already be dampening economic activity. While we anticipate the Fed will increase rates at next week's meeting, Board members now have enough supporting market-driven evidence to soften their tone around the magnitude and pace of 2019 hikes. Fundamentals and technicals still warrant higher bond yields, although sentiment indicators have sent warning signs that the picture remains mixed. We expect bond yields will rise based on the market underappreciating 2019 rate hikes, growth, inflation, heavy U.S. Treasury issuance and large global central banks becoming net sellers of assets. The primary risk to our view is that we are indeed closer to the end of the economic cycle than the fundamental data currently indicates, meaning growth and inflation estimates could come down further.

Look for a rate hike and softer tone out of the Fed next week. The market now prices a 95 percent chance of a rate hike next week, assuming a 0.25 percent increase to the target funds rate band and a 0.2 percent increase to interest on excess reserves (IOER). However, the market now prices only a 75 percent chance of even a single rate hike in 2019 (+0.19 percent). We believe this is likely too low, and bond yields will rebound to a degree as the market reprices higher in coming months. The Fed's September median estimates for 2019 rate hikes were for three (+0.75 percent). We believe the Fed now has the cover needed to moderate its 2019 outlook lower at next week's meeting, likely to two 2019 hikes (+0.50 percent). This is due to financial conditions remaining under pressure,

wider credit spreads (the difference in yield between risky bond yields and comparable U.S. Treasury yields), the yield curve flattening, inflation expectations falling and continued uncertainty around the impact of trade negotiations on economic activity. Despite this likely moderation of rate hike expectations, we think the market's current pricing of only a 75 percent chance of a single 2019 hike remains too low.

We remain neutral on credit while emphasizing the importance of continued exposure to U.S. Treasury bonds. Messages from the market and from economic data remain in conflict. U.S. data indicates continued economic strength, but at a slightly moderating pace. Market sentiment remains negative, as indicated by wider credit spreads, falling equity prices, falling Treasury bond yields and high volatility. We are comfortable remaining neutral on high yield bonds (with a negative bias) and emerging market debt, and remaining balanced on investment-grade credit relative to U.S. Treasuries, because it is inconclusive whether the market's degree of negative sentiment is justified despite the fundamental data. For the time being, credit spreads near long-term medians, low default rates and relatively strong domestic economic data lend support to modest credit exposures while still ensuring they do not crowd out the safe and diversifying portfolio characteristics of U.S. Treasuries.

Real estate markets

Publicly traded real estate investment trusts (REITs) were unchanged last week, but with a decline in the broader market, the sector outperformed the S&P 500 by 4.4 percent. For the year, REITs have outperformed the broader market by almost 4 percent. Defensive sectors in the REIT market are beating the more cyclical sectors as investors worry about the pace of GDP growth. Bond proxies, in general, are outperforming due to the flattening of the yield curve — Utilities gained 1.5 percent last week and are now up 9.4 percent for the year. These trends will continue if the market remains in risk-off mode and rates continue to decline.

Commodities markets

The oil market experienced another gain, with West Texas Intermediate crude rising 3.3 percent last week. The rally came at the end of the week after OPEC agreed to a production cut that was slightly larger than market expectations. Adding to the rally was the first weekly decline in oil inventory in the United States in more than two months. OPEC feels it has done its part to reduce the chance of a supply glut and stabilize oil prices. Now the demand side needs to hold up.

 Important disclosures provided on page 5.

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