Market and economic update

February 12, 2018

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Current economic events

Market turmoil dominated headlines over the past week, with little in the way of new economic data. Rising interest rates and resetting of equity market valuations belie what has been a relatively solid economic backdrop. In the United States, consumers remain healthy and inflation benign, and it appears business spending is set to improve. Outside the United States, economic growth is generally solid and improving in most developed economies, and inflation indicators show benign inflation, despite the rally in oil prices. Eurozone flash estimates for January consumer prices indicated that inflation pressures remain soft. At the start of the month, the outlier was an uptick in average hourly earnings. A key test this week is the release of U.S. consumer price inflation for January. The market is likely to treat an upside surprise in inflation as confirmation of possible rising inflation. Any disappointment could cause market concerns around rising inflation to subside.

Equity markets

Equities traded in rollercoaster fashion last week, with the Dow Jones Industrial Average experiencing two declines of more than 1,000 points, which left investors riddled with stress and uncertainty. On balance, the fundamental backdrop remains favorable, but sentiment has weakened and technical indicators are inconclusive. In aggregate, it appears premature to declare that a bottom in equities has been reached.

The macro environment remains constructive for equities.

- Global growth, increasing earnings, generally restrained inflation and relatively low interest rates continue to provide valuation support while serving as the basis for stocks to trend higher.
- As of February 12, 68 percent of S&P 500 companies have released fourth quarter results. According to Bloomberg, sales and earnings are up roughly 8.5 percent and 15.5 percent, respectively. For 2018, consensus estimates are for earnings growth of roughly 15 percent. The highest year-over-year earnings growth is coming from growth and cyclical sectors. Energy, Materials, Information Technology, Financials, Real Estate, Consumer Discretionary and Consumer Staples sectors are all reporting year-over-year earnings growth of 10 percent or higher. Over the longer term, while there's no guarantee, rising earnings tend to equate to higher stock prices.

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- Valuations are being reset lower as equity prices retreat, thus becoming less of a concern. Mindful that valuation can be a poor timing tool, as of February 12, the S&P 500 traded at 21.1 times and 16.8 times trailing 12-month earnings and 2018 estimates, respectively.

Sentiment has waned over the past two weeks.

- The S&P 500 closed last week 9.6 percent below the January 26 peak. Selling was remarkably indiscriminate, leaving investors with few places among sectors to hide. All 11 S&P 500 sectors posted losses last week. Year to date, 10 of the 11 S&P 500 sectors are in negative territory, and only the Consumer Discretionary sector has posted a gain, advancing 2.2 percent as of Friday's close. The lackluster performance of the Energy sector is perhaps most surprising since it is delivering the highest year-over-year earnings increase. Clearly, the Energy sector is being negatively impacted by prospects of higher interest rates.

The technical outlook is inconclusive, which suggests that more time is required to determine if a bottom has been reached.

- The S&P 500 Friday close was fractionally above the 200-day moving average level of 2,539, a key support level. The index moved below the 200-day moving average on Friday during intraday trading before closing higher. Typically, this suggests more volatility is likely to ensue. A series of price trend higher highs and higher lows would be among indications suggesting that a bottom has been reached. We believe this process is likely weeks away.

We continue to favor growth-oriented sectors, preferring companies and sectors that tend to benefit from an expanding global economy. Companies growing faster than peers while operating in segments of the market growing faster than the broad economy seem particularly well positioned.

- An unanticipated acceleration in inflation that leads to a faster pace of interest rate hikes is among potential risks to equity prices.

Fixed income markets

With 10-year U.S. Treasury yields nearing 2.9 percent, stocks have been shaken by questions around whether bonds offer a compelling substitute for equity investors' cash flow needs after years of paltry bond yields. While we remain underweight in fixed income and favor modest credit exposure over U.S. Treasuries, the opportunity cost of remaining in lower risk U.S. Treasuries is declining as nominal yields rise and credit spreads remain tight.

In recent months, we have cited expectations for rising growth, inflation and pricing in projected Federal Reserve (Fed) funds rate increases as likely catalysts for higher bond yields. These factors are largely coming to fruition since fiscal stimulus (a boost to growth, potentially inflation and additional U.S. Treasury supply in coming quarters) is adding additional upward pressure on yields.

This week, Consumer Price Index (CPI) data will be the most-watched economic release because data indicating higher wages is what triggered the initial jump in bond yields two weeks ago. Despite the rise in yields and our underweight to fixed income, high quality bonds continue to be a necessary means of achieving portfolio diversification. While Treasuries now price in more realistic expectations around growth, inflation, Fed rate hikes and changes in issuance and demand, modest upside risk to yields (downside risk to prices) remains and credit likely has room to outperform if markets continue to stabilize.

Real estate markets

Publicly traded real estate investment trusts (REITs) declined 3.5 percent last week, despite a 2.6 percent gain on Friday. This was better performance than the S&P 500, which declined 5 percent. For the year, REITs still trail the broader market by 10 percent and continue to be negatively affected by concerns over higher rates. This fear has also affected Utilities and other infrastructure assets. While we expect the trend of defensive stocks underperforming the broader market to continue, valuations in the defensive sectors of the market are becoming more attractive.

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Commodities markets

Crude oil prices tumbled 10 percent last week from more than $65 per barrel to $59.20 per barrel. Price declines accelerated sharply lower on Wednesday, with U.S. daily crude production surpassing the 10 million barrel per day mark and reaching 10.25 million barrels per day. Total U.S. inventories also edged slightly higher, according to the Department of Energy. The production increase was too large for a market that is positioned overly bullish to absorb and caused prices to decline through a key technical level of $61.05. If the shale patch continues to increase, production prices could decline to other key technical levels of $57.30 and maybe even a mid-$52 level.