Weekly Markets Commentary

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Have We Reached a Tipping Point?

Yields on Treasury securities surged higher last week in response to a round of solid economic reports and comments by Fed officials about the future path of interest rates. The ten-year Treasury note began the year at a yield of 2.41 percent, and by the middle of February had climbed to 2.95 percent. Except for a brief spike to 3.11 in mid-May, the yield remained in a tight band between roughly 2.80-3.00 percent for the better part of the next six months. But after Fed Chairman Powell's speech at Jackson Hole in late August, the yield began a steady climb from 2.80 to 3.06 percent by the middle of last week. Then the lid came off. Over just the last three days of past week, the yield suddenly surged higher to close at 3.23 percent. It is the highest level on the ten-year since 2011. The yield spike followed comments from Powell on Wednesday that the Fed intends to continue raising rates at a gradual pace, but would do so more aggressively should inflationary pressures rise. Powell also indicated that the Fed funds rate at present was likely a long way from neutral.

These remarks were preceded by the ISM non-manufacturing survey, which rose to its highest ever reading in the relatively short history of the survey. Coupled with the previously released manufacturing survey it showed that the economy was not only performing well, but possibly firming. And Friday's September jobs report likely did nothing to suggest otherwise. Although the total number of new jobs created was less than expected, the upward revision to the August total more than compensated. And the unemployment rate fell to a five-decade low at 3.7 percent, suggesting that whatever slack remains in the labor market continues to diminish. The year-over-year rise in average hourly earnings remained at a manageable 2.8 percent, reinforcing Powell's observation that wage pressures were not yet resulting in rising inflation.

Equity Prices Likely to Come Under Pressure as Bonds Become More Attractive

The sudden climb in bond yields spooked equity markets. The S&P 500 shed 1.0 percent on the week, with most of the damage coming on Thursday and Friday. It was the second weekly drop in a row for the first time since June. And it was a week in which the previous winners were replaced by the laggards. Sharp losses in consumer discretionary, technology, communication services and real estate were supplanted by solid gains in financials, utilities and energy.

The price of oil continued its steady march higher last week. West Texas Intermediate (WTI) added another $1.09 a barrel to close at $74.34. WTI has risen 10 percent in just the past four weeks, after beginning the year at $58.38 a barrel. The dollar rose for the second straight week as well.

In the absence of evidence of firming inflationary pressures, last week's move in yields can be considered in part a response to evidence of firming growth. New York Fed President Williams made that very point in a speech on Friday. Market-based indicators of inflation have barely moved. The September Consumer Price Index (CPI) report this week will provide the latest reading on prices. And the 2-10-year yield curve widened to 34 basis points last week, up from 24 the prior week, taking some pressure off worries over a possible yield curve inversion. But even if the move in rates is a growth and not inflation story, at some level equity prices are likely to come under increasing pressure, as bonds become relatively more attractive, and air comes out of equity valuations. One development that may bear watching, was last week's rise in high yield credit spreads. After hitting a ten-year tight last Wednesday at 316 basis points, the option-adjusted spread between the Bank of America Merrill Lynch High Yield index and the ten-year Treasury jumped to 332 by week's end.

Investors Turn to Third Quarter Earnings for Signs of Trade Implications

Earnings take center stage this week as third quarter reporting season gets underway. According to Factset, earnings growth of 19.2 percent is expected. That is down slightly from when the quarter began, a modest reversal from the experience of the first two quarters. Of particular interest will be what management teams have to say about the trade war with China and its impact on both input costs and supply chains.

Stock markets in mainland China reopened on Monday after a week-long holiday, and the results are ugly. The Shanghai Composite fell 3.7 percent on the day, as participants catch up with developments elsewhere. Japanese markets are closed on Monday, but the weakness has extended to early trading in Europe, where stocks are lower across the board. U.S. futures are pointing to a modestly lower open.

Lastly, the Congressional Budget Office updated its report for the 2018 fiscal year, estimating a deficit of $782 billion, some $116 billion higher than in fiscal 2017. That equates to 3.9 percent of GDP, up from 3.5 percent in the prior year. Backing out shifts in the timing of certain payments, the deficit would have totaled $826 billion, or $166 billion higher than last year. That would equate to 4.1 percent of GDP.

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The S&P 500 is an index containing the stocks of 500 large-cap corporations, most of which are American. The index is the most notable of the many indices owned and maintained by Standard & Poor's, a division of McGraw-Hill.

The Bank of America Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The ISM manufacturing index is a national manufacturing index based on a survey of purchasing executives at roughly 300 industrial companies.

The Shanghai Composite Index is a capitalization-weighted index of all stocks on China's Shanghai Stock Exchange.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

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