To What Should We Attribute An All-Time Market High: Consumers, Trade Talks or Monetary Policy?

The S&P 500 made it five straight weeks of gains, in a rally that has taken it higher by almost 5 percent, to an all-time high of 3,093. The strength of the rally, and the nature of its leadership, has been impressive, and the return disparity between the leaders and the laggards is stark. In the past five weeks, financial stocks have returned 8.7 percent, while utilities have dropped 4.7 percent. Consumer staples and real estate have also declined, while industrials, technology, and materials have surged higher. This sharp cyclical rotation has been mirrored within the bond market. On October 4 the yield on the ten-year Treasury note was 1.53 percent. It closed last week at 1.94 percent, its highest level in more than three months. Credit spreads have narrowed as well.

To what should we attribute the rally? It’s not as if the hard economic data has been exactly robust. In the past five weeks we learned that third quarter gross domestic product (GDP) grew by an estimated 1.9 percent, the slowest pace of the year thus far. We learned that the manufacturing sector contracted for the third straight month in October. Leading indicators fell for the second straight month in September, as did orders for capital goods. And third quarter earnings season has turned out to be as sluggish as advertised. Earnings declined by an estimated 2.4 percent, led by declines among this rally’s best sector performers, including energy, materials, technology, and financials.

Strong Consumer Confidence Continues, As Does Hope for a U.S.-China Trade Agreement

To be sure, the economic expansion continues to grow, led by a strong consumer. The labor market remains healthy, consumer confidence has remained buoyant, and the services sector has stayed firm. To the extent that these latest reports show the consumer continues to be the workhorse of the expansion, dispelling fears to the contrary from late summer, some relief rally might be expected, but certainly not of the strength witnessed in the past five weeks.

Arguably, some of the rally can be attributed to apparent improvement on the U.S.-China trade front. Talk of great progress toward a so-called phase one agreement has kept hopes alive that something constructive might actually get done, but so far, nothing has really changed. The two sides almost seem content to simply talk past one another and string the process out indefinitely, while releasing the occasional statement that progress is being made. Interestingly, to the extent that this is determined by investors to be a cause for celebration, the lack of anything tangible to show for the effort doesn’t seem to matter. Certainly,
the positive economic impact of a comprehensive deal would be powerful indeed. But we are such a long way from that, to attribute the current rally to a few threads of optimism over a deal as limited as what is being talked about in phase one seems like a stretch. And, the same is true regarding the interminable saga of Brexit. It does seem like a deal is finally within reach, but then again maybe not. With so many twists and turns, one is tempted to ignore the daily news flow until there is truly something to talk about.

Current Monetary Policy Has Precedent

Which leaves us with the most likely catalyst for the current rally, monetary policy. The Federal Reserve (the Fed) recently lowered the overnight rate for a third time, apparently completing its so-called mid-cycle adjustment. The two previous examples cited by Fed Chairman Powell as precedent occurred in 1995 and 1998. The 1995 example is perhaps most analogous to the present situation. When the Fed made the first of three rate cuts in July 1995, the S&P 500 was already up for the year by more than 20 percent according to Bloomberg. The same was true this time. So in both instances, the Fed was adding additional support to an already rather ebullient market environment. The S&P went on to climb 34 percent for the full year. The index is currently higher by 23 percent, and it remains to be seen where it closes out the year. In the three years between July 1995 and July 1998, the S&P 500 doubled in value. It was then that the Fed initiated its second mid-cycle adjustment, but the conditions were very different. Long-term capital was imploding and needed to be bailed out. Between July and October, the S&P 500 had dropped 20 percent. From that low point the index climbed by 55 percent over the next eighteen months, before sliding into a debilitating bear market in the fall of 2000.

Of course, how instructive history is to our present situation depends on the interaction of all the variables cited above. At the very least, we can say that the monetary backdrop is certainly supportive.

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