Weekly Market Flash

Bomb Cyclones and Melt-Ups, Hello 2018!

January 5, 2018

Sometimes the New Year starts off with a genteel slowness, allowing folks to ease their way back into the normal routine of things after the holidays. Sometimes, though, the New Year accelerates from zero to eighty in the space of barely a day. 2018 seems a likely candidate for that latter description. Not that any of the headline events thus far appear much different from those that dominated 2017 -- crazy weather, even crazier politics and a stock market that seems to only know how to go one way -- this is continuity, not change. It's the tempo that's different -- more frenetic, as if a marathon runner suddenly broke into a 100 meter sprint pace. Heaven help us if we have this much breaking news to digest for each of the next 51 weeks.

Let the Good Times Roll

The nascent economic headlines of 2018 could be summed up with a single folksy refrain: "and the skies are not cloudy all day." Business confidence indicators are close to decades-long highs, global GDP is predicted to come in around 3.7 percent, and US corporate earnings are positioned for a year of double-digit growth. The first job numbers out this morning were a bit slow on payroll gains, but wage growth stayed predictably on-trend at 2.5 percent.

Perhaps more significant than earnings, which represent the company's bottom line net profit, is the outlook for top-line sales. After languishing for years at near-flat levels, sales for S&P 500 companies this year are estimated to grow in mid-to-high single digits. Sales are in many ways a more useful economic measure than earnings, as they are less affected by all the arcane accounting gimmicks that pile up as one goes down each line of the income statement. Strong sales suggest that global demand is back in a meaningful way. Most importantly for investors, sales and earnings growth can provide a steady tailwind for continued gains in share prices.

The Market's Post-QE Life

Is that rosy economic and earnings picture strong enough to withstand the final coda on supportive monetary policy? So far, so good -- the Fed has managed to wind down QE and raise rates a few times without upsetting any apple carts. Investors will be watching the final acts of monetary stimulus play out in several venues this year. While the Fed plans to continue with rate hikes and to get on with reducing its balance sheet, the ECB will need to provide clarity on timing for winding down QE, and even Japan is expected to start applying the brakes on its expansive embrace of the Japanese Government Bond market.

Assuming that the overall macro/earnings picture doesn't change much from what the numbers tell us today, we do not see any particular reason why an orderly winding down of global monetary stimulus should be disruptive to financial markets. The caveat to this, as we have discussed on numerous occasions, is that a sudden resurgence of inflation in wages and consumer prices could pressure the Fed to take more dramatic action, which would likely result in a radical repricing of bonds and, by extension, most risk asset classes.

The Dollar Conundrum

One asset that has not fared well thus far this year is the world's reserve currency. The US dollar fell against most of its major trading currency partners this week, sending the euro back up over $1.20 while the pound sterling and Aussie dollar also rallied. Investors appear curiously bearish on the greenback. Strong corporate earnings and expected higher bond yields from Fed action should make dollar-denominated assets attractive. There does not appear to be a single compelling narrative to explain dollar weakness, with opinions varying from uncertain domestic politics ahead of the November midterm elections to a vague sense of "better opportunities elsewhere."

We do not necessarily share the bearish consensus on the dollar. Washington shenanigans, for all their train wreck-like “must-look” qualities, are likely to have little impact on actual economic activity. As for “elsewhere” -- well, there are plenty of risks where those other opportunities may lie. Europe’s optimistic headlines aside, there are plenty of challenges ahead both economic and political for the currency union. China is once again intent on reining in the highly leveraged sectors of the economy that it had to turn to again last year for hitting GDP growth targets. And the world trade picture is anything but assured in a world wrestling with still-potent nationalist-populist sentiments.

Watch the Numbers, Not the Pundits

All that being said, we are not quite ready to join the growing chorus of Cassandras in pundit-land warning that the bubble is nigh. Equity valuations are stretched, no doubt about it. Bargains are hard to come by. But a bubble will only truly form if share prices accelerate much faster than underlying earnings. In other words, the sprint we have seen in share gains from January 2 to today is most likely unsustainable, but a measured pace of growth over the coming months is achievable. If investors get too carried away by animal spirits and the January melt-up continues, we could expect a reversal to potentially follow. But if the larger economics & earnings picture hasn’t changed, we would expect any such reversal to be short and not indicative of a more prolonged reversal.

One way or the other, it’s likely to be an interesting year, probably at times for better and at times for worse.

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