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Bullish jobs and wage data send yields higher, equities lower

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Article Highlights

- The S&P 500 Index suffers its worst week since January 2016, while a rising euro hurts European stocks.
- The fastest wage growth since 2009 highlights January's employment report.
- Other data releases show strength across a broad spectrum of the U.S. economy.
- Expectations for a quicker pace of Fed rate hikes send the 10-year Treasury yield to a fresh four-year high.
- With the Fed and ECB at different stages of the tightening cycle, we believe the gap between U.S. and European government bond yields will remain wide.
- Despite the past week's equity-market setback, we don't believe stocks are headed for a larger correction.

Quotes of the week:

"This is one time where television really fails to capture the true excitement of a large squirrel predicting the weather."– From the movie "Groundhog Day"

Lead Story: Rising wages are the key to January's jobs report

In yet another solid employment report, the U.S. economy added 200,000 jobs in January, ahead of forecasts for about 180,000. The unemployment rate held steady at a 17-year low of 4.1%. What differentiates this release from recent ones, though, is the upside surprise to average hourly earnings (AHE). Wages rose a better-than-expected 0.3% in January, while December's figure was revised up slightly, to 0.4%. Over the past 12 months, AHE have advanced 2.9%—their fastest pace since May 2009.

This long-awaited increase could be a sign that labor-market tightness is finally translating into heftier paychecks. Moreover, with the economy now reaching full employment, still-higher wage growth could emerge in the coming months, filtering through to consumer price inflation and leading to an even faster pace of Fed rate hikes.

U.S. Treasuries slumped in response to the January jobs data and the possibility of higher interest rates. The yield on the bellwether 10-year Treasury note, which began the week at 2.66%, closed at a fresh four-year high of 2.83%. (Bond yield and prices move in opposite directions.) It was at 2.4% at the beginning of the year.

Global bond yields moved in sympathy with U.S. Treasuries. For example, the 10-year German bund, which was mired in negative territory as recently as mid-2016, reached 0.76% on February 2, a 2½-year high. Despite this increase, we believe the gap between U.S. Treasury and European rates will remain substantial in the near to medium term—and perhaps for much longer.

Supporting our view is the fact that the Fed and the European Central Bank (ECB) are at different stages of the tightening cycle. Although the Fed held rates steady at its January 31 meeting, as expected, officials have become more convinced that the U.S. economy no longer requires extraordinary monetary stimulus to function. Indeed, the Fed's latest policy statement indicated that "further gradual increases" in its target fed funds rate will be warranted. Conversely, the ECB has just started to taper its bond-buying program and, with inflation stuck below its 2% target, is likely months away from raising rates.

In other news: U.S. equities stagger into February

After surging more than 7% over the first four weeks of the year, the S&P 500 Index reversed course suddenly on January 29 and 30, falling by a combined 1.8%. A modest midweek gain was followed by two more losing sessions to begin February. As a result, the index lost 3.9%, its steepest one-week decline in just over two years.

Rather than focus on a slate of better-than-expected fourth-quarter earnings reports, investors fretted over elevated equity valuations and the possibility that equity prices had outpaced fundamentals by too much in the short term. Meanwhile, the higher yields available on U.S. Treasuries increased their relative attractiveness as an alternative to stocks, creating a further headwind for equity prices. Despite this equity-market setback, we don't believe stocks are headed for a larger correction.

The mood in stock markets across the Atlantic was similarly downbeat during the week. With a rising euro weighing on European exporters, the STOXX 600 Index fell 2.9% and 3.1% in U.S. dollar and local currency terms, respectively.

Despite January's rocky ending, the S&P 500 returned 5.7% for the month as a whole, its best one-month performance since March 2016. Among sectors, Consumer Discretionary (+9.3%) and Information Technology (+7.6%) led the way, benefiting from the synchronous uptick in global growth. Not surprisingly, Real Estate (-1.9%) and Utilities (-3.1%), both of which tend to struggle when interest rates rise, lagged.

Below the fold: Markets digest a full plate of economic data

A number of the past week's data releases showed strength across a broad spectrum of the U.S. economy. Among the reports:

- **Consumer spending** capped its best year since 2011 by jumping 0.4% in December. Households dipped into savings to finance their expenditures, as the savings rate plunged to 2.4%, a 12-year low.

- **Consumers' outlooks** were upbeat in January. The Conference Board's consumer confidence index rebounded, while the University of Michigan consumer sentiment gauge stayed at an elevated level.

- **Housing prices** continued to climb, as the S&P/Case Shiller 20-City Composite Index surged 0.7% in November and 6.4% over the past 12 months. A combination of high demand for homes and falling inventory has contributed to decreased affordability for many would-be buyers.

- While the pace of **manufacturing activity** eased slightly in January, it remained robust. The Purchasing Managers' Index (PMI) published by the Institute for Supply Management (ISM) registered 59.1—still comfortably above the 50 threshold separating growth from contraction and better than last year's impressive average monthly reading of 57.4. In 2018, manufacturing should benefit from pickups in domestic and external demand, a result of the recent tax cuts and strong overseas growth, respectively.

- **Factory orders** improved in December for the fifth straight month, and November's number was revised higher.

- The Fed's preferred **inflation** barometer, the personal consumption expenditures (PCE) price index, rose 0.1% in December and 1.7% year over year. Core inflation, which excludes food and energy prices, increased 0.2% but just 1.5% compared to a year ago.

The back page: The bull market persists—but are expectations for future equity returns realistic?

Notwithstanding the past week's sharp drop, after nine consecutive years of gains, the S&P 500 Index is in the midst of the third-longest bull market in history. Since the financial crisis, the S&P 500 has returned 13.2% per year, on average, exceeding its 90-year mean of 10%. Market participants seem to think there's still room to run, even amid rising rates. We agree. In our view, U.S. tax reform and synchronized global growth should support double-digit equity returns in 2018. That said, in such a strong market it's easy to become complacent. Investors may want to consider whether their portfolio allocations remain optimal or if some rebalancing is in order.

Even professional investors can lean toward being overly optimistic. A recent **study** by Erasmus University Rotterdam and Stanford's Graduate School of Business, for example, looked at long-term investment return expectations of 238 public pension funds. Although these funds have lowered their expectations for overall investment returns (from +8.0% to +7.6%), they also project substantially higher returns for cash (+3.2%) and bonds (+4.9%) than those two asset classes have averaged over the past nine years (+0.36% and +3.97%, respectively).

Regarding stocks, the funds have moderated their forecasts from +10.0% to +8.7%. Given years of better-than-average equity gains, it's reasonable to prepare for substantially below-average performance over the next market cycle. But even +8.7% may not be attainable, so further tempering of expectations might be warranted.

Investors of all types and experience levels may find themselves grappling with how best to manage return expectations—and position their portfolios—in the face of this extended bull market. A prudent place to start is with a review of long-term investment objectives, diversification levels, risk tolerance, and whether the time is right for portfolio rebalancing.

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