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Equity markets power higher amid strong underlying trends in GDP report

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Article Highlights

- Fourth-quarter U.S. GDP growth is better than the headline figure suggests.
- U.S. equity markets surge to new all-time highs.
- The 10-year Treasury yield hovers around its recent highs, while higher-yielding fixed-income sectors benefit from continued healthy demand.
- We see potential supply/demand imbalances for Treasuries amid the government's need to finance deficit spending priorities.
- Overseas economic data outshines mixed U.S. releases.

Quotes of the week:

"Don't look back. Something might be gaining on you."
—Satchel Paige

Lead Story: No, fourth-quarter GDP growth did not disappoint

On the surface, the government's advance estimate of 2.6% fourth-quarter GDP growth may look like a disappointment, falling short of expectations that the economy would grow at a 3% rate for the third consecutive quarter. But a look beyond the headline number reveals continued improvement in U.S. economic conditions.

Personal consumption, the largest component of GDP, grew by 3.8% in the quarter, while nonresidential fixed investment surged 6.8%, capping off a torrid year for spending on equipment. Exports continued to grow as the global economy accelerated, but a greater than 13% increase in imports caused trade to be a net drag. Inventories, typically a volatile part of the calculation, subtracted nearly 0.7% from growth, after adding around the same amount in the prior quarter. Private sales to private domestic purchasers—a measure some economists prefer as a gauge of domestic economic health (because it strips out inventories, trade, and government spending)—grew at an impressive 4.6% rate.

For 2017 as a whole, GDP growth came in at 2.3%, due mainly to a weak first quarter. While that's essentially the same average trajectory the U.S. economy had followed for the previous two years, there's solid momentum heading into 2018. Combined, consumer and business spending entered the new year growing at their fastest rates in years, and that's before the drop in individual and corporate tax rates. We expect the tax cuts to support both higher levels of spending growth in the first and second quarters combined and a sharp increase in the household savings rate, as people at varying income levels use their extra cash in different ways.

If equity markets were disappointed by the headline GDP "miss," they certainly didn't show it. The S&P 500 Index climbed 1.2% on January 26, and was up 2.2% for the full week, closing at another new all-time high.

Likewise, fixed-income markets seemed to interpret the GDP report as evidence of further economic strengthening likely to lead to higher inflation and interest rates. The yield on the bellwether 10-year Treasury note, which in the prior week closed above 2.60% for the first time since March 2017, hovered around its recent highs and ended the week unchanged at 2.66%.

Outside of the Treasury market, investor appetite for higher-yielding fixed-income assets remained healthy across most categories, including securitized products (such as asset-backed securities and commercial mortgage-backed securities), emerging-market debt, and high-yield bonds and loans.

In other news: Supply-side yield-o-nomics for U.S. Treasuries?

A looming challenge for the markets is the potential impact of increased Treasury issuance. Assuming the current political wrangling in Washington eventually results in a full-year budget agreement (instead of a series of short-term continuing resolutions), it will include larger deficits due to hurricane relief spending and higher caps on military and discretionary programs. New debt to finance these priorities—along with the $1.5 trillion in recently-enacted tax cuts—will add to Treasury supply, pushing up yields.

Absent an extreme outcome, the federal budget process is unlikely to be the main driver of yields this year, as heavier borrowing by the U.S. Treasury is largely priced into the market. Greater impetus for rising rates will come from gradually less accommodative monetary policy from the Fed and other central banks, as well as potential upside surprises in growth and inflation data.

Nonetheless, Treasury supply and demand imbalances on the horizon warrant caution. As non-U.S. economies pick up steam, for example, their bonds are becoming more attractive. This could stem global demand for Treasuries just as supply is increasing, boosting yields further. Continued weakening of the dollar could exacerbate this dynamic. For now, U.S. yields are still higher than those in much of Europe and Asia, providing some cushion for dollar weakness.

Below the fold: Overseas economic data outshines mixed U.S. releases

Aside from the GDP report, U.S. economic data releases were mixed. On the plus side, The Conference Board's **index of leading economic indicators** jumped for the third consecutive month, bolstered in part by the bull market in stocks and higher consumer confidence. Less encouraging: Both **existing and new-home sales** tumbled in December amid continued short supply and rising prices. On a year-over-year basis, however, home sales were up.

Non-U.S. data was broadly positive. Global **Purchasing Managers Indexes** (PMIs) showed accelerating activity, particularly in Europe. German **business sentiment** continued to rise to lofty heights, though expectations were less favorable than current conditions. Meanwhile, **corporate and consumer loan demand** in the Eurozone improved in the fourth quarter, bolstered by low interest rates, rising confidence levels, an increase in fixed investment, and strong demand for durable consumer goods. European Central Bank (ECB) president Mario Draghi acknowledged the region's impressive economic gains, but the ECB left its still-accommodative monetary policy unchanged.

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