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TIAA

Treasury markets wrest attention from the S&P 500's latest leg up

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Article Highlights

- U.S. Treasuries stumble as the 10-year yield closes at a 10-month high.
- We expect Treasury rates to increase gradually amid solid demand for U.S. debt and low inflation globally.
- The S&P 500 notches fresh record peaks, and European equities also rally.
- December's inflation data should give even the more "dovish" Fed officials confidence to raise rates in March.
- With the ECB likely to follow the Fed's slow-and-steady approach, Eurozone interest rates may remain at record lows well into 2019.

Quotes of the week:

"I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."– James Carville

Lead Story: The 10-year Treasury gets a lift

After remaining rangebound (between 2.30%-2.40%) for much of the fourth quarter, the yield on the 10-year U.S. Treasury reached nearly 2.60% during intraday trading on January 10. (Yield and price move in opposite directions.) The brief mid-week spike was driven largely by China, which threatened to trim or halt its Treasury purchases in response to trade tensions with the Trump administration. Because China has not been a major Treasury buyer in recent years, markets regained their composure, sending the 10-year yield lower. It closed the week at 2.55%, still a 10-month high.

Potential foreign government influence aside, higher yields reflect the strong global economy and the U.S. Treasury's plan to issue significantly more debt this year, partly because of the deficit funding requirements brought about by the recent tax law changes. Moreover, the Fed expects to raise interest rates several times in 2018 while reducing its massive bond portfolio. That, too, will add supply to the market, potentially pushing up yields.

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Although we think Treasury rates will head higher in 2018, the increase should be measured. Inflation worldwide remains low, and U.S. government debt continues to offer relatively attractive yields compared to that of other countries. From an asset allocation perspective, an orderly rise in rates could prevent credit spreads from widening too fast, increasing the attractiveness of non-Treasury spread sectors.

In other news: U.S. stocks take brief break before rallying further

After beginning the year with six consecutive record closes, the S&P 500 Index edged down 0.1% on January 10, a pause that seemed to reinvigorate the market. Over the next two days, the index rose 1.4%, bringing its gain for the week to nearly 2% and year-to-date advance to more than 4%.

Bloomberg recently published an amusing article "calling out" specific sell-side equity strategists whose 2018 S&P 500 targets had already been breached fewer than 10 trading sessions into the new year. (Full disclosure: last July, my S&P 500 target for 2018 was only 2,600.) But in fairness to my fellow strategists, as recently as early December, not many were certain that Congress would enact tax reform. Even fewer anticipated a tax-reform-fueled rally.

It will take some time for consensus earnings estimates to stabilize at higher, post-tax-bill levels. Already though, since the year began, both 2018 and 2019 consensus estimates have risen by nearly 3%. They almost certainly have further to go, and these upward revisions will effectively lift the ceiling on how high the S&P 500 can rise without equities becoming unduly expensive. All told, corporate tax cuts should boost earnings-per-share growth by 5%-7% beyond what they would have been otherwise in 2018, to a total of around 15% for the full year.

In Europe, the STOXX 600 Index rose 0.29% in local terms but a far superior 0.98% in U.S. dollar terms, thanks to a surging euro. The common currency reached a three-year high of $1.21 on news that German Chancellor Angela Merkel's Christian Democratic Party had reached an agreement to form a coalition government with its rival, the Social Democrats. (Last September's German election failed to produce an overall majority in parliament for any party.)

Below the fold: December's inflation data should satisfy the Fed

Inflation, as measured by the Consumer Price Index (CPI), increased 0.1% in December and 2.1% compared to a year ago. "Core" inflation, which excludes food and energy costs, rose 0.3% in December, its fastest pace since last January, and 1.8% over the past 12 months. Although the CPI is not the Fed's preferred inflation gauge—the PCE Index is—this reading will likely affirm the Fed's view that inflation is indeed heading toward its 2% target. This should give even the more "dovish" Fed officials confidence to raise rates again in March.

Meanwhile, **retail sales** rose 0.4% in December, just below forecasts, but were revised higher for October and November.

Back Page: The market's need for clear and credible central bank guidance

The Fed's December rate hike and the European Central Bank's (ECB's) January reduction of its monthly bond-buying program were both well-telegraphed. In contrast, the Bank of Japan's (BoJ's) so-called "stealth taper" on January 9, in which the BoJ announced it would scale back purchases

of long-dated government bonds, was a surprise to markets. The reaction was swift, as global long-term interest rates rose, and the dollar fell sharply versus the yen.

The ECB's playbook appears to be closer to the Fed's. Its president, Mario Draghi, has communicated that the ECB doesn't intend to raise interest rates until "well past" the end of its quantitative easing (QE) program. By pricing in a Eurozone rate hike in early 2019, the markets seem to be reflecting too hawkish a scenario for rate hikes, just as they were in 2014. Back then, the Fed announced the conclusion of its asset purchases but waited more than a year to raise rates. Because we believe the ECB will follow the Fed's slow-and-steady approach, we expect it to raise rates closer to the end of 2019 than the beginning.

What does this mean for markets? Bond yields are being heavily influenced by central bank behavior, in particular their focus on keeping yields low. While it's difficult to predict when the BoJ will wrap up its QE program, markets are already anticipating the end of easy monetary policy in Europe. If the ECB extends QE or keeps its policy rates lower for longer than expected, however, the euro may struggle to stay at current levels—a positive scenario for European equities.

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