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Markets surge to end the week, but there's a certain something missing

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Article Highlights

- Markets grapple with U.S. policy uncertainty, including the noise related to largely non-financial-related actions taken by the Trump administration and the lack of clarity over potential changes to existing laws.
- The S&P 500 finishes the week with a modest gain, while Europe's STOXX 600 loses ground.
- Although January's jobs report is encouraging, we still believe that over time, employers will struggle to find skilled workers, leading to slower job growth.
- Despite the recent calm in fixed-income markets, we expect volatility among non-Treasury "spread sectors" to pick up should equities also become more volatile.
- As the current earnings season shows, U.S. corporate profits bottomed last year and have been on the rise for two quarters now. This should support stocks in the near term.

Quote of the week

"Uncertainty is an uncomfortable position. But certainty is an absurd one." — Voltaire

The Lead Story

Markets hate uncertainty. And during the past week, there was plenty of uncertainty to go around, particularly related to U.S. policy. We see two main policy obstacles at the moment: The first is the daily—sometimes hourly—political "noise," which often relates to issues having little to do with stocks or bonds.

Still, to the extent controversy surrounding an issue like immigration, for example, creates social unrest or contributes to broader political gridlock, it can indirectly impact financial markets. The second and related source of uncertainty is the lack of action and details we've received about expected changes to the tax code and other laws such as the Affordable Care Act. Both of these obstacles could contribute to a lasting period of policy uncertainty, which historically has not been a positive for equity markets. Just ask Europe.

Voltaire, whom I quote above, appears of have been of two minds on the question of certainty. You see, he made his fortune by exploiting a loophole in the French lottery in 1729 to make himself a "certain" winner. Not only was his scheme fully legal, it also allowed him to remain well fed as a prodigious but underpaid writer for the rest of his life.

In other news: Stocks get a late-week boost, while high-yield bonds continue to outperform

Not surprisingly, equity investors were cautious for most of the past week amid the uncertainty. But a rally following the release of January's employment report on February 3 enabled the S&P 500 Index to finish with a small gain. So far, around 70% of S&P 500 companies have topped their 4Q16 earnings forecasts, in line with historical averages, while revenue growth is at its highest level in two years.

In Europe, Friday's surge in bank stocks, buoyed by the prospect of looser regulations under a Trump administration, trimmed the one-week loss for the broad STOXX 600 Index to 0.6% (in local terms).

Meanwhile, U.S. fixed-income markets traded in an orderly fashion, little affected by the rhetoric emanating from Washington. The yield on the bellwether 10-year Treasury note closed the week roughly unchanged at 2.48%. Positive flows supported high-yield bonds, which have returned 1.65% year-to-date through February 2, building on their impressive 2016 haul (+17.1%).

Despite this recent stretch of market calm, we expect volatility among high-yield and investment-grade debt, along with other non-Treasury "spread sectors," to pick up should equity markets become more volatile. In terms of asset allocation, we remain broadly diversified across credit sectors, avoiding the riskiest segments of the market while keeping an eye on duration.

Current updates to the week's market results are available here.

Below the fold: A "Goldilocks-ish" jobs report

The U.S. economy added 227,000 jobs in January, well ahead of expectations for about 175,000. With some 500,000 people entering the workforce, the labor participation rate increased by 0.2%, to 62.9%—an encouraging sign—and the jobless rate ticked up to 4.8%. Wage growth (+0.1%) cooled a bit after jumping 0.4% in December. All told, this was a "Goldilocks" data release: strong enough to keep investors positive about the economy but not so robust to convince the market that the Fed will hurry to raise interest rates.

Some believe January's better-than-anticipated jobs report reflects improved business sentiment, which has translated into stronger hiring. If this is true, upcoming payroll growth should top 200,000 per month. We think it's prudent, however, to wait for the next few reports before jumping to conclusions, as seasonal hiring factors may have skewed the January numbers. Regardless, our overriding thesis doesn't change: as the economy moves to and through full employment, employers will struggle to find skilled workers, and job growth will slow while wages rise.

Among the week's other data releases:

- **Consumer spending** improved a healthy 0.5% in December and 3.8% for 2016, while **personal income** rose 0.3% in December.
- **Inflation,** as measured by the Fed's preferred inflation barometer (the PCE index), rose 0.2% in December and 1.6% over the past 12 months, its largest increase since September 2014. The "core" PCE index, which excludes food and energy costs, increased 0.1% and 1.7% compared to a year ago.
- **Manufacturing activity** continued to strengthen. The Purchasing Managers' Index published by the Institute for Supply Management (ISM) improved to 56 in January, its fifth consecutive monthly rise and best showing in more than two years. (Readings over 50 indicate expansion.) **U.S. factory orders** (+1.3% in December) easily outstripped expectations.
- **Service-sector activity** dipped to 56.5, according to ISM's non-manufacturing index, but remained near a 12-month high.

The Eurozone also released some encouraging economic data:

- **Manufacturing** activity kicked off 2017 by posting its fastest rate of expansion in more than five years. A declining euro fueled multi-year highs in new orders and exports.
- The weaker currency also supported higher **inflation**, which rose 1.8% in January—in line with the European Central Bank's target of below, but close to, 2%.
- **GDP** for the region grew by 0.5% in the fourth quarter, with unemployment reaching a seven-year low, and 1.8% for 2016 as a whole. This marked the first time since 2008 that the Eurozone economy outperformed the U.S. for a full year.

Back page: Looking past the uncertainty

How should investors regard the current political noise? Investors "bought the rumor" of pro-growth policy changes shortly after the November election, spurring a surge in equity markets and the U.S. dollar. Should they now think about "selling the news," with the legislative calendar yet to come into focus? We don't think so. As the current earnings season shows, U.S. corporate profits bottomed last year and have been on the rise for two quarters now. This should support stocks in the near term.

On the other hand, we don't necessarily expect stocks to rally further if and when corporate tax reform or infrastructure spending passes. These policies were at least partially accounted for in the rally late last year. Similarly, a policy-driven upturn in corporate profits appears to be seeping into analysts' estimates. We're accustomed to seeing consensus earnings estimates fall by 4-5% at the beginning of a calendar year, but this year they've held steady. This lack of negative revisions should be taken as a sign of optimism but also an indication that at least some good news is already baked in.