THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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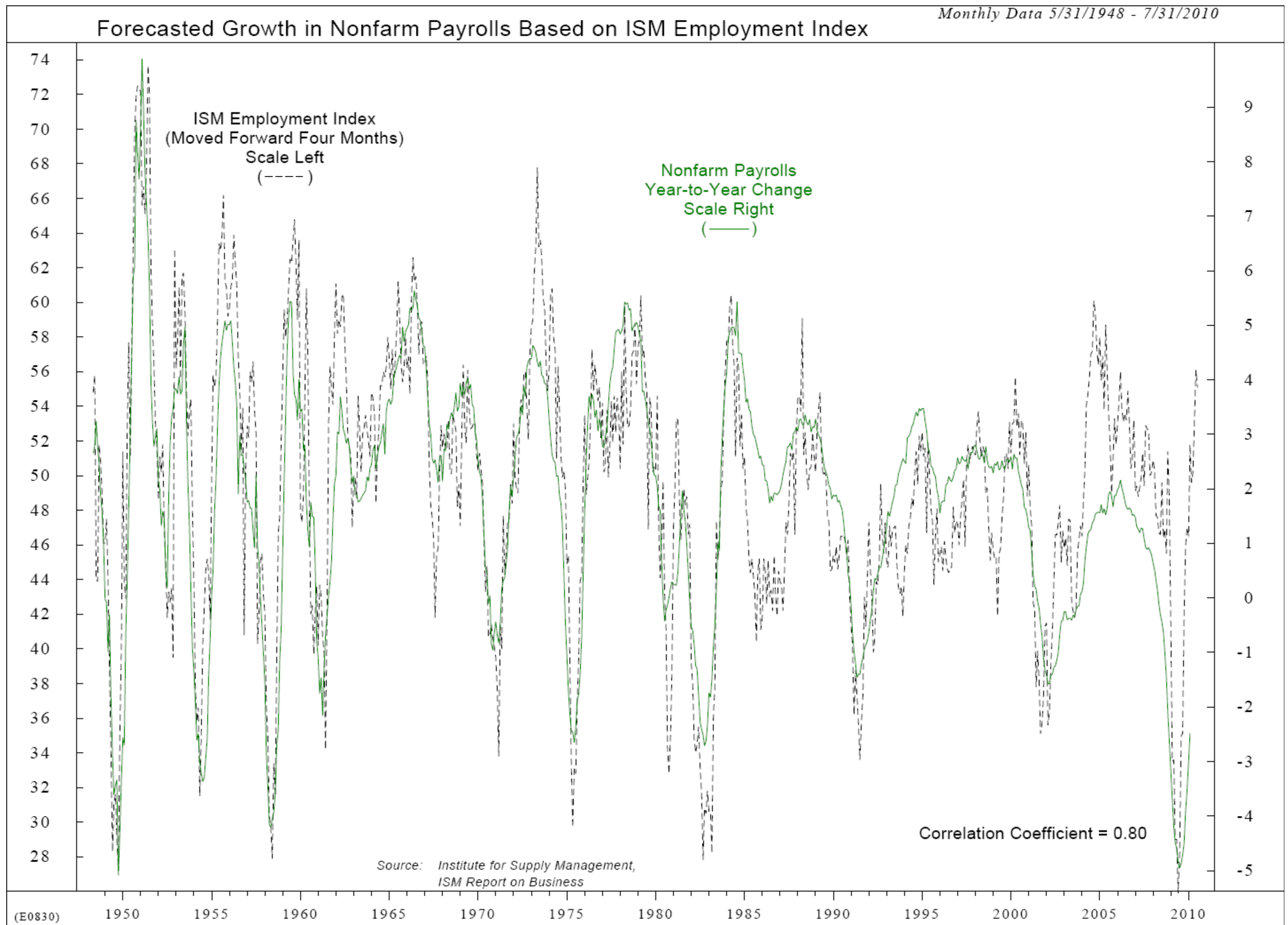
When 'Good News' Is Still Good News

- There is a moment in most economic and market cycles when the stock market ceases to be comforted by good economic news because it fears Fed tightening. Last week's market strength on the back of positive economic news suggests we have not reached that point. A month ago we set a short term technical objective for the S&P 500 of 1170 to 1200. 1170 was breached decisively last week and 1200 looks achievable over the near term (with upside to 1300 over the course of the year). Our only note of caution at the moment is that crowd sentiment, while not yet at an extreme, is entering excessive optimism territory. When extreme optimism occurs, a pullback should be expected, but the message from the recent breakout to new cyclical highs is that the current bull market remains healthy. Two weeks ago we flagged the possibility that trade tensions with China might escalate ahead of the Treasury's highly anticipated April 15 report on China's currency policy. However, Chinese President Hu Jintao's recently announced April 12-13 US visit to meet with President Barack Obama and the Treasury's subsequent decision to delay its report suggests their intent to defuse the situation.
- Last week's 'good news' included positive purchasing manager surveys and employment figures. Despite being below consensus expectations, the jobs report for March was actually stronger than the headline disappointment would suggest. Although 'only' 162,000 jobs were created against a consensus of 184,000, expectations were that most, if not all, of the increase would be the result of government hiring of temporary census workers. To better gauge underlying job strength many investors (ourselves included) were mentally prepared to exclude the distortion from census hiring where some estimates were for 200,000. In fact, census hiring was just 48,000 (government as a whole was actually 39,000) whereas private sector job creation of 123,000 was much larger than expected. Moreover, the previous two months were revised 62,000 higher.
- Job gains are still being led by temporary and health care workers, but other sectors are starting to contribute as well. Notably, goods producing industries — such as manufacturing, construction and mining — added 41,000 jobs during the month, its first increase in three years. Also supporting the view of a broadening job recovery is the fact that aggregate hours worked have risen to new highs for the cycle after a weather-related dip in February.
- The main question for investors is whether job growth can continue (see Weekly Chart). We believe it can. Companies are enjoying strong earnings growth and an increase in revenues, which is an encouraging recipe for further hiring. The health of the corporate sector is reflected in purchasing manager surveys. The Institute for Supply Management manufacturing index rose 3.1 points to 59.6 in March, its highest level since 2004. Not only do purchasing manager surveys in the US continue to strengthen, measures of manufacturing activity have risen world-wide to their highest level in nearly six years, underscoring the global nature of the economic expansion, a favorable environment for profits and growing business confidence.
- Ten-year Treasury yields are nearing the 4% level, above which we think near-term technical resistance is at 4.3%. So long as rates are rising because of evidence and expectations for greater economic growth, we think investors shouldn't be alarmed. Rising rates due to better economic prospects is not an impediment to further stock gains in our view. Indeed, last week's purchasing manager surveys and employment report have put some of our recent fears to rest. If, however, rates rise due to growing credit concerns and/or inflation expectations, then we think stocks would be vulnerable. With high yield credit spreads near their lows and no evidence of funding difficulties (no doubt helped by the Fed's zero interest rate policy, which it has pledged to keep for an "extended period") credit concerns show no signs of derailing the cyclical bull market. In addition, inflation expectations remain quiescent; we think in large part due to still-high unemployment and labor productivity, low capacity utilization and falling rents amid record vacancies. So far so good, but we need to be vigilant.

- With longer term rates rising, we are trying to assess at what level we should become cautious. Housing market fragility remains evident, so there is clearly a point when mortgage rates climb high enough to cause home prices to resume their declines. It's hard to say what that exact level might be, but we think it is somewhere around 6.5% for a conventional 30-year fixed loan, which would roughly correspond with a 10-year Treasury yield of about 5% (assuming mortgage spreads widen a bit as government housing support is unwound). Needless to say, a spike in mortgage rates of this magnitude would be an unwelcome event, potentially triggering a 'double-dip' recession. Fortunately, the Fed is actively working to prevent just such a scenario, which is why we view a spike in rates as unlikely. With 10-year Treasury yields still nowhere near 5%, we think there is room for interest rates to climb somewhat higher without undue effects on housing or stocks.

The Weekly Chart: More job gains likely through the spring



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Past performance is no guarantee of future results

The employment component of the ISM Index (dotted line) strongly suggests that nonfarm payrolls (solid line) are likely to turn positive on a year-over-year basis by the summer. Because the ISM Employment Index is moved forward four months and has an 80% correlation with payroll growth, we think there is a high likelihood that employment will continue to improve.

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