MARKET NOTES

Week of February 20, 2017

Stocks Go on Record Run as Inflation Heats Up

Last week, numerous major global equity indices hit all-time highs as stocks continued their bullish run. In the U.S., for example, the S&P 500, the Dow Jones Industrial Average and the Nasdaq all closed at record highs for five straight trading days—a feat that last occurred in January 1992.

Meanwhile, inflation in January accelerated significantly, with consumer prices rising by 0.6%—higher than many analysts had expected. Retail sales for the month were also stronger than anticipated, led by electronics, appliances, sporting goods and clothing.

In her testimony to Congress last week, Federal Reserve Board Chairman Janet Yellen said she "expects the evolution of the economy to warrant further gradual increases in the federal funds rate" to satisfy the Fed's employment and inflation targets. She also repeated that "waiting too long to remove accommodation would be unwise."

Overseas, the European Union raised its GDP growth forecast (to 1.6% from 1.5%) and inflation forecast (to 1.7% from 1.4%). The EU sees accelerating growth leading to less slack in the economy, resulting in greater inflationary pressures.

GAIN: Active Asset Allocation

Global equity markets (S&P Global BMI Index) continued to rally last week, up approximately 1%. In contrast, bonds (Bloomberg Barclays US Aggregate Bond Index) had a flat week, and are up modestly for the year (.44%).

In the equity portfolios, we are currently evaluating opportunities and risks in international small-company stocks and the healthcare sector as well as the upcoming presidential election in France. At this point, we believe that the risks to markets of any outcome in the French election is overblown.

In the fixed-income portfolios, we continue to keep our eye on emerging markets debt and convertible bonds.

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PROTECT: Risk Assist

Volatility across asset classes remained at historically low levels, despite a spike in the CBOE Volatility Index (VIX) mid-week. This means that option prices are also at historically low levels.

SPEND: Real Spend

From an economic standpoint, the big story last week was the 0.6% increase in inflation (Consumer Price Index) in January. The January increase was the largest seasonally adjusted all-items (including energy and food) monthly increase since February 2013, due largely to a sharp rise in the gasoline index (which was up 7.8%).

For the 12-month period through January, 2017, the CPI rose 2.5%—the biggest year-over-year increase since March 2012, but also roughly in-line with expectations. A sharp rise in the gasoline index accounted for nearly half the increase, and advances in the indexes for shelter, apparel, and new vehicles also were major contributors.

For the full year 2016, inflation as measured by the CPI was up 2.1%.

Despite the inflation data, market prices of inflation expectations barely budged last week—which suggests that the market was not surprised by the magnitude of the increase in prices. The consensus is that core inflation (after stripping out the volatile food and energy segments) is likely very close to the Fed's 2% inflation target.

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