Market Showing Nerves Despite Better News on GDP, Earnings

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News from the markets and the broader economy has been improving lately, so now there's a lot riding on Friday's employment report for October. If the numbers meet or beat expectations, it could confirm this positive trend and accelerate markets. If not, we could be in for a bumpy stretch as investors react to the conflicting indicators.

We're already seeing an upswing in turbulence — the Volatility Index (VIX) for stocks is up for six straight sessions through Tuesday. This is perhaps due to any combination of uncertainties: Along with the upcoming jobs report, there's also an election generating plenty of last-minute controversies and the growing likelihood that the Federal Reserve will increase interest rates next month.

A Fed move is bolstered by the recent report that growth in U.S. gross domestic product for the third quarter was 2.9% — significantly higher than the Fed's GDPNow forecast of about 2%. The fourth-quarter GDP projection is also rising. In addition, inflation is climbing closer to the Fed's target level; there are signs that wage growth is picking up, and manufacturing activity increased in October in both the U.S. and Europe.

The stock market also has seen a notable surprise when it comes to profitability. As recently as mid-October, it had been a given that earnings growth for the Standard & Poor's 500 would be negative for 3Q — the only question was how negative.

But according to tabulations by FactSet, an above-average number of companies have beaten analyst estimates for the quarter, and those wins have been by a greater-than-average amount. With more than half of the S&P having reported results, the current estimate for 3Q earnings growth has climbed into the black at 1.6%. It would be the first time in the past six quarters that year-over-year profit growth has been positive. Fourth-quarter projections call for further gains in both revenue and earnings.

KEY TAKEAWAYS

- Volatility has picked up in recent sessions, with investors on edge over next week's election and a likely rate hike in December. Friday's jobs report is the next number to watch for indications on economic strength.
- The outlook for 3Q earnings growth has seen a surprising turnaround. Instead of a sixth straight negative quarter for the S&P 500, the forecast is now for positive results. Revenue growth, long elusive, is a key contributor.
- Rising yields is the market reacting to bond overvaluation — this is no cause for alarm if rates rise gradually. Income-minded investors should take heart, as higher yields tend to mean higher coupon payments on newly issued bonds.

And that turnaround appears to be spread across the market. FactSet reports that eight of the 11 S&P sectors are expected to show positive earnings growth, with the only sizable drag coming from the battered energy sector. Minus energy, projected earnings growth for the S&P jumps to about 5%. And even though 3Q energy earnings are negative year over year, more than two-thirds of the companies in the sector are reporting positive surprises.

Of particular interest to us are the improvements in the financial sector, which for some years now has struggled in a low-rate environment and as new rules have been imposed. So far, nearly three-quarters of the companies in the sector have surpassed 3Q analyst consensus on revenue and earnings. This is helping us, as our portfolios are overweighted to financials.

Most of the big banks saw higher trading revenue in the quarter, but they're also benefiting from higher interest rates ahead of any Fed action. The yield on the 10-year Treasury note rose from 1.36% in early July to just under 1.6% at quarter-end, and it has continued to climb this quarter. It nudged up close to 1.9% Tuesday, the highest level since April.

The ironclad rule of bond math is that rising bond yields mean falling bond prices. Fixed-income investors are seeing this relationship in their 3Q statements, and there's a good chance they'll see more of it in the fourth quarter if the Fed opts to raise rates in December.

In our view, there's no cause for alarm — in fact, we see longer-term positives from rising yields as long as they don't rise too quickly. We've seen nothing to change our belief that rates will increase on a very gradual basis.

Bonds have been fundamentally overpriced for some time, so it's a natural function of the market to adjust those valuations closer to their intrinsic value. And from an income perspective, higher yields stand to push up coupons on newly issued bonds. Given that a bond's income accounts for the lion's share of its total return over time, this is a good thing for long-term investors.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are best suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

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