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MARKETS

Stocks' Climb Continues as Inflation Remains Just Right

Investors will get a double dose of inflation data this week

Companies ranging from Kleenex maker Kimberly-Clark Corp. to Tide detergent producer Procter & Gamble Co. have raised prices for core products in part to offset their own rising costs. **PHOTO:** ROBERT NICKELSBERG/GETTY IMAGES

By Akane Otani

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U.S. stocks are hitting records again after a monthslong drought, powered by fresh signs that the domestic economy is perking up without spurring a jump in inflation.

The stock market's latest leg higher has been fueled by better-than-expected earnings, as well as data suggesting the economy grew faster than initially expected in the first three months of the year. Those reports have offered investors reassurance that the economy is on solid footing after a soft patch had cast some doubt on the expansion's durability in the final months of 2018.

The S&P 500 has soared 17% this year, building on gains after closing out its best quarter in nearly a decade. The Dow Jones Industrial Average has advanced 14%.

Whether the gains last depends in part on data continuing to show the economy is growing at a just-right pace: one that is fast enough to support corporate profits but slow enough to prevent inflation from racing higher, investors and analysts say. That's key because many believe a big enough breakout in inflation would force the Federal Reserve to resume its rate-increase campaign, possibly taking some air out of an aging bull market's run.

The stock market had a muted reaction to Friday's strong gross-domestic-product report, in part because it showed that even as exports rose, other key drivers of growth like consumer spending and business investment slowed.

Investors will get their next look at how well their bets on modest growth and inflation are playing out on Monday, when the Commerce Department releases inflation data for March, as well as February, which was delayed because of the government shutdown. Economists are expecting the price index for personal-consumption expenditures, which tracks household spending on everything from soap to Netflix subscriptions, to undershoot the Fed's 2% inflation target for both months from the year prior. Another reading under the 2% mark would strengthen the Fed's case for leaving rate-increase plans on hold.

"While the economy has improved, this is still the slowest expansion in the postwar era. Price pressures are going to be much slower to build up than in the past," said Mike Ryan, chief investment officer Americas at UBS Global Wealth Management.

His firm is holding more longer-duration Treasurys than it is cash, betting that inflation will remain tepid even as U.S. and global growth accelerates. At the same time, it is scooping up more shares from emerging markets and Japan, a position that he hopes will pay off as the global economic environment improves.

Much of the argument for low inflation stems from the fact that prices haven't picked up quickly, even with strong job creation and the unemployment rate at its lowest in years. Adding to investors' skepticism, the PCE price index—the Fed's preferred inflation gauge—failed in 2018 to break above 2% for the seventh consecutive year.

Still, some analysts caution that investors may have gotten too comfortable with the notion that inflation will be muted for the rest of the expansion.

Commodities prices have soared this year, with U.S. crude oil booking a 39% gain through Friday thanks to major producers' efforts to rein in output. Wages have ticked higher following a subdued start to the year. And companies ranging from Kleenex maker Kimberly-Clark Corp. to Tide detergent producer Procter & Gamble Co. have raised prices for core products in part to offset their own rising costs.

Despite that, market indicators suggest investors haven't been anticipating much of a pickup in overall inflation. The 10-year break-even inflation rate, which tracks investors' expectations for average annual inflation over the next decade, hasn't broken above 2% at all this year despite getting within striking distance of the level multiple times. It also remains below the four-year high it hit in May.

Because investors' inflation expectations have dropped off significantly from last year, "we could see at some point in the next few months or quarters an inflation scare," said Michael Arone, chief investment strategist at State Street Global Advisors.

With bets on inflation looking increasingly unpopular, some firms see the shift as an opportunity to scoop up insurance cheaply against an eventual pickup in price pressures. Morgan Stanley Wealth Management's global investment committee is advising its clients to buy more inflation-protected securities: Treasurys that repay investors more principal if price increases exceed certain thresholds.

"We do believe that the market is too complacent about inflation," said Lisa Shalett, chief investment officer at Morgan Stanley Wealth Management. The U.S. dollar's rally this year has helped mask some of the pickup in price pressures among imported goods. But Ms. Shalett expects the greenback's rally to lose some steam, potentially driving up imported inflation pressures by making goods purchased from outside the U.S. more expensive.

Some analysts and investors are also doubting growing expectations that the Fed will lower interest rates before the end of the year.

Federal-funds futures, which traders use to place bets on the course of monetary policy, showed Friday the market pricing in a 41% chance of one rate cut and a 19% chance of two rate cuts by the end of 2019, according to CME Group.

But both Mr. Arone and Mr. Ryan believe those bets are overblown.

To the extent that stocks and bonds have rallied on hopes that the Fed is done raising rates for the remainder of the cycle, markets may be vulnerable to a reversal, Mr. Arone said. That's especially true with stocks at all-time highs and valuations for U.S. shares looking less attractive now than they did at the end of last year.

"I find it hard to believe the Fed will cut rates with the economy growing and with financial markets having their strongest run in decades," he said.

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