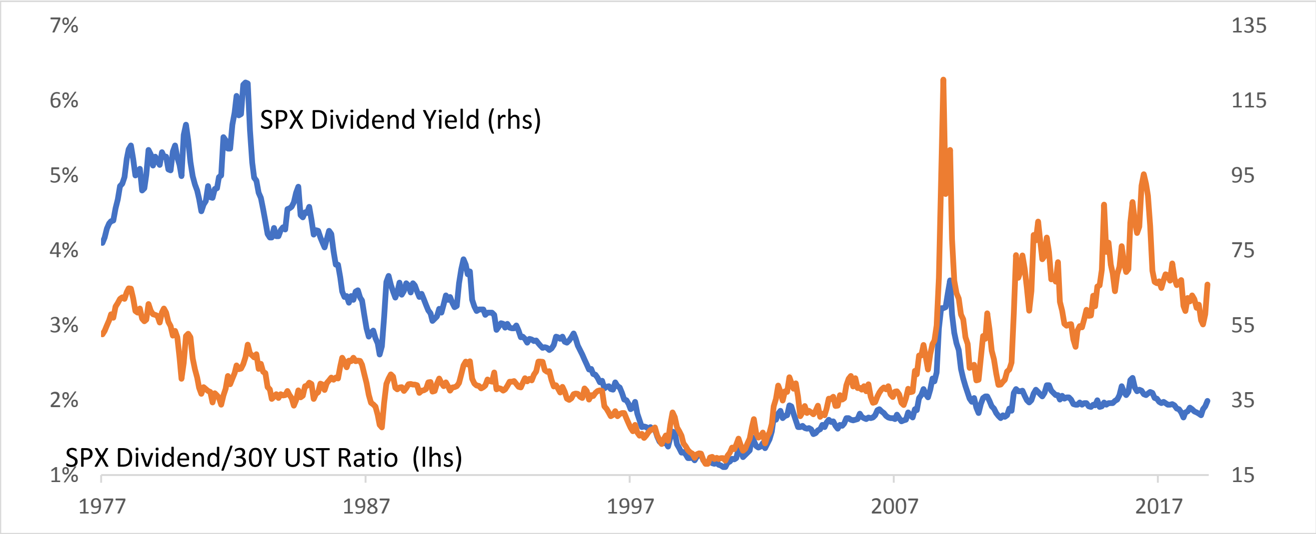
MARKET VOICE

January 2019

Out with the old and in with the old

The process of predicting the future is never easy, but the challenge has been particularly difficult in the early weeks of 2019. While the first three quarters of 2018 were a positive for markets as the year closed, there was plenty to be gloomy about; the SPX finished the year down 6.4% with the worst December performance since the Great Depression and market volatility hit levels not seen since the financial crisis. The issues driving shares lower – slowing global growth, a potentially worsening U.S. trade war with China, the Federal Reserve apparently still intent on hiking rates and looming concerns about Brexit – largely carried over into the New Year. Yet by mid-January the market turned back upward and, as long as the earnings season is not a major disappointment, it looks like the gloom is over and we could see a resumption of last year's bull market.

Figure 1: SPX dividend yield vs. 30-year bond yield

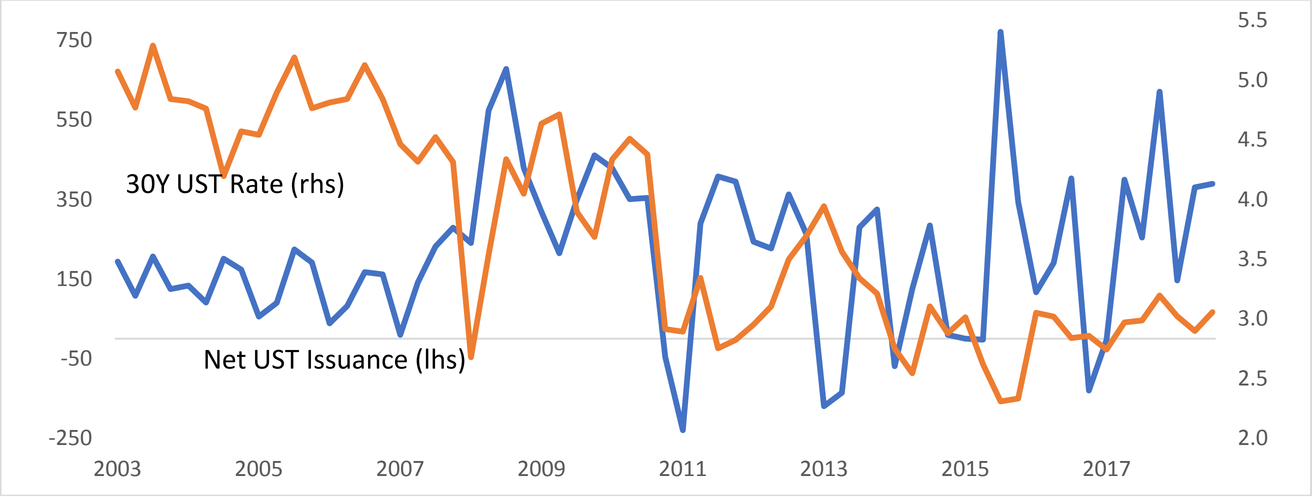


Source: Eikon and Datastream

Some of the renewed optimism reflects the Fed showing less commitment to stick with the established pace of rate hikes and hopes for a China trade deal before the scheduled March tariff increases. That said, with the fiscal stimulus from last year's tax cuts fading, 2019 is certain to see slower GDP growth which is likely to moderate corporate performance so upcoming earnings reports will be more important than usual. The threat of slower earnings growth is a key factor behind market jitters, but we think the picture is not that gloomy because, contrary to much of the market commentary, we do not believe equity valuations are excessive.

A historically high price/earnings ratio – or inversely low dividend yield – is the reason generally cited as evidence of overvaluation. The blue line in figure 1 is the SPX dividend yield – so a higher level implies more attractive stock valuation - the current yield of just below 2% is above the dotcom associated bottom but remains low relative to levels of earlier decades. By this measure stocks are expensive, but it is also relevant to ask how stocks are priced vs. alternative assets – especially bonds. The red line in the chart is the ratio of dividend yield to the interest rate on U.S. 30-year Treasury bonds which paints a very different picture of equity valuation. Since the Fed pushed interest rates to zero in the wake of the financial crisis, equities generally were attractively valued when scaled by the super-low rates of interest. Currently the ratio is roughly in the middle of the post-crisis range but well above levels in prior decades which suggests that stocks are not particularly expensive. The current SPX vs. 30-year yield ratio of 65 is roughly 50% above the long-term average and it would take a drop in the SPX yield to 1.25% - not far from the post 1960 1.11% low – to take the ratio to the average level of 65.

Figure 2: U.S. Treasury debt issuance net of Fed purchases and the 30-year Treasury bond rate



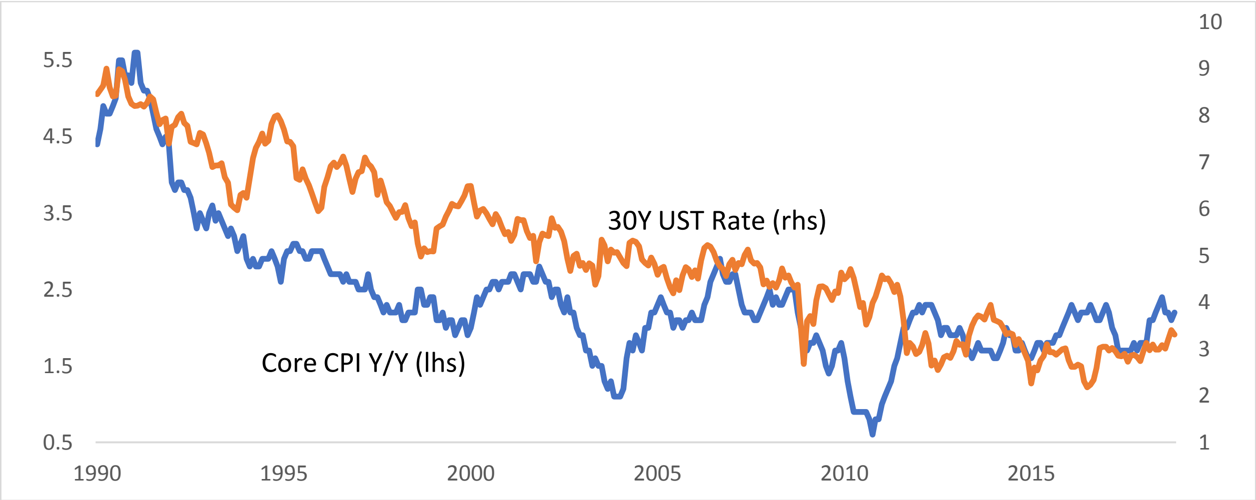
Source: Eikon and Federal Reserve Bank of St Louis

How high can interest rates go?

The ratio could also decline via a rise in the denominator – the 30-year bond rate. Based on Fed Chairman Powell's comments following last month's Board meeting, the Fed remains committed to continuing the gradual unwinding of quantitative easing by not replacing maturing U.S. Treasury bond holdings – roughly averaging $35 billion per month. It would seem logical that the original Fed quantitative easing policy of taking bonds onto their balance sheet took supply off the market which should push yields lower – at least vs. where they would otherwise be. By the same reckoning, the reverse of quantitative easing should give bond yields an upward bias, but there is no consensus on the overall impact of quantitative easing and the history shown in figure 2 is one indication of why the issue remains moot. The blue line is the net quarterly U.S. government debt issuance less what the Fed added or subtracted to its balance sheet. In response to government actions to deal with the financial crisis, debt reaching the market surged in 2008, but debt hitting the market gradually diminished for much of the next decade due both to moderation of the fiscal deficit and Fed purchases. The 30-year bond rate did trend lower as bond sales net of Fed purchases diminished, but this was an extension of an established secular downtrend, so it is not at all clear that quantitative easing had any material effect on the yield.

Figure 3 suggests that the established two-decade secular downtrend in the 30-year bond rate can in fact be largely attributed to a relentless decline in the rate of core CPI inflation. It seems then that Fed QE reverse notwithstanding, bond rates are unlikely to rise significantly in the absence of a meaningful rise in inflation. While inflation has been in a flat range since 2012, it is currently pushing toward the top of this range. Even with the breakdown of the traditional Philips curve relation between labour conditions and inflation, we believe there is still potential for a strong jobs market to lead to higher levels of inflation.

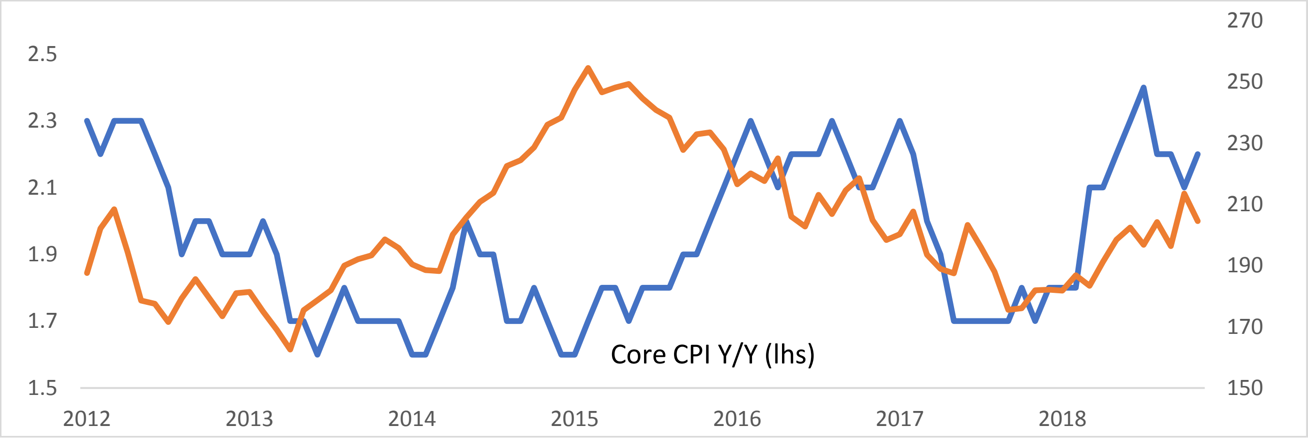
Figure 3: Core CPI inflation and the 30-year bond rate



Source: Eikon

Figure 4 shows the pace of job creation is still a dominant inflation driver, but this connection indicates that higher levels of inflation would require a payroll gain greater than the current 200,000 per month. With growth likely to slow this year, we expect payroll growth to remain positive but trend well below 200,000 per month so inflation is not likely to move much above current levels. Hence, despite a large fiscal deficit and the unwinding of quantitative easing, bond yields are not likely to move much above recent highs.

Figure 4: Monthly payroll change and core CPI inflation



Source: Eikon

A bearish – though unlikely – scenario for 2019

Based on our valuation analysis, a dire picture for stocks would require some combination of diminished earnings growth but rising inflation driving yields higher, a combination which seems unlikely to emerge. While not our base case, a deepening trade war between the United States and China – and possibly other countries – could create this extremely bearish combination. Trade barriers are inflationary, in part, because in some forms – esp., tariffs – they directly raise the cost of doing business, feeding directly into consumer prices. More importantly, trade barriers are often designed specifically to dissuade U.S. based companies from moving operations overseas. The by-product of sticky production is more bargaining power for workers. Trade wars then could create barriers that put upward pressure on wages and inflation and, at the same time, hurt earnings through raising the cost of business and disrupting supply chains – the trend toward rising minimum wages could further assist this inflationary process. The result could be higher yields on bonds and lower yields on stocks – a truly bearish combination. We do not believe the trade wars will deteriorate to the point that this scenario becomes a reality but cannot rule it out. The two indicators to keep an eye on as early warning signs are rising import costs and hourly earnings.

Have we already seen the SPX lows for 2019?

The prospects for the market have improved in the early days of January. Since the December Fed meeting Powell – and other board members – have made several public comments suggesting more flexibility on the timing of interest rate hikes and the Trump Administration is optimistic on getting a trade deal with China ahead of the March-scheduled tariff hike. In addition, the much stronger than expected December payrolls report moderated concerns about a slowing economy. The stock market is now trading with a firm tone in response to this spate of good news, but it is probably premature to think the dark days are over.

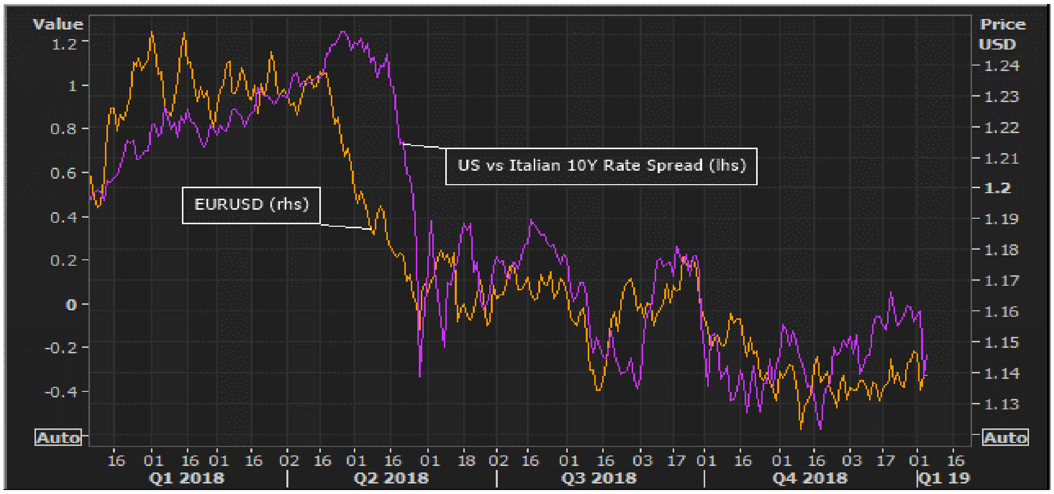
In the December Market Voice, we highlighted Refinitiv survey data showing portfolio manager allocations to both equities and alternative investments suffered at the expense of fixed income in the months since September and the sharp selling in December further reduced allocations to equities. Low equity allocations suggest there is substantial buying power and sentiment is turning decidedly more bullish with the turn of the year. We think that with the absence of the negative trade war scenario, there is potential of the market making new highs. But we think stocks are unlikely to get materially higher than this. Even the optimistic scenario leaves room for some firming of inflation and declines in earnings growth which should create valuation resistance above the prior highs. More importantly, global growth is slowing and the U.S. yield curve is nearing inversion and we believe there is growing potential for a recession in 2020. The prospect of this would weigh on markets later in the year. On balance, we are likely to see a sideways market with an upside bias in the first half of the year and the early stages of a bear market emerging as we close 2019 – Happy 2020!

What about the dollar?

While the dollar's volatility picked up in 2018, the rise was modest compared to the equity market and it moderated at the close of the year. Despite the market focus on Fed policy, overall rate moves are likely to be modest next year throughout the developed-world so we expect currency volatility to stay relatively low. Probably the two biggest factors for dollar performance are the potential event risk from Brexit and concerns about the potential for a credit event in the Italian government bond market.

We will be addressing these issues in detail in future months, but figure 5 highlights the importance of the Italian bond market for EURUSD. The chart shows EURUSD and the spread between Italian and U.S. 10-year government bond rates. The two are not only linked but in a perverse fashion. The EUR has a positive link to the spread between German and U.S. bond rates, but in this instance a higher Italian spread advantage tends to drive the EUR weaker. The divergence is because the German rate is primarily driven by expectations on economic strength whereas a higher Italian rate also reflects heightened credit concerns. Probably the biggest factor for the dollar in the year ahead is not expectations on the Fed, but the Italian government's ability to service their debt. More broadly, the emergence of any global credit event would be very bullish for the dollar.

Figure 5: EURUSD and US vs. Italian 10-year Government Bond rate



Source: Eikon – Click on chart to request a free trial

The Bottom Line

We think that 2019 is going to be a year of a lot of churn but without much to show for it. Inflation is not likely to move materially higher which should cap bond rates, but bonds will also not be able to rally much in the face of the heavy supply likely to hit the market. Stocks are probably in a bottoming process and sustained upside will have to await a resolution of the trade dispute with China and a clearer picture on the prospects for growth and earnings. Some moderation in economic activity will prevent the market from breaking significantly above last year's highs. The dollar is likely to remain firm this year but is modestly vulnerable to the Fed tightening less than priced in. The major risks to this view are an escalation in the trade conflicts, a default of the Italian bond market and a messy Brexit.

About the Author

Following a long career in banking and working for Thomson Reuters, Dr. Ron Leven recently became the Huff Professor of Economics at Duke University and continues to serve as an adjunct Professor at Columbia University. Dr. Leven has a consulting practice and clients include Refinitiv and the hedge fund Brick Accretive Management

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