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Volatility Returns

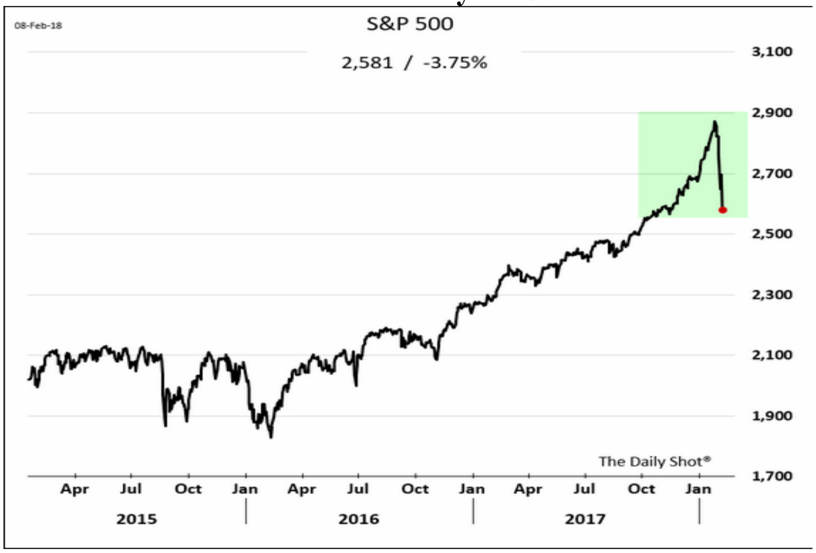
Perfection has come to a halt, at least temporarily. 2017 turned out to be the first year on record when the S&P 500 had a positive return every month. Previously, the closest year to perfection was 1995 (see Table 1). And, to top off last year, the S&P 500 had a total return of 5.73% during the first month of 2018. As sure as night follows day, stock markets inevitably experience downward moves. The main difference is that we can know with certainty when the night will come by looking at our watch, but most of these downward moves in prices happen in a random fashion, especially in modern times because of a large amount of automated and computer driven trading which exaggerates downward shifts. But business conditions remain excellent and the outlook for the economy is positive. Hence, we expect that stock prices will resume their upward trajectory before long. The time to become seriously concerned about a deeper and more protracted downturn in stocks will occur when a recession is on the horizon, which is not yet the case.

Table 1

S&P 500 Total Returns

1995		2017	
Jan	2.59%	Jan	1.90%
Feb	3.90%	Feb	3.97%
Mar	2.95%	Mar	0.12%
Apr	2.95%	Apr	1.03%
May	4.00%	May	1.41%
Jun	2.32%	Jun	0.62%
Jul	3.32%	Jul	2.06%
Aug	0.25%	Aug	0.31%
Sep	4.22%	Sep	2.06%
Oct	**-0.36%**	Oct	2.33%
Nov	4.39%	Nov	3.07%
Dec	1.93%	Dec	1.11%

S&P 500: In Correction Territory -10%



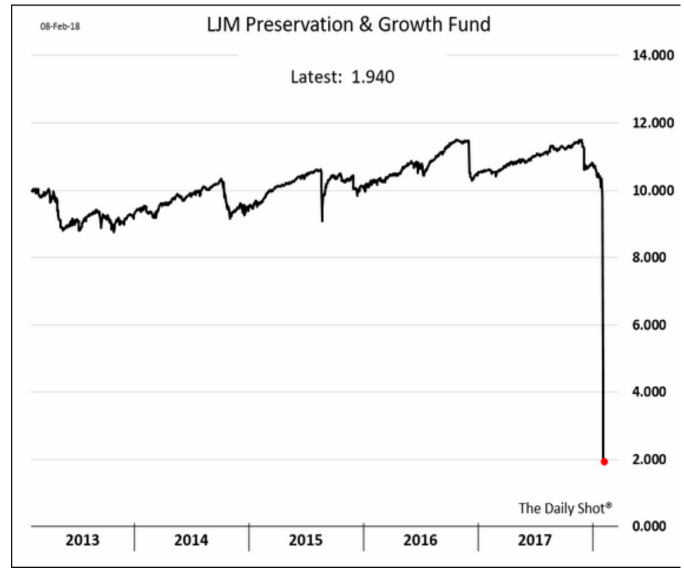
Source: Wall Street Journal

The extreme speed of this correction reflects the "engineering" of the markets today, including levered exchange traded products, computer driven trading, and certain hedging strategies. Risk Parity, for example, is an "all weather" strategy that generally requires hedge fund managers to sell assets as volatility increases, which itself only adds to selling pressure and increase volatility further. Leveraged exchange traded products have also become popular in recent years, including some tied to the VIX index, which measures the implied volatility in the prices of options on the S&P 500 Index. Volatility had become extremely low for a long period and speculators had bet that volatility would remain low. But as soon as the numbers started to rise, it was a *Torschlusspanik* moment. As seen in Chart 2 below, the level of assets in such products has collapsed. One widely noted firm, LJM Partners, had an ironically named hedge fund called the "LJM Preservation and Growth Fund," which was heavily levered to a low volatility bet. The fund collapsed 82% within a week (see Chart 3).

Chart 2

Source: Bloomberg Markets

Chart 3



Source: Bloomberg Markets

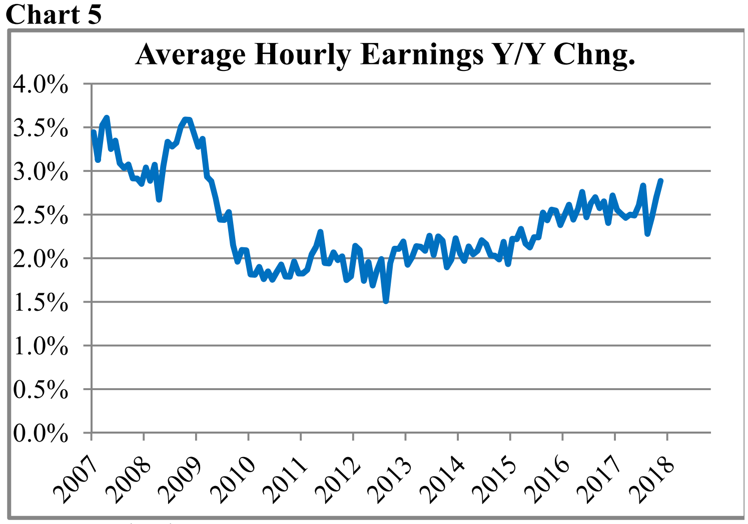
Labor Causes Inflation Scare

The fundamental factor behind this spike in volatility seems to be the tight labor market and rising wages. The selloff in stocks began on Friday February 2nd after the U.S. labor department reported that 200,000 new jobs were created in January while the unemployment rate stayed at 4.1% (see Chart 4). But what really seemed to spook investors was that average hourly wages jumped 2.9% from a year earlier, which was the biggest increase since June 2009 (Chart 5). The reason that the markets negatively reacted to this news is because some people believe that low unemployment and rising wages will cause inflation, which is certainly poison for the stock and bond markets. However, as we will discuss further, we do not believe that inflation is an imminent threat.

Chart 4

Source: Federal Reserve

Chart 5



Source: Federal Reserve

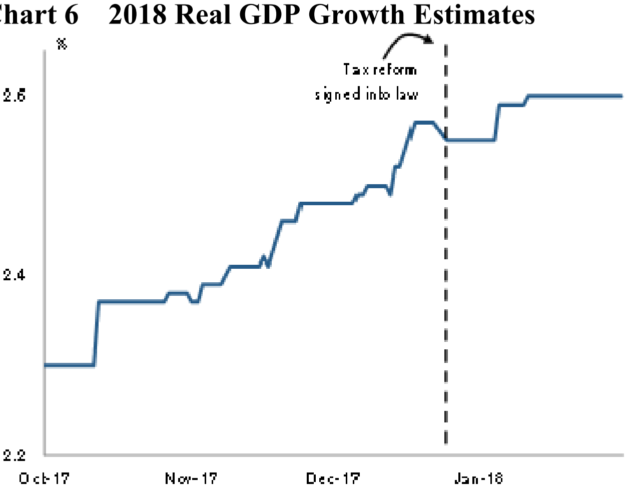
The position at FVCM is that low unemployment is not a factor in the problem of inflation. Admittedly, our opinion is not consistent with the "Phillips Curve," which is a main component of the Federal Reserve's own models. Certainly, we would not be so bold as to say that the price of labor (wages) is independent of the supply of labor. Surely wages will rise as labor conditions tighten. However, rising employment is a proxy for rising production, which if anything satisfies spending growth and reduces inflation. In other words, more dollars chasing more goods and services is not inflationary. The problem is more dollars chasing the same amount of stuff, i.e., spending growth without production growth. Furthermore, businesses can pass wage gains through price increases only if such price increases are possible from a demand perspective (spending, the real cause). Without demand, businesses must eat the rise in costs and suffer lower profit margins. At the end of the day, the unemployment rate is not a factor in inflation, or Japan, with its historically low unemployment rates, wouldn't have such a persistently low inflation rate, and Venezuela, which has mass unemployment and falling production, wouldn't be experiencing hyperinflation.

Popular economic discussions also display signs of cognitive dissonance when it comes to the labor markets. On one hand, there is an abundance of concern that the U.S. is running out of labor. On the other hand there has been wide discussion about how automation is putting people out of work, especially with minimum wages going up. Even McDonald's is now trying to reduce labor costs by allowing people to order food with their phones. What will become of all those McDonald's workers at the restaurant counters? The threat of unemployed laborers has even caused some otherwise rational people to propose a "guaranteed income" to all people. From our prospective, the labor markets in the U.S. are sufficiently fluid that automation will indeed result in some job losses, but that business activity is dynamic and that those workers will find employment in other areas like manufacturing and construction, which now have high demand for workers. The bottom line is that high productivity growth is consistent with low unemployment and automation. All the moaning and hand wringing about "Secular Stagnation" or a "New Normal" will ultimately be proven false if markets are free to adjust.

Rising Bond Yields Not Signaling Inflation Either

Bond yields are up, but they are signaling stronger real economic growth, not inflation. As seen in Chart 6, economists have been raising estimates for real economic growth since Trump was elected, reflecting his pro-business policies. Estimates have continued to rise since the new tax law was passed (the vertical dotted line) but probably have further to go. Purchasing Manager Indexes (PMI) have been strong in most advanced economies and it appears that a synchronized global expansion is underway. This view is consistent with the fact that bond yields have risen in tandem in both the U.S. and Germany (Chart 7).

Chart 6 2018 Real GDP Growth Estimates



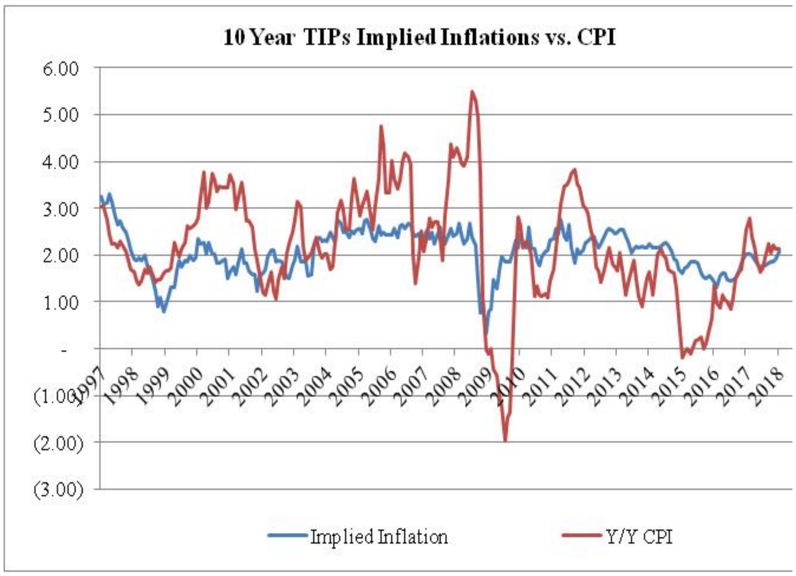
Source: Credit Suisse

Chart 7 U.S. vs German 10 Year Bond Yields

Source: European Central Bank, Federal Reserve, FVCM

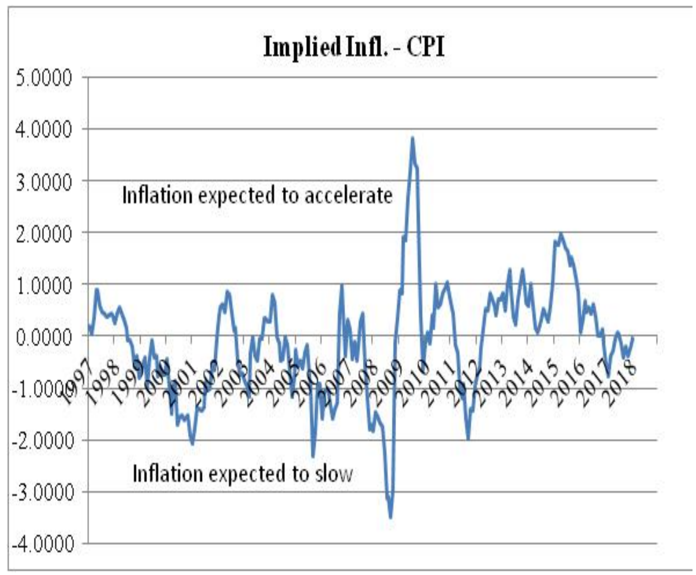
A way to measure inflation expectations in the bond markets is through the Treasury Inflation-Protected Securities (TIPS), and they are not showing signs of higher inflation. TIPS pay interest twice a year like ordinary Treasury bonds, but the principal amount is adjusted based on the Consumer Price Index (CPI). Since TIPS protect investors against inflation, the spread between the yield on nominal 10 year Treasury bonds and 10 year TIPS is a market-based measurement of inflation expectations for the next 10 years. As shown in Chart 8, the implied rate of inflation and the year-over-year change in consumer prices are both right around 2%. Chart 9 shows the spread between those two lines. The implication is that the TIPS market does not expect inflation to either accelerate or decline. If that is the case, the rise in nominal bond yields would be due entirely to rising real bond yields, which is consistent with expectations for faster real economic growth. <u>This is important because if bond yields are rising due to expectations of faster real growth, the implication for equities is positive</u>. <u>Only if the rise in yields is due to inflation is it negative for equities.</u>

Chart 8



Source: Federal Reserve, FVCM

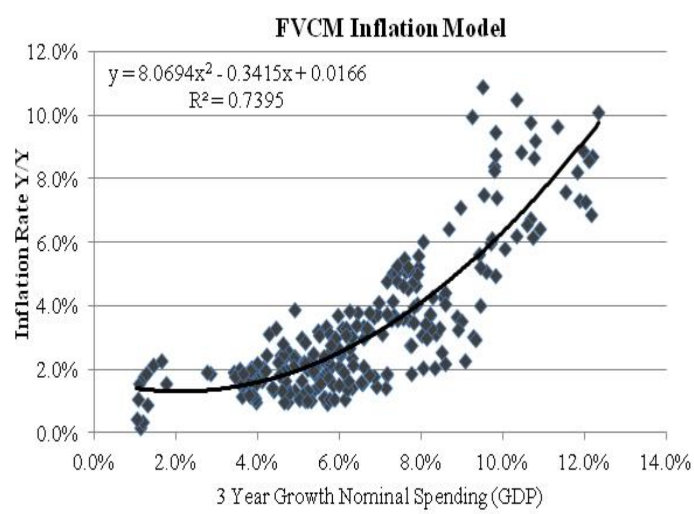
Chart 9



Source: Federal Reserve, FVCM

FVCM's model (Chart 10) still predicts inflation down in the 1.5% - 2.0% range. Monetarists famously theorized and found empirical data to show how money growth is the fundamental source of inflation. However, money is only inflationary when spent. If people hoard money, inflation is necessarily unaffected. Our model is tied to that essential fact. We found that aggregate spending for the previous 3 years, currently only a 3.6% annual rate, works best in estimating current inflation pressure. Inflation is like a big ship that changes speed very slowly. Even if nominal spending were to accelerate to 6% in 2018, inflation pressures would still not be enough to generate inflation much above 2%.

Chart 10

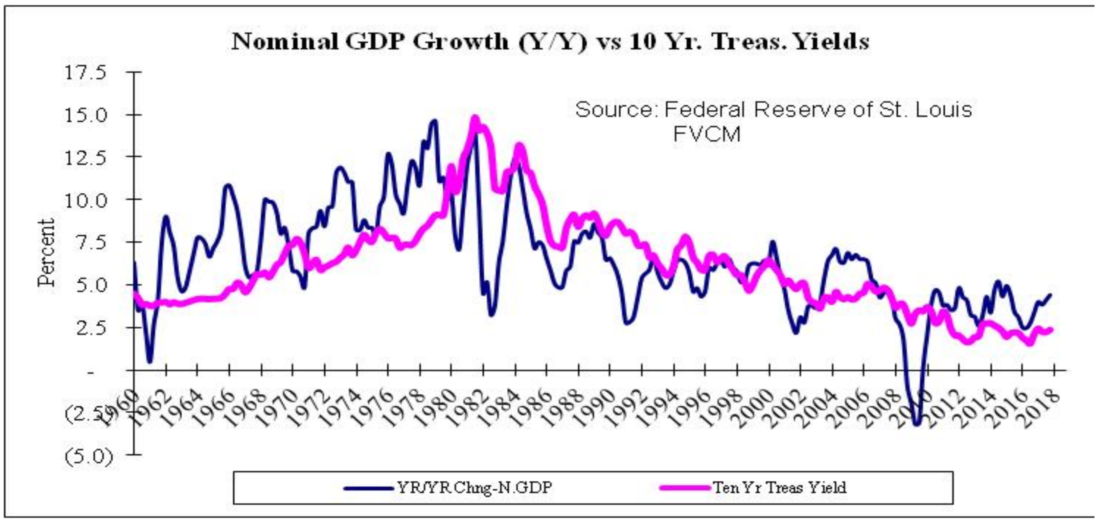


Source: Federal Reserve, FVCM

Bonds at Risk but Still Ok for Portfolios

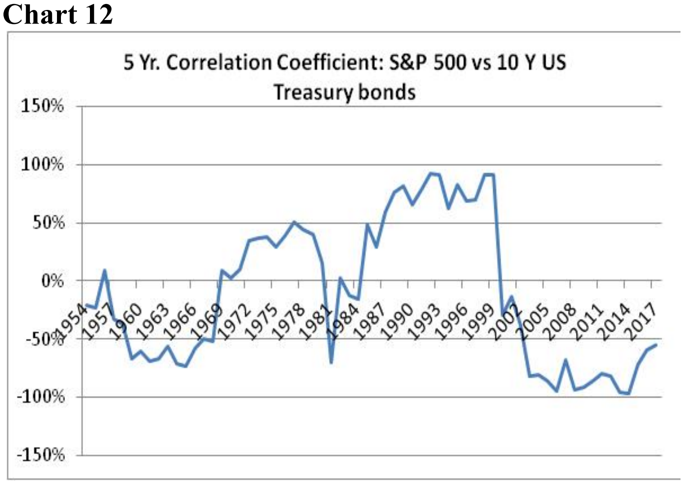
While inflation is not a material problem, long bond yields could still experience further upward pressure due to rising growth expectations. The German bund, in particular may see higher yields and the spread with Treasuries may narrow (refer back to Chart 7). U.S. yields have historically trended around nominal GDP growth (Chart 11). In the 1960s and 1970s nominal GDP growth was above the 10 year yield and both series were moving upward. Starting in the 1980s those roles reversed and bond yields were consistently above nominal growth. With the end of the tech bubble in 2000, the relationship has become more unstable as interest rates were depressed by central banks in order to stimulate incremental growth (people don't want to spend if they are already high in debt). Because this business cycle is being elongated and accelerated by fiscal policies, higher yields are still possible over the next couple years. But when the business cycle eventually turns south because of tighter monetary policy, we suspect that bond yields will turn sharply lower again.

Chart 11



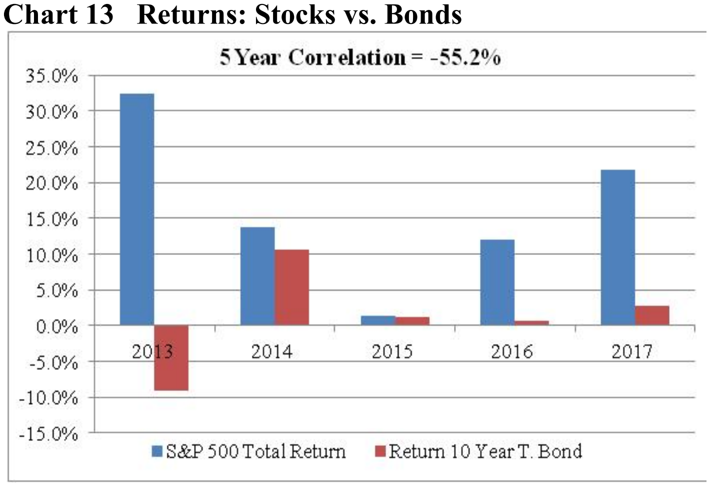
Long bonds can still play an important role in investor portfolios. As shown in Chart 12, the return on the S&P 500 and 10 Year Treasury bonds tend to be inversely correlated over long stretches of time, including since the year 2000. Over the past five years, stocks and bonds have had a negative correlation of 55% (see Chart 13). Thus, bonds can play a role as a hedge to equity portfolios. In particular, when the business cycle changes, investors will likely find that their overall portfolio returns smoothed by the inclusion of fixed income securities.

Chart 12



Source: Federal Reserve, Standard & Poor's, FVCM

Chart 13 Returns: Stocks vs. Bonds

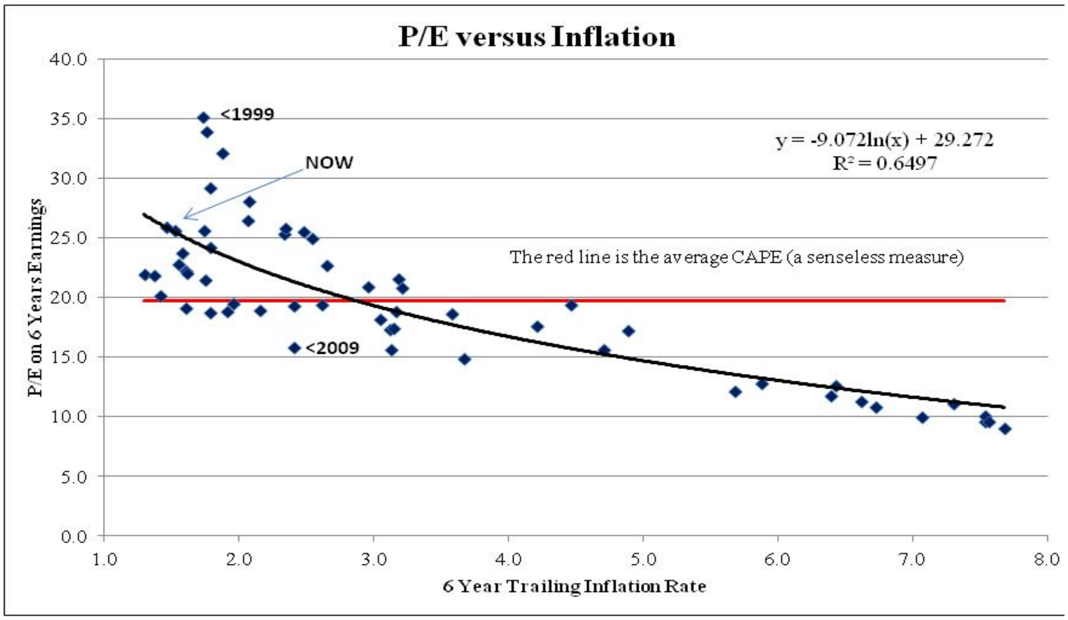


Source: Federal Reserve, Standard & Poor's, FVCM

Positive Outlook for Stocks

The S&P 500 is fairly valued based on the FVCM model (Chart 14). The big run up in stock prices over the past year left stocks 10% overvalued by our model, which calculates the fair P/E using a regression between cyclically adjusted earnings and trailing inflation. But following the recent correction, values are back right on the regression line, i.e., fair value. But keep three things in mind: 1) the fair value goes up at about 6.4% per year due to earnings growth; 2) valuation is a poor predictor of stock action within a couple years time frame; 3) stocks tend to go from undervalued, to fully-valued like today, to overvalued, before a Bull Market ends. Momentum is often your friend. Our primary point here is that stocks are not overvalued, as is so often repeated in the media, because inflation remains low and valuations deserve to be high.

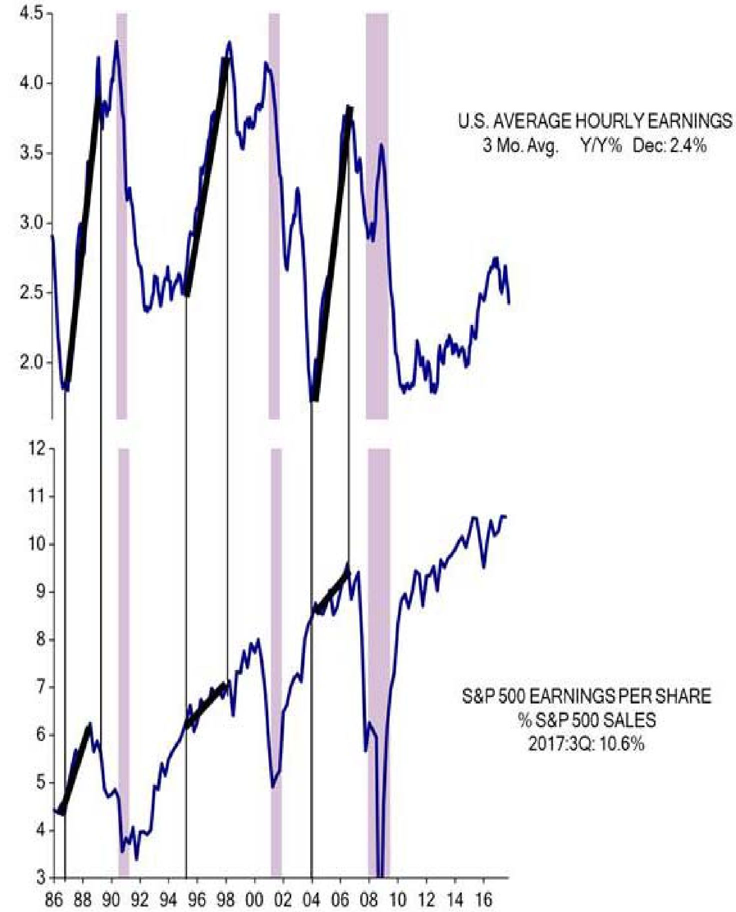
Chart 14



Source: Federal Reserve, Standard & Poor's, FVCM

The performance of stocks over the next couple years will be determined mostly by earnings growth, and on that score things are looking bright. As we have shown in previous reports, Bear Markets are caused by recessions and the downward move in corporate earnings that follows. The Purchasing Managers index (PMI), the Leading Index, the slope of the yield curve and other primary indicators are all still flashing green and economic expansion and profit growth lies ahead. In that context, probably the best argument for higher stock prices in the year or two ahead is that earnings will almost certainly continue its upward momentum.

Chart 15



Source: Evercore ISI

The economists at Evercore ISI have pointed out that, in the past, earnings for the S&P 500 have risen at the same time that average hourly earnings were accelerating (Chart 15). This does not greatly surprise us since labor costs are only perhaps half of total costs. And because most businesses have large fixed costs, margins typically widen during an economic expansion. Such "operating leverage" tends to more than compensate for rising wages.

Evercore ISI is projecting earnings for the S&P 500 to be up 14%, year to year, as of 4Q17, and 20% as of 1Q18. The S&P 500 is now about 15.5 times the 170 ISI is forecasting for 2019. We think these figures look aggressive but achievable. After years of disappointing growth, general expectations—including ours—are probably going to have to be reset higher.

Final Stock Market Comment

The return of volatility that we have seen in February is really more of a return to normalcy. Over time, the reason equity holders profit more than bond holders or people with money in bank accounts is because the equity investors are willing to stomach the swings downward in prices that periodically come along. Volatility is part of the package. We do believe that investors can improve long term returns by making changes to equity exposure when the risk of inflation and recession really appear. But the minor "corrections," such as the one that began this month, are better ignored or used as an opportunity to buy more equities.

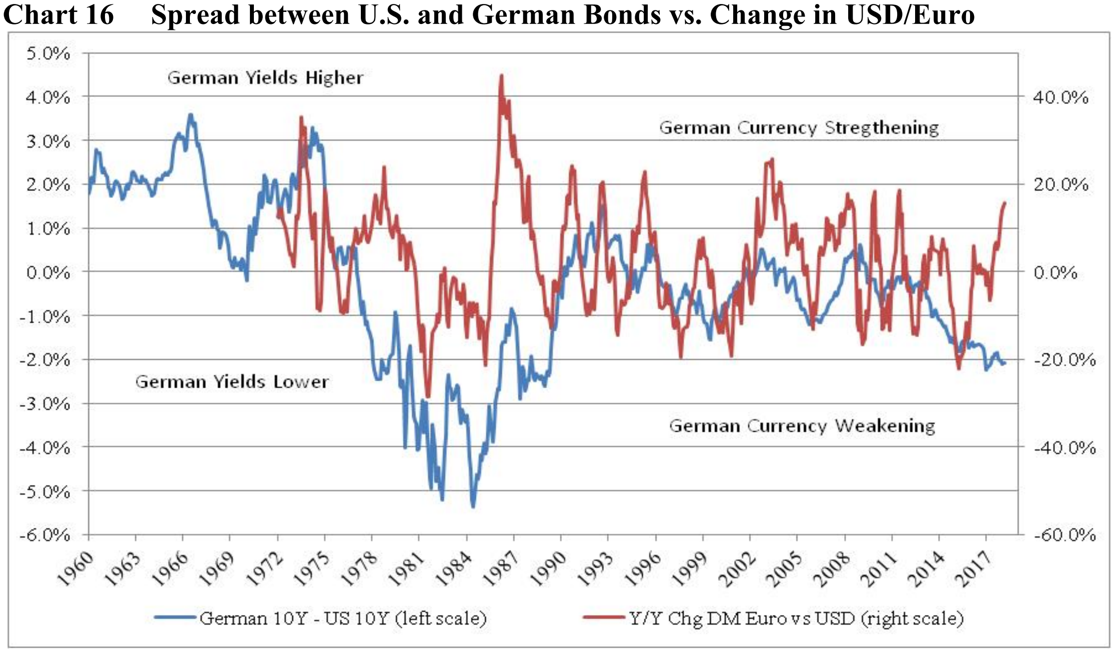
Exchange Rate Paradox

We don't expect any major moves in exchange rates, although we're somewhat skeptical of recent Euro strength. Alan Greenspan, former Chairman of the Federal Reserve, famously commented about the difficulty of modeling foreign exchange rates. The reason for the difficulty is that F/X rates are largely determined by capital flows, which far outsize demand for foreign currencies due to trade in goods. And capital flows are fickle. But to a large degree, capital flows are a function of interest rate differentials—capital looks for higher yields. Therefore, it is rather curious that the Euro has strengthened against the dollar (the red line in Chart 16) since the spread between the 10 year U.S. Treasury bond and the 10 year German bund has held steady (the blue line).

The Euro strength is tied to expectations that the ECB will start "tapering" its Quantitative Easing (QE) program. Specifically, the Euro broke upward out of its two year trading range with the dollar in July 2017 when Mario Draghi spoke publicly about underlying inflation rising in Europe and that the ECB would have discussions about the QE program at that September meeting. But while the ECB continues to only discuss the possibility of ending QE, the Federal Reserve has already started raising rates and is already letting its balance sheet shrink. Simple analysis might have led one to think that the economy with the rising rates and shrinking central bank balance sheet would be the one with the strengthening currency, but that's not the case. The F/X markets always present themselves as a paradox.

An actual announcement by the ECB that it will scale back its QE program may strangely be the time the Euro corrects downward. As we already noted, the divergence between the Euro's F/X value (red line in Chart 15) and the spread between the 10 year German bund and the 10 Year Treasury (blue line) is a reason to doubt that the Euro's recent strength will have real lasting power. There is an old saying in the stock market to "buy on the rumor and sell on the news." We suspect, admittedly without high conviction, that the Euro may lose its momentum when the ECB makes QE tapering a reality. That's when investors will begin to focus on the business fundamentals of the Eurozone and the implications of tapering.

Chart 16 Spread between U.S. and German Bonds vs. Change in USD/Euro



Source: European Central Bank, Federal Reserve, FVCM