Charts That Bear Watching

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis looks at key charts that he uses to track the U.S. economy.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Charts that bear watching**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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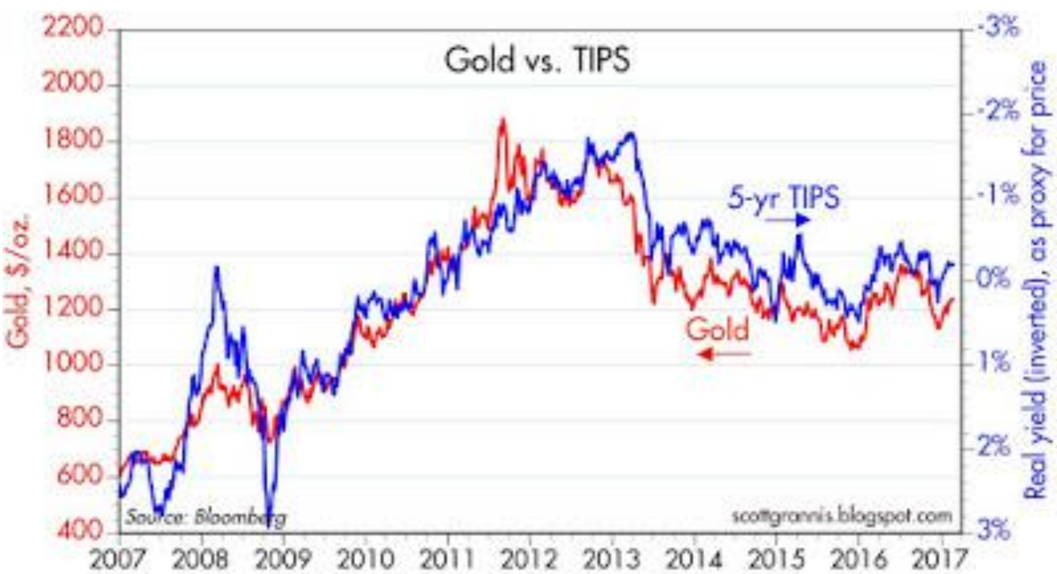
Charts That Bear Watching

Here are some charts that I have been following for quite some time. Many of them show interesting relationships between seemingly-unrelated asset classes, and all tell an interesting story.

The first chart compares the price of gold to the price of 5-yr TIPS, using the inverse of their real yield as a proxy for their price. The only thing these two assets have in common is their supposed ability to hold their value over time relative to other things: over very long periods, gold tends to track the rise in the general price level, while TIPS pay a real yield that is guaranteed by the U.S. government, thus compensating investors for the effects of inflation. Call them "safe-haven" assets of a sort. As such, it makes sense that their prices would rise and fall together as investors became more or less concerned with "safety." In fact, this is what has happened for the past decade: the price of gold and TIPS have tracked each other remarkably well.



If they tell a story, it is that investors were willing to pay ever-higher prices for safety for the first half of the past decade, while they have been ever-less willing to pay for safety in the past 5 years.

This is another way of saying that markets were very risk-averse in 2012 (when the PIIGS crisis was most acute), but have become gradually less risk-averse since then. Both assets, however, are still trading at prices that are relatively elevated compared to their longer-term history which, in turn, suggests that markets are still struggling with risk aversion.

It is a well-known fact that the stock market tends to fall when investors' nervousness increases: stock prices tend to move inversely to the VIX index, a good proxy for fear. Dividing the VIX index by the 10-yr Treasury yield gives a number that tends to rise as fear rises and to rise more as yields fall—with yields, in turn, being a proxy for the market's confidence in the economy's growth prospects.

What we have seen since just before the November elections has been a pronounced decline in fear, coupled with a modest rise in 10-yr yields, and that has coincided with a rather impressive rise in stock prices.

Investors are a lot less fearful and somewhat more confident in the economy's growth prospects, and that has—not surprisingly—correlated with a rise in equity valuations. It is also the case that corporate earnings have stopped declining and are now starting to rise.

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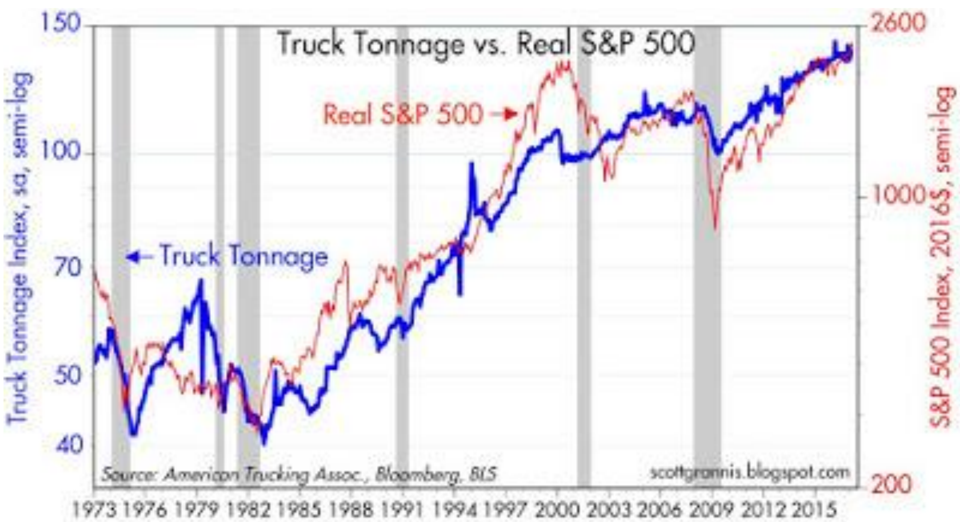
The American Trucking Association publishes an index of the amount of tonnage that is hauled around the U.S. economy by our massive fleet of trucks. As the chart below shows, this index tends to move by the same order of magnitude as the real value of the nation's largest companies (using the inflation-adjusted value of the S&P 500 index as a proxy). The economy is moving more goods today than ever before, and companies are worth more than ever before.



It is a well-accepted fact that interest rates tend to track inflation—except when they don't, as this next chart shows.

For the past 6 years, 5-yr Treasury yields have not tracked the course of core inflation very well.

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With inflation running at 2%, yields should be closer to 4% today, yet today they are just under 2%. This suggests to me that the market is still quite risk-averse, since the market is willing to accept a very low (even negative) real yield on 5-yr Treasuries, presumably in exchange for their government guarantee.

As a general rule, very low Treasury yields are symptomatic of very strong risk aversion. Consider: if people were wildly optimistic about the future, no one would want to hold a bond that paid a zero real rate of interest; real interest rates would have to rise considerably to compete with the generous returns expected of other assets.

The next chart compares the value of U.S. and Eurozone stocks.

What stands out is the huge divergence between the two that began some 8 years ago. Since then, U.S. stocks have outperformed their Eurozone counterparts by over 40%.

We know the U.S. economy is still mired in its weakest recovery ever, so what this says is that the Eurozone economy is really in abysmal shape. No wonder the Brits voted to exit the European Union.

I would not hold out a lot of hope for the future of the EU, but that is good news, in the long run, for Europeans. If they succeed in getting rid of an expensive, burdensome, and unproductive layer of government bureaucracy, European economies could be set up for a huge boom.

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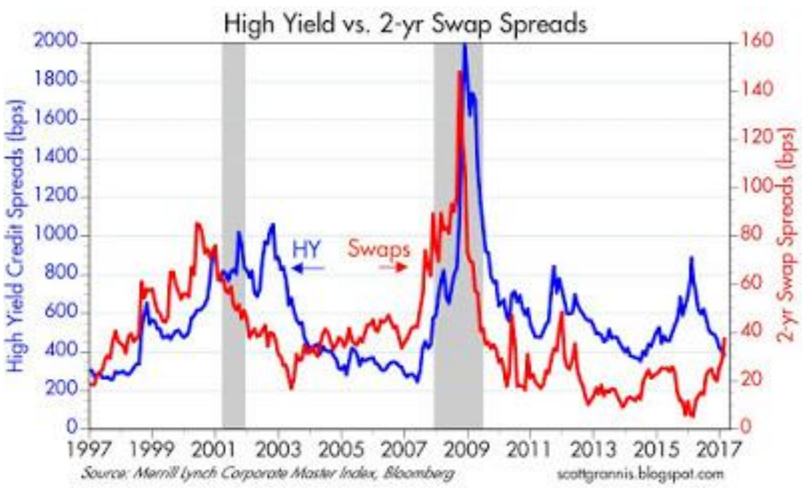
Over the years, I have highlighted the key role that swap spreads play in signaling the health and future growth prospects of financial markets and economies. As the following chart shows, swap spreads (see here for a short primer on what swap spreads are) have tended to rise in advance of recessions, and they have tended to decline in advance of recoveries.



At the very least swap spreads are good coincident indicators of economic and financial market health (i.e., higher spreads reflect deteriorating conditions, falling spreads reflect improving conditions), and they have often been good leading indicators.

Swap spreads are far more liquid than high-yield credit spreads, so they tend to react quicker to changing fundamentals. That swap spreads have been rising of late while HY spreads have been falling is thus a potential cause for concern.

What is going on? Swap spreads are still relatively low, so they are not necessarily forecasting a meaningful deterioration in the economic and financial fundamentals but, over the years, I have developed a healthy respect for swap spreads, and so I am reluctant to dismiss their somewhat troubling message today. Something is going on out there that is worrisome, so some degree of caution is warranted. Maybe that helps explain why 5-yr Treasury yields are as low as they are.

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Over the past year or so, the Brazilian stock market has surged more than 145%. Wow. What this says is that a year ago Brazil was considered to be on the cusp of disaster.

Instead of collapsing, Brazil is slowly getting back on its feet, having purged at least some of the government corruption that was plaguing the economy. It helps that commodity prices have surged over this same period as well, and despite the fact that the dollar has strengthened (a strong dollar has typically seen falling commodity prices and terrible news for most emerging market economies).

Rather than signaling a boom, I think the surge in Brazilian equities is telling us that, even though Brazil is still in lousy shape today, it is doing much better than most people expected a year ago.

If the U.S. and Eurozone economies start picking up, Brazil's future could look very bright, with lots of upside potential.

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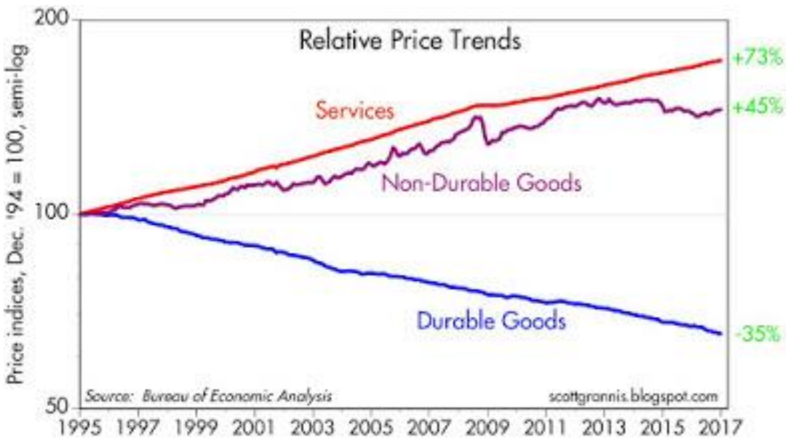
The chart below compares the prices of the three major types of goods and services that comprise the U.S. economy. Services (which are mostly driven by wage costs) and non-durable goods prices (e.g., food, gasoline) have been rising more or less steadily since 1995, whereas durable goods prices have been steadily declining.



It is not a coincidence that China first emerged as a major source of durable goods beginning in 1995. China has been a source of deflation, and that has helped to moderate the inflation that has persisted outside the durable goods sector.

It has all been a tremendous boon to U.S. consumers. Service sector prices (mostly determined by wages) have risen by over 70%, while durable goods prices have fallen by almost one-third.

An hour's worth of labor, in other words, today buys 2.2 times as much in the way of durable goods as it did 22 years ago. That is why nearly everyone is able to afford a smartphone these days. We have no reason to fear China. Are you listening Mr. Trump?

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Warren Buffett says that the ratio of stock prices to nominal GDP is his preferred measure of stock market valuation. The next chart compares this measure (blue line) to the inverse of 10-yr Treasury yields, because I think that comparison adds value to Buffett's preferred measure.

Stock prices, in theory, are the discounted present value of future profits, so it is not unusual to see, as the chart above shows, that equity valuations tend to increase as interest rates (i.e., discount rates) decline, and they tend to fall as interest rates rise. Valuations and yields are roughly the same today as they were in the late 1950s and early 1960s, and neither valuations nor yields appear greatly distorted relative to their historical relationships.

Stocks are certainly not cheap at current levels, but neither are they egregiously over-valued. However, it is reasonable to think that, unless the U.S. economy picks up and corporate profits resume their long-term rise, the stock market is going to run into trouble at some point. Stocks are also vulnerable to an unexpected rise in inflation, since that would result in much higher interest rates.

BW: See ABOUT THE AUTHOR on the next page.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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