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One More Wall Of Worry

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

In this article, Mr. Grannis shows why he believes the market will overcome the latest "wall of worry".

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **One more wall of worry**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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Sunday, February 11, 2018

One More Wall Of Worry

I have featured the above chart numerous times in recent years. What it shows is that every significant decline in stock prices in recent years has coincided with a spike in market nervousness (which I define by dividing the VIX index by the yield on 10-year Treasuries — this measure increases as nervousness rises and yields decline, and vice versa).

To date, all those "panic attacks" have proved unfounded—the economy kept on growing at a modest pace. I am guessing that the current bout of nerves is being driven primarily by rising bond yields which, in turn, are the natural result of improving economic fundamentals that are laying the groundwork for a stronger economy. There are other worries at work, to be sure, and the list would include: (1) concerns that the Fed is going to be spooked by rising inflation expectations and stronger growth and, thus, tighten too much; (2) volatility hedgers caught in a squeeze; (3) concerns that valuations are too high; and/or (4) the combination of tax cuts and increased spending, which could lead to more trillion-dollar budget deficits.

So, as has been the case during most of the bouts of nervousness in recent years, there is no shortage of things to worry about. But, I would argue, the main thing to worry about is the health of the economy. If the economy continues to strengthen, that will "trump" just about all the above worries.

For example, if the deficit increases temporarily but we end up with a stronger economy, the burden of debt will likely decline.

So let us review some key economic and financial market fundamentals, all of which are quite positive. (All charts reflect the most recent data available as of February 9th.)

Chart #1

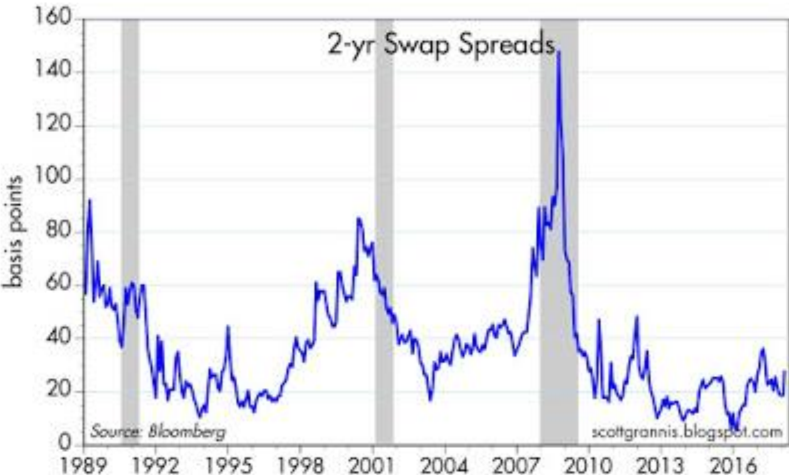


Chart #1 shows that 2-year swap spreads (a highly liquid and reliable measure of generic, high-quality credit risk) have increased only slightly during the recent equity sell-off, and remain well within a "normal" range. This further indicates that financial markets are liquid and that financial market fundamentals are healthy. Historically, swap spreads have been good predictors of recessions and recoveries, rising in advance of recessions and declining in advance of recoveries.

Chart #2

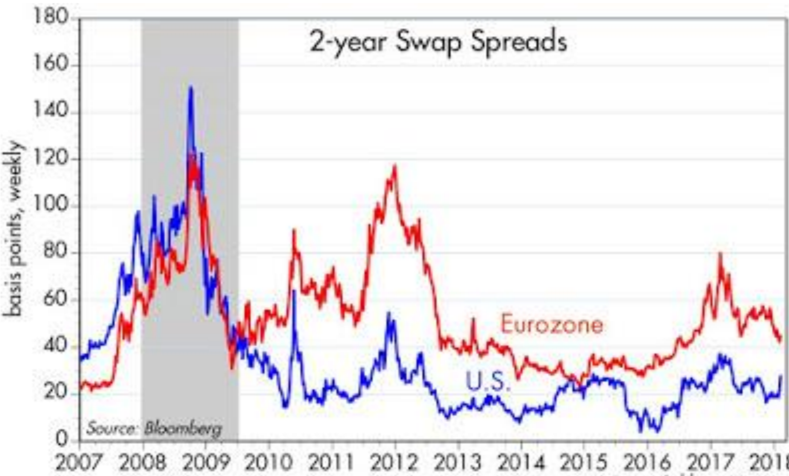


Chart #2 compares swap spreads here with those in the Eurozone. Notably, Eurozone financial fundamentals have been improving of late. No hint of trouble either here or abroad.

Chart #3

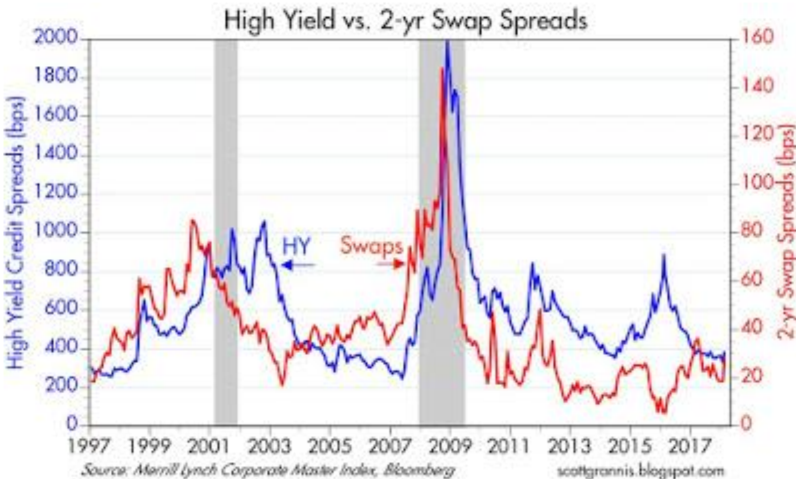


Chart #3 shows that swap spreads have also been good predictors of credit spreads in general. Currently, there is little reason to be concerned.

Chart #4

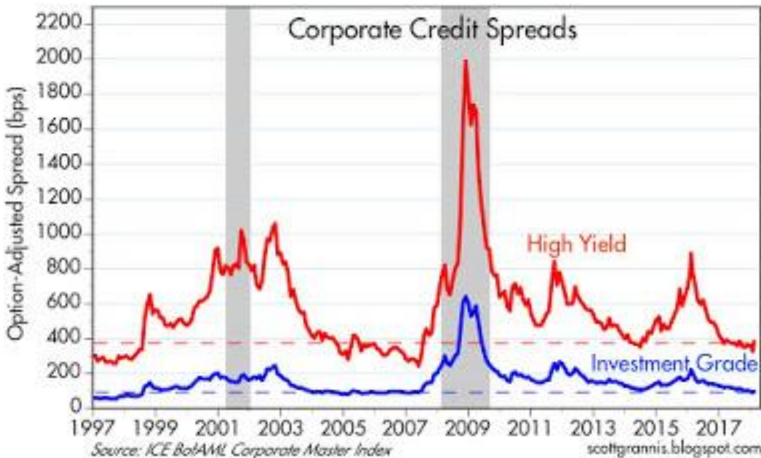


Chart #4 shows that both high- and low-quality corporate credit spreads are relatively low, having risen only marginally in the past week. This indicates that the bond market is not very concerned at all about the quality of earnings or the health of the economy.

Chart #5

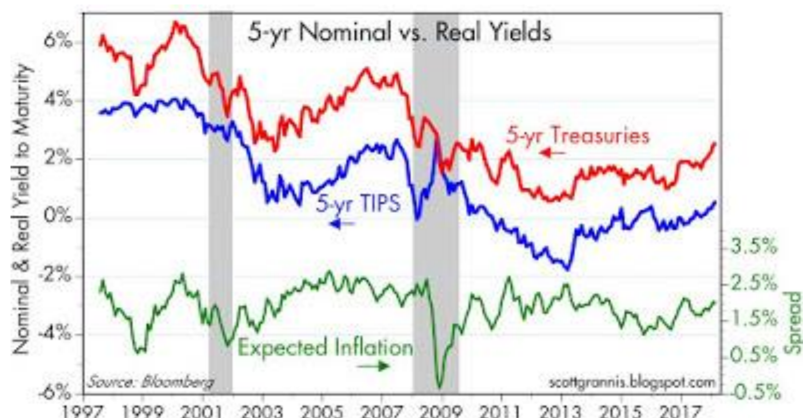


Chart #5 shows the nominal and real yields on 5-year Treasuries, and the difference between the two, which is the market's expected annual rate of inflation over the next 5 years. Inflation expectations are well-anchored at just slightly above 2%. It is tough to conclude from this that the market is concerned about either too much or too little inflation. Current inflation expectations are very much in line with what we have seen in recent decades.

Chart #6

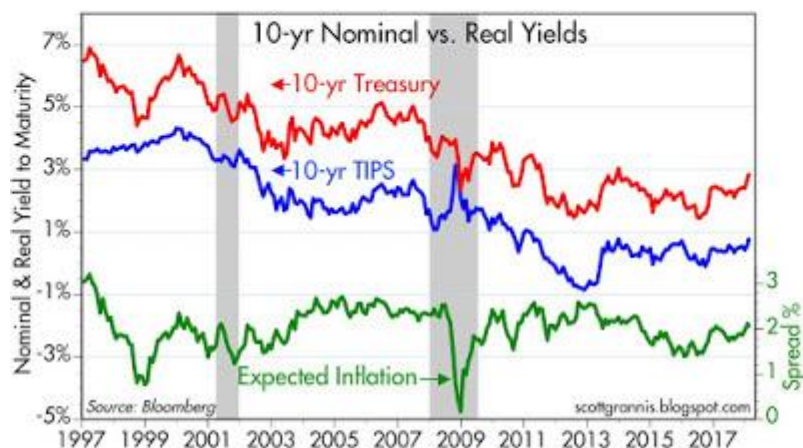


Chart #6 shows the same comparison as Chart #5 for 10-year Treasuries and expected inflation over the next 10 years. Again, current expectations are very much in line with past experience.

Chart #7

Chart #7 shows two measures of the dollar's value vis-a-vis other currencies, on a trade-weighted and inflation-adjusted basis. These are arguably the best available measures of the dollar's relative value against other currencies. What we see is that the dollar today is roughly equal to or slightly above its long-term historical average.

Chart #8

Chart #8 shows a simpler measure of the dollar vis-a-vis major currencies since the beginning of last year. The dollar has been declining meaningfully over this period. Taken alone, this would suggest that the market has either become bearish on the outlook for the U.S. economy and/or concerned that the Fed has been too complacent about raising interest rates. I am inclined toward the latter explanation, since it is hard to believe the world has ignored the many signs of improvement in the U.S. economy over the past year.

As I have explained before, over the past year we have seen accumulating evidence that the demand for money in the USA has been weakening. That is the natural result of a return of confidence and a growing desire on the part of the public to become less risk-averse. Yet the Fed has been slow to take off-setting measures (e.g., by raising short-term interest rates and/or draining excess reserves, which remain quite abundant). In short, this suggests that the Fed has fallen a bit "behind the curve." They have not kept the supply of dollars and the demand for dollars in balance; the result has been a surplus of dollars and, thus, a weaker dollar. This has shown up as well in higher gold and commodity prices in the past year. If the dollar were to weaken more, then I would become concerned but, for now, with inflation expectations still reasonable, it is premature to conclude that the Fed has made a big mistake. I am somewhat reassured by the recent decline in gold, commodity prices, and oil prices that has occurred opposite the strengthening of the dollar.

Chart #9

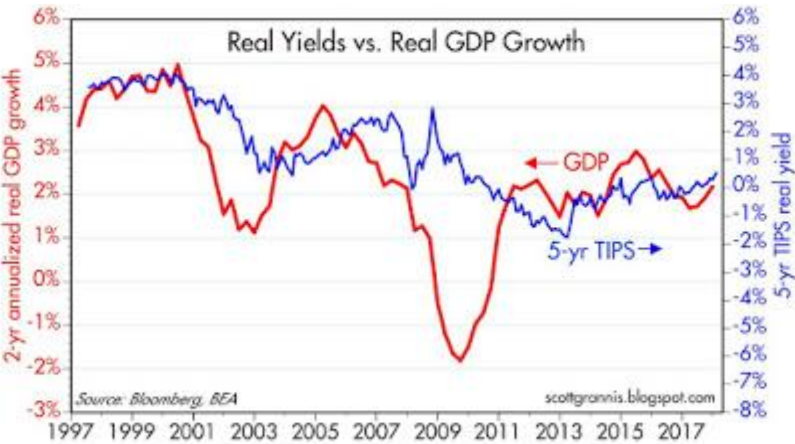


Chart #9 compares the real yield on 5-year TIPS with the 2-year annualized growth of the U.S. economy. It strongly suggests that real yields over time tend to follow the real rate of growth in the economy. The recent rise in real yields, which is still modest, tracks very well with the growing perception that the rate of growth in the U.S. economy is picking up. In fact, over the last three quarters the economy has grown at a 2.9% annualized rate, which is comfortably above the 2.2% rate it has averaged since the recovery began in mid-2009. Growth expectations from the NY and Atlanta Fed offices put first quarter GDP growth at somewhere between 3.3% and 4%.

The rise in rates is thus fully explained by the improvement in the outlook for growth, and is nothing to be concerned about.

There is no *a priori* reason equities cannot continue to rise in value even if stronger growth results in higher interest rates. But, it is nevertheless likely that higher interest rates will tend to depress PE ratios and, thus, keep future equity returns more modest than we have seen in the past.

Chart #10

Chart #10 above compares the real yield on 5-year TIPS with the inflation-adjusted Fed funds rate. The blue line is the overnight real short-term interest rate, while the red line is the market's expectation for what the blue line will average over the next 5 years. This tells us that the market expects only a modest amount of "tightening" from the Fed in coming years. The slope of the real yield curve today is positive; if it were negative, that would be a sign that the market thinks the Fed has tightened too much and will need to lower rates in the future.

Chart #11

Chart #11 looks at the nominal yield curve, from 2 years to 10 years. Rates have risen and the curve has flattened in recent years, which is very much in line with what one would expect when the economy is growing. But, importantly, the yield curve is not flat nor is it negative. During most of the fast-growing 1990s, the curve was actually a bit flatter than it is now. So it is hard to get concerned about recent developments in the yield curve.

Chart #12

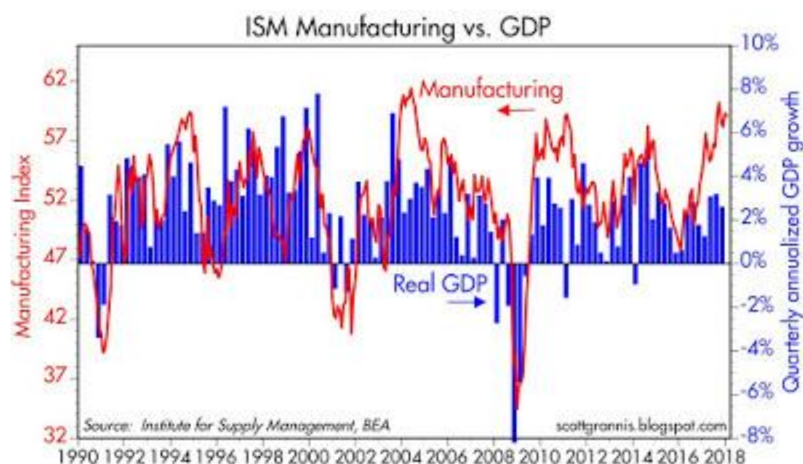
Chart #12 is the classic way to see whether the economy is at risk of recession. Recessions have always been preceded by a substantial increase in real short-term interest rates (blue line) and a flat or negatively-sloped yield curve (red line). Today we are not even close to the conditions that would suggest a near-term risk of recession. That is another way of saying that the Fed is not even remotely too tight, nor is it expected to be any time in the foreseeable future.

It is also important to note that excess bank reserves are still abundant (about $2 trillion). Past recessions were triggered by very tight Fed policy, when the Fed drained bank reserves and squeezed liquidity in order to boost short-term interest rates.

Today, thanks to an important change in the Fed's operating policy in late 2008, the Fed can tighten by either draining reserves (but it might take a long time to create a scarcity), and/or directly raising short-term interest rates. To date, they have done neither in a way that might be considered a threat to financial stability. They have merely nudged rates higher in response to a healthier economy.

<continued>

Chart #13



Meanwhile, the signs of improving economic fundamentals are abundant and impressive. Chart #13 above suggests that the current health of the manufacturing sector is consistent with a substantial pickup in overall growth.

Chart #14

Chart #14 shows that manufacturers are experiencing healthy demand from overseas. The USA is improving and so is the rest of the world. That is a heady combination.

Chart #15

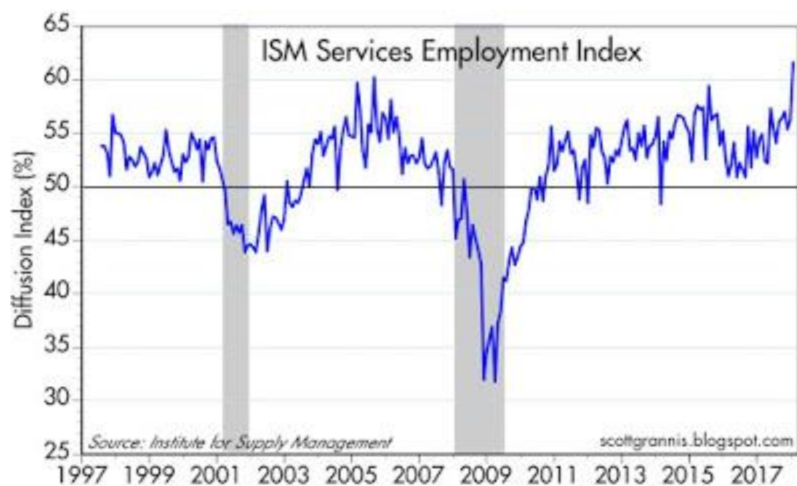


Chart #15 shows that the all-important service sector is expecting to increase hiring significantly in coming months. This is consistent with surveys of consumer and small business confidence, all of which are showing a big improvement over the past year.

Chart #16

<Comment on Chart 16 is on the following page>.

Chart #17

Charts #16 and #17 compare—very favorably—the health of the manufacturing and service sectors in the USA and Eurozone. All are looking about as good as it gets.

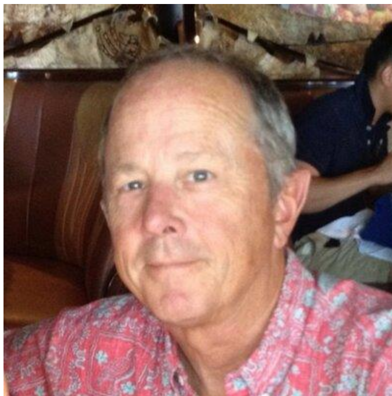
Chart #18

As for equity valuations, Chart #18 reflects the recent decline in the PE ratio (using trailing 12-month earnings) of the S&P 500 to 21.1. The one-year forward PE ratio is now only 15.2, only slightly above its long-term average. Trailing 12-month earnings are up almost 13% as of January 2018, and sharply lower corporate tax rates going forward can only boost them further. Stocks are no longer cheap, that is for sure, but neither are they are egregiously overvalued.

The current sell-off may well continue for a while, but sooner or later the reality of a stronger economy and a non-threatening Fed likely will allow the market to overcome this latest wall of worry.

BW: See ABOUT THE AUTHOR below.

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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