Still Just A Panic Attack?

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

In this article, Mr. Grannis shows that the recent market plunge is not justified by economic fundamentals and that the current negative sentiment could provide an excellent buying opportunity.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: Still just a panic attack?

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

***e*Research** was established in 2000 as Canada's first equity issuer-sponsored research organization. We write on a variety of small- and mid-cap, under-covered companies. We also provide unsponsored research reports on middle and larger-sized companies, using a combination of fundamental and technical analysis. We complement our corporate research coverage with a diversified selection of informative, insightful, and thought-provoking research publications from a wide variety of investment professionals.

Bob Weir, CFA: Director of Research

Monday, October 29, 2018

Still Just A Panic Attack?

A few weeks ago I opined that the sudden equity sell-off was just another panic attack, and unlikely the start of a major rout or a harbinger of another recession. It is now turned into an official correction, with the S&P 500 down 10% from last month's peak.

Has anything changed to make the prognosis worse? Lots of things have changed, mainly equity valuations (which have improved significantly), but the underlying fundamentals are still healthy and, therefore, at odds with the market's apparent level of distress.

Nine months ago (January 26th) the market was enthusiastic: the PE ratio of the S&P 500 (using Bloomberg's measure, which counts only profits from ongoing operations) was just over 23x. Today, despite the fact that profits have since risen almost 16%, that same PE ratio has fallen over 20% and now stands at 18.5x. That is quite remarkable, considering the market currently expects profits to grow by another 25% over the next 12 months, which would imply a forward PE ratio of a mere 14.7x, significantly below the market's long-term average of just under 17x (see charts below).

In short, the market has gone from enthusiastic to very worried in a relatively short time-frame. To judge from these metrics, while a recession seems very unlikely in the next year, beyond that, the market appears to have lost all confidence.

The causes of this dramatic turn of events are many, and I am now going to sum them up as "global angst:" a weakening Chinese economy, budding tariff wars, concerns about Fed tightening, a fragile EuroZone, weakening emerging market economies, rising oil prices, and all coupled with the fact that we are entering the 10th year of an economic expansion (which, by itself, makes investors quite nervous—how much longer can the good times last?). None of these factors have appeared out of the blue however; they have all been headwinds for a while, but it seems they have rather suddenly combined into something like a perfect storm.

Equity valuations have plunged, but it is hard to find any evidence of a sudden or imminent economic downturn. In fact, financial market and economic fundamentals remain solid: swap spreads are low (which implies low systemic risk and abundant liquidity), credit spreads are up only slightly from relatively low levels, the yield curve is still positively sloped, and real yields are still relatively low (which, together, imply that the Fed is far from being tight), the U.S. dollar is reasonably strong, and inflation expectations are reasonably anchored. The Powell Fed has given no hint of being willing to ignore the market's sudden distress in pursuit of an aggressive tightening agenda, and I seriously doubt they would do so anytime soon.

So it seems this is still in the nature of a panic attack and, as such, it should pass. But of course, there are events that can pop up that are unpredictable, and investors must always shoulder the burden of the unforeseen. If you cannot take that heat, you should not be in the market.

Here are some updated charts which flesh out the story:

Chart #1

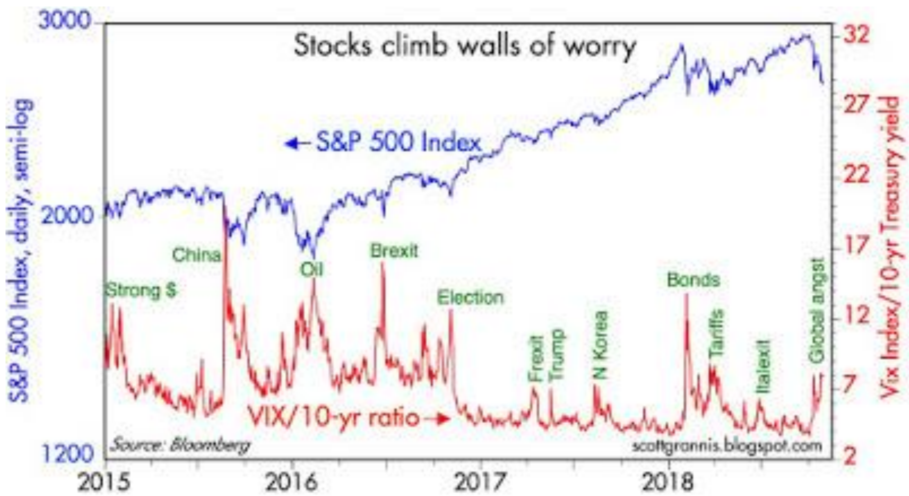


Chart #1 illustrates how all of the market sell-offs in recent years have been accompanied by a sharp rise in "worries." For "worries", I use the VIX index divided by the 10-yr Treasury yield. The VIX index rises as fear rises, while the 10-yr Treasury yield tends to rise as confidence in the economy rises. We have seen much more serious levels of worry in recent years than we see now.

Chart #2

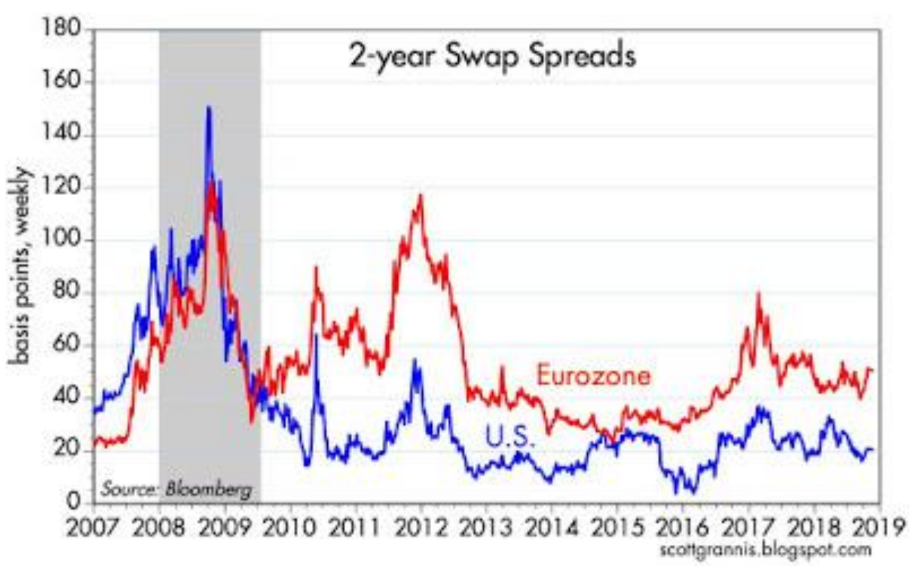


Chart #2, on the previous page, shows that swap spreads, which are a key coincident and leading indicator of financial market and economic health, remain relatively low. At 20 bps, U.S. swap spreads are fully consistent with healthy and liquid financial markets. At the same time, they tell us that systemic risk is low. Liquid financial markets are a *sine qua non* for a healthy economy. No problem here.

Chart #3

Chart #3 shows the level of real and nominal 5-year Treasury yields and the difference between the two, which is the market's expected annual inflation rate over the next 5 years. Inflation expectations today are very close to the Fed's 2% target. No problem here.

Chart #4

Chart #4, on the previous page, compares the level of 5-year real TIPS yields with the real Fed funds rate. This tells us that the real yield curve is positively sloped, and the market is not concerned that the Fed has tightened too much. The time to worry is when the blue line exceeds the red line, as that would be an indication that monetary policy was too tight and the Fed would likely be forced to cut rates in the future. That is not the case today. At worst, the bond market is telling us that, perhaps, the Fed will need to move rates up more cautiously in the future. That is not a problem.

Chart #5

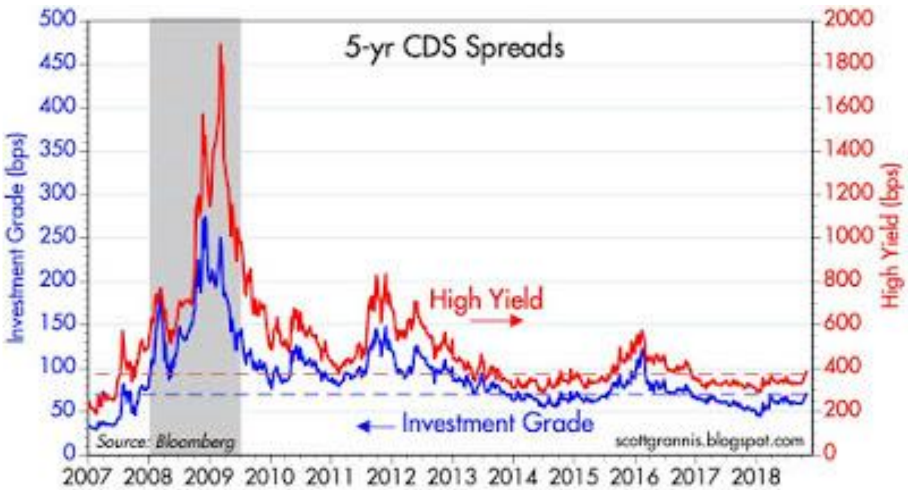


Chart #5 shows 5-yr Credit Default Swap Spreads. These are highly liquid and generic indicators of the market's confidence in the outlook for corporate profits. These spreads have increased only modestly despite the sharp equity sell-off, which further suggests the market is still confident in the outlook for corporate profits and the health of the economy. No obvious problem here.

<continued>

Chart #6

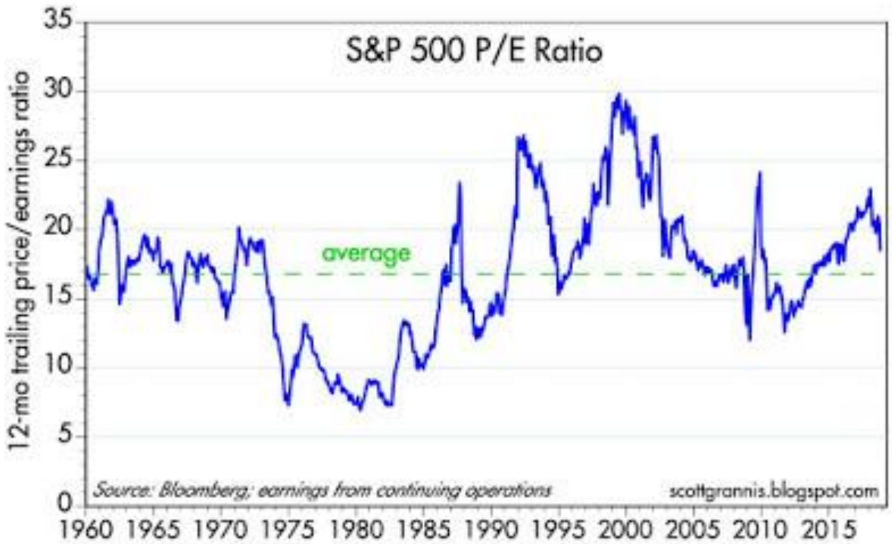


Chart #6 shows Bloomberg's measure of the S&P 500's PE ratio, which uses profits from continuing operations. Since January of this year PE ratios have plunged from 23.3x to now 18.5x (-20%). This reflects a rather sudden loss of confidence in the long-term outlook, especially considering that profits continue to rise. Curiously, the bond market appears to be much more confident about the future than the stock market, given the low level of swap and credit spreads. This further suggests the equity market may just be in the throes of a panic attack.

Chart #7

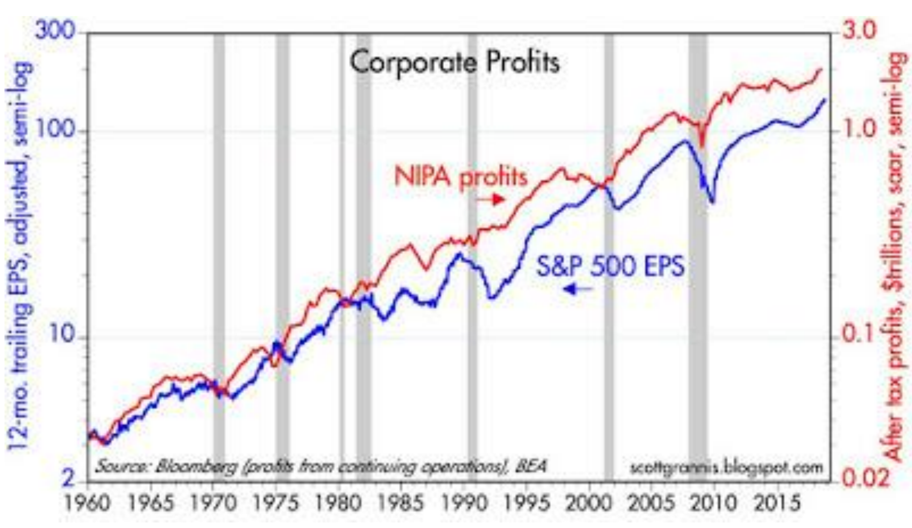


Chart #7 compares two measures of corporate profits: after-tax corporate profits as calculated in the National Income and Product Accounts (**red** line), and after-tax earnings per share based on a 12-month trailing average of reported quarterly earnings (**blue** line). Both are at all-time highs and rising. No problems here.

Chart #8

Chart #8 shows the Fed's preferred measures of inflation, based on a broad measure of personal consumption. Both total and core inflation are very close to the Fed's 2% target. No problem here.

Chart #9

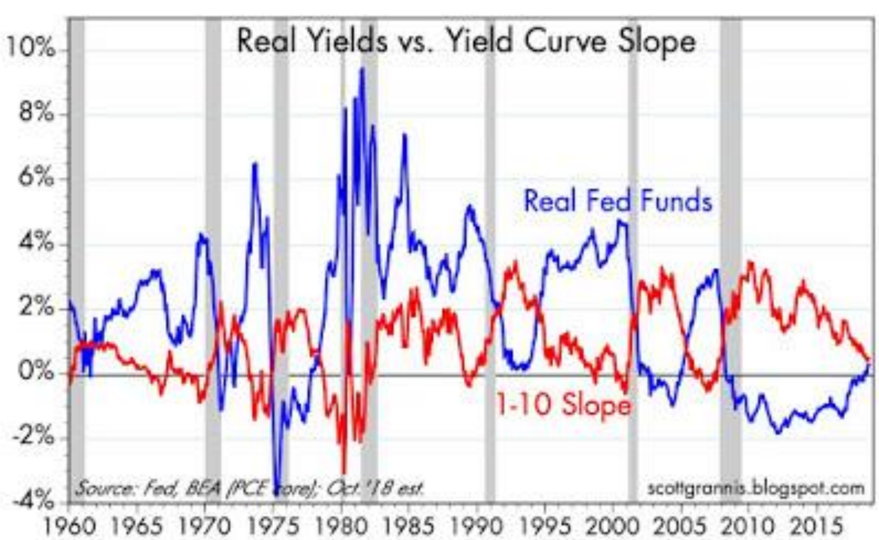
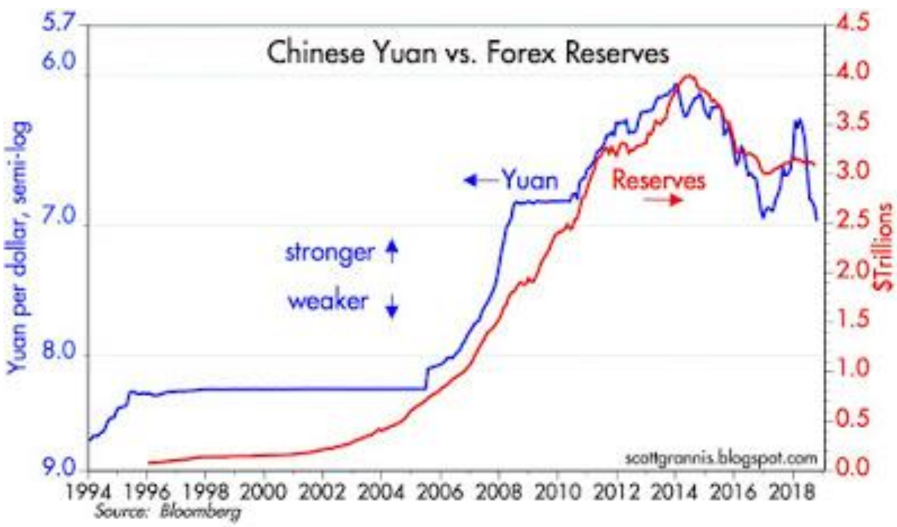


Chart #9, on the previous page, compares the real Fed funds rate (a good measure of how loose or tight monetary policy is) with the slope of the Treasury yield curve. Recessions have always been preceded by a substantial tightening of monetary policy and a flattening or inversion of the yield curve. We are a long way from those two conditions today.

Chart #10



China has taken a beating in recent years, and especially this year, which has seen the steepest-ever drop in the value of the yuan. This has occurred in tandem with a decline in the Chinese central bank's holdings of foreign exchange reserves, and both are symptomatic of capital flight.

Capital is leaving China because investors are worried about the future of the Chinese economy. In a relative sense, that is good for the USA but, if China were to fall off a cliff, well, that would not be good for us.

China is the biggest concern in the world right now, but their leadership could fix that problem by simply acquiescing to Trump's (and the WTO's) demands: respect intellectual property rights, and reduce or eliminate tariffs and subsidies. In short, China's outlook would improve dramatically if they simply adopted sensible policies. How hard is that?

(BW: It would take a change in the Chinese mind-set!)

<continued>

Chart #11

Chart #11 compares the Chinese and U.S. stock markets.

Note that both y-axes have the same ratio between top and bottom values (15x), and both use a semi-log scale.

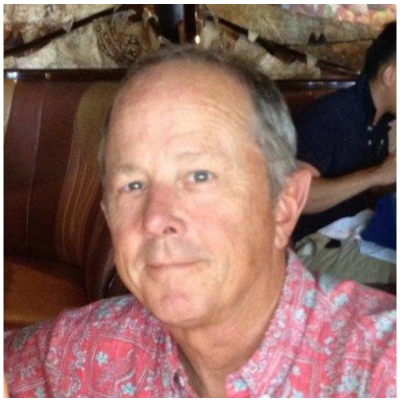
China's stock market has truly plunged since January of this year, suffering a punishing loss of almost one-third of its value. Worse still, China's stock market today is trading at close to the same level as it was over 20 years ago, whereas the U.S. market has risen 460% over the same period. Big problem for China. Free market-style reforms could do wonders for China's wealth. What is good for China would be very good for the rest of the world.

Conclusion:

What stands out in all of this is that equity market fears are not supported by any deterioration in the economic and financial fundamentals, at least in the U.S. economy. That could always change for the worse but, for now, it is still in the realm of speculation.

BW: See ABOUT THE AUTHOR on the following 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.

#####