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Clouds and Silver Linings

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

In this article, Mr. Grannis believes that the market is overly doing its pricing in of market fears.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: Clouds and Silver Linings

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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Bob Weir, CFA: Contributing Analyst

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Friday, December 7, 2018

Clouds and Silver Linings

Markets have been unusually nervous and volatile since late October, driven by fears of an escalating trade war with China, emerging weakness in European economies, tighter monetary policies from most major central banks, the post-election realities of a divided Congress, and a growing sense that the U.S. economy is struggling and/or possibly staring a recession in the face. I have called it "global angst" in my current favorite chart (see Chart #16 below), "Stocks climb walls of worry."

Without doubt, things could be better than they are, but there are silver linings to a lot of the clouds. Business investment is relatively weak, but corporate profits are at record levels. The housing market and residential construction have softened, but this is being at least partially offset by the recent 40 bps decline in mortgage rates. Today's jobs number was disappointing, but jobs growth this year still is stronger than it was last year. The Fed says it plans to raise short-term rates in gradual fashion, but the market has priced out two of the tightenings it expected earlier this month (the market now expects only one more tightening in the next 12 months, and no more after that). The yield curve has flattened in some areas, but remains positively sloped, and real short-term interest rates are still very low (only slightly above zero). Inflation expectations have fallen below the Fed's target, but this is almost entirely due to a recent sharp drop in oil prices. None of this points to recession.

The problem is not the Fed, not deflation (or even low inflation), and not the yield curve. I think the main problem is a general angst that finds it strongest expression in the outlook for the US-China conflict. This creates uncertainty which acts as a headwind to growth and risk-taking in general.

Regardless, we are besieged by worries of all sorts these days. What follows are 16 charts which help put things in a useful perspective:

Chart #1

Chart #1 compares real and nominal 5-yr Treasury yields, and the difference between the two. Note how real yields (blue line) remain in a gradual uptrend: this is a direct reflection of the market's perception that the US economy remains healthy and is likely to continue growing at a 2.5-3% pace, in my estimation. Note also the recent decline in expected inflation: it's entirely due to the decline in nominal yields.

Chart #2

As Chart #2 shows, the decline in oil prices fully explains the drop in inflation expectations. No problems here.

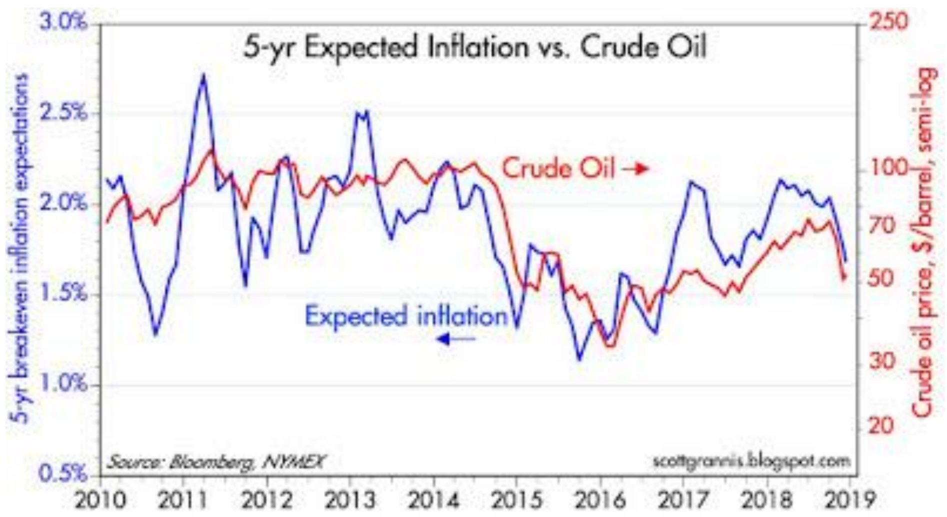

Chart #3

Chart #3 shows two points on the real yield curve, which is the most important yield curve to watch (real yields are the true measure of how high or low interest rates are). The blue line is the overnight real rate, and the red line is effectively the market's forecast for what the blue line is going to average over the next 5 years. The time to worry is when the blue line exceeds the red line. There is still a healthy spread between the two.

<continued>

Chart #4

Corporate credit spreads have widened a bit as oil prices have plunged. But as Chart #4 shows, credit spreads are still relatively tight, and the most important measure of spreads (swap spreads, because they tend to lead other spreads) remains very low. Swap spreads are also a good measure of financial market liquidity, and at today's levels they continue to suggest that liquidity is abundant. That is very important, since liquid markets allow for market participants to exchange risk freely. Note how the sharp rise in swap spreads priced the Great Recession; they got so high that the market was almost paralyzed, and that contributed significantly to the meltdown of mortgage-backed and other risky securities. Liquid markets can deal with all sorts of problems, just as free markets maximize economic efficiency.

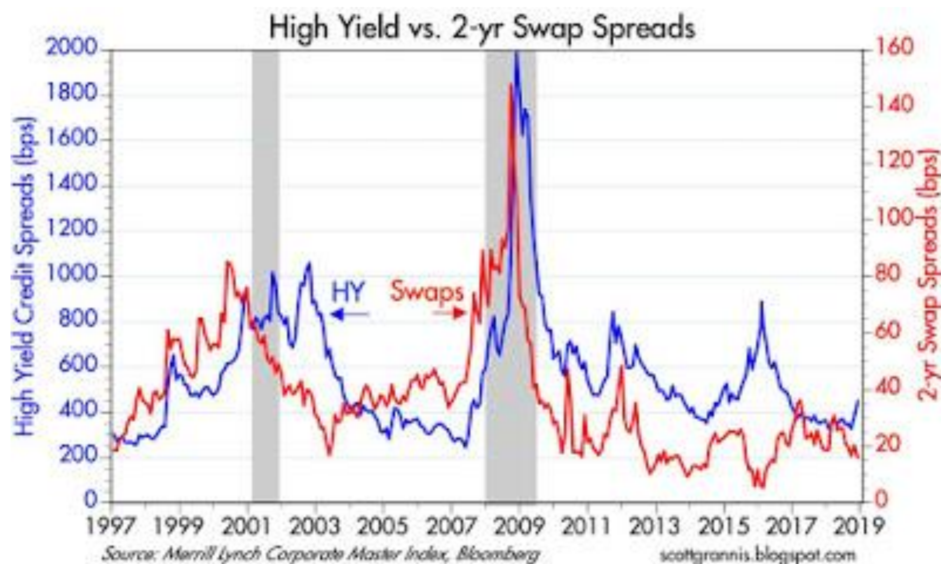

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Chart #5

Chart #5 below shows the very impressive reduction in private sector leverage that has occurred since the end of the Great Recession. The average household today has very strong financial fundamentals, and that is effectively a buffer against negative shocks.

Chart #6

Nominal and real net worth of the private sector reached an all-time high as of the end of September: $109 trillion. As the next chart shows, recent increases in household net worth are very much in line with the long-term, inflation-adjusted historical trend. This was not the case with the asset price "bubble" that occurred prior to the Great Recession, and prior to the 2001 recession—markets and households got overextended. Note also the 10-fold increase in real net worth in the past 66 years! This is nothing short of breathtaking progress.

Chart #7

Chart #7 shows that the increase in private sector (household) net worth since 2008 has been driven mainly by rising stock prices and increased savings (i.e., financial assets). Real estate values and debt levels have increased only modestly.

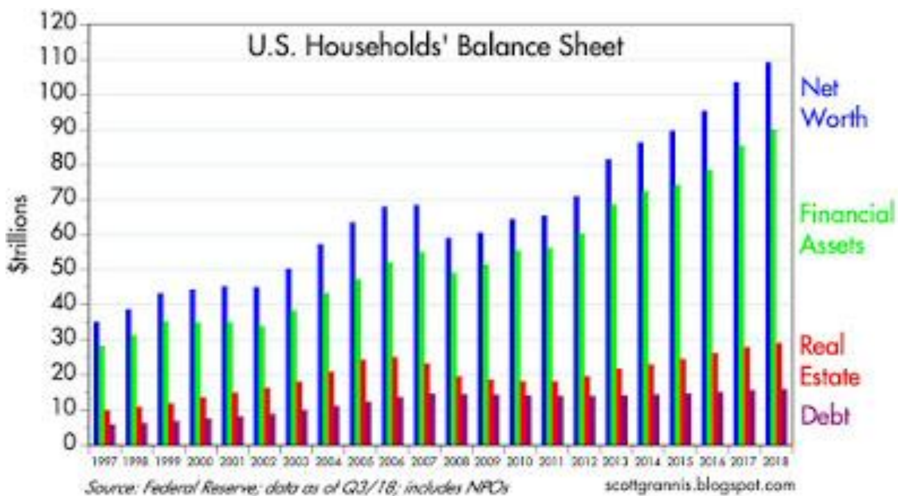


Chart #8

In turn, as Chart #8 below shows, rising stock prices have been supported by rising corporate profits. It is not at all obvious that we are living in a bubble that threatens to pop.

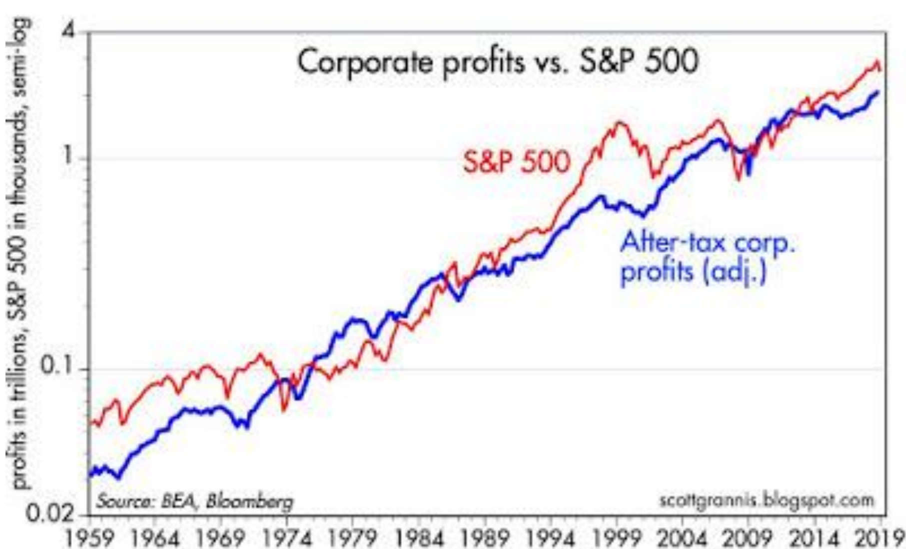


Chart #9

The ISM manufacturing and service sector indices provide very timely insights into current economic activity. Both have been very strong of late. Chart #9 compares the ISM manufacturing index and quarterly GDP growth. The current strength in the manufacturing sector points to very strong economic growth overall, at least 4% for the current quarter. That contrasts significantly from the modest 2.4% Q3/18 growth rate projected by the NY and Atlanta Feds' forecast models.

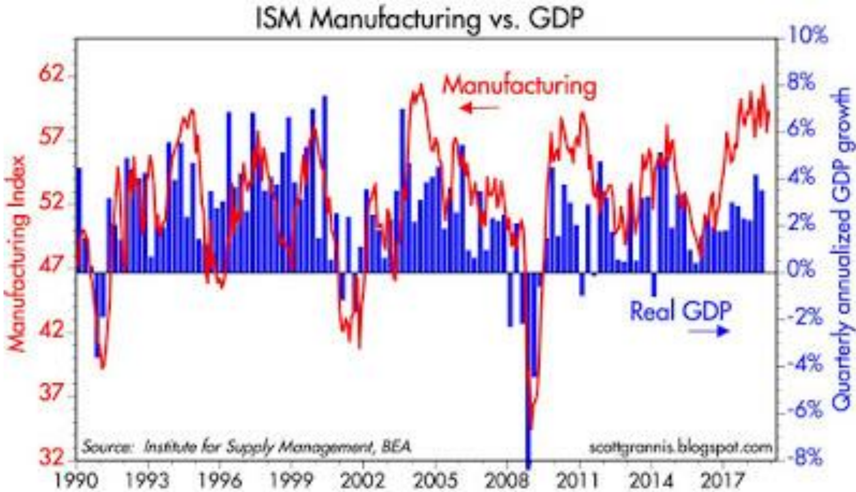


Chart #10

As Chart #10 below shows, hiring intentions in the all-important service sector (70% of the economy) are strong. This bodes well for future jobs growth.

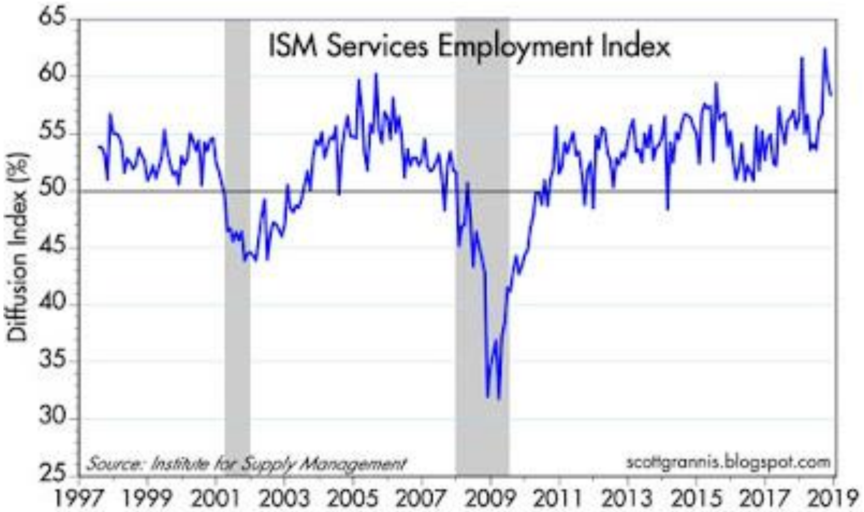


Chart #11

Chart #11 below suggests that the U.S. manufacturing sector is outpacing Europe's handily; it also shows how much the Eurozone economy has suffered of late. That is not necessarily bad for the USA, but it is another headwind to worry about.

Chart #12

As Chart #12 shows, the U.S. service sector these days appears to be stronger than it has been for a long time. As with Chart #11, it also highlights the weakness in the Eurozone economy.

Chart #13

Today's release of the November jobs numbers was weaker than expected (+155K vs. 198K), but as Chart #13 shows, this series is notoriously volatile on a month-to-month basis. One month's data is hardly significant. I prefer to look at the 6- and 12-month averages. Private sector jobs growth averaged 180K per month in 2017, and so far this year it has averaged 200K: that's an 11% improvement!

Chart #14

Chart #14 shows the 6- and 12-month rates of growth for the monthly private sector jobs numbers. Here we see the modest uptick in growth rates this year relative to last year. By these measures, private sector jobs currently are growing at a 1.8-1.9% rate, and that is only marginally less than the 2.0% average annual growth rate for the past 8 years.

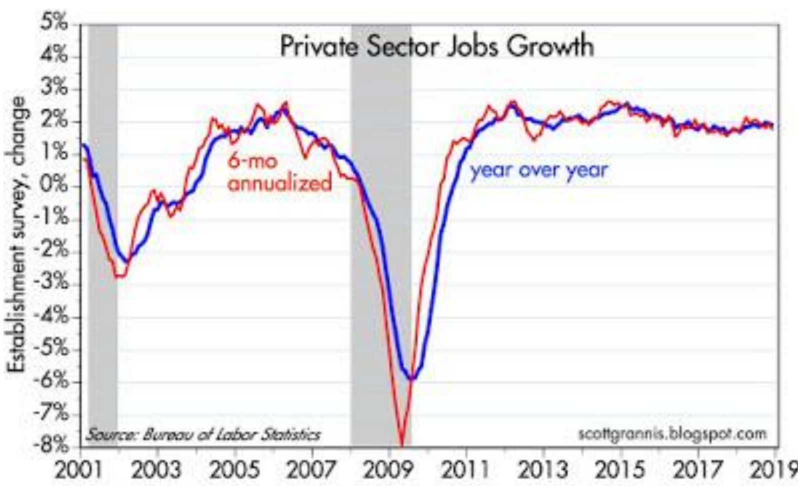
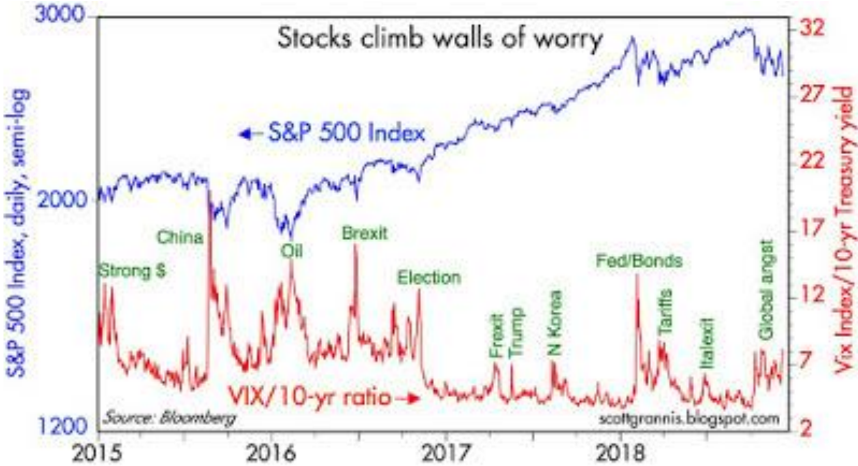


Chart #15

Chart #15 shows the year over year growth rate of the labor force (the total of those working plus those looking for work). Today's 1.4% annual growth rate is substantially higher than 0.5% average growth rate we have seen since the economy bottomed in mid-2009.

Chart #16

Stock prices today are down a tad over 10% from their all-time highs of last September, as shown in Chart #16. That's mostly due to an increase in the market's worries (as measured by the ratio of the VIX index to the 10-yr Treasury yield), but it also reflects the fact that the economy has failed to accelerate as supply-siders (like me) had expected. Growth has picked up modestly in the past two years, but not as much as we would have liked to see considering how much deregulation and tax-cutting there has been in the interim.



China is the wild card these days, but it is also the case that, for the next two years, we are going to have a divided Congress that is unlikely to pursue a pro-growth agenda, and there are few signs, if any, that global growth is picking up.

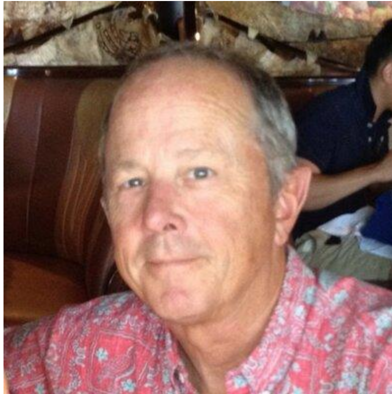
The market has priced in a lot of slowdown expectations. According to Bloomberg, the current PE ratio of the S&P 500 is 18, and that is as low as we have seen since February 2016. Today's equity premium (the difference between the earnings yield on stocks and the yield on 10-year Treasuries) is 2.7%, and that is as high as we have seen since November 2014. This rather substantial repricing of equities is a potential positive, since it makes taking risk more attractive, and that, in turn, helps offset the de-risking forces of uncertainty emanating from places like China and Congress. Clouds and silver linings.

The question confronting investors today is not whether the economy is going to slow down (that is priced in already); the question is whether it is going to slow down by a lot, and how certain one is of that future.

In this regard I remain optimistic that things will not be as bad as the market already fears. That has been my position for the past 10 years, actually: always thinking that the market was too pessimistic in its assumptions about the future.

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.

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