February 6, 2018

2018: Year of the Dog, Not of the Bear

Massive moves in the financial markets in the last few days have investors running for cover, searching for explanations. In this note, our Chief Economist Megan Greene analyzes the various theories that have been making the rounds in the markets, and concludes that – while scary and painful – the sell-off in the last week does not represent the beginning of a major bear market.

The movements we've seen in the equity and Treasury markets over the past two trading days have been both aggressive and surprising. Everyone is naturally searching for explanations, and a number of investors have declared to me that we have left this frustrating era of 'lower for longer' for good. It is natural to think this time is different, but from a macroeconomic perspective, we just aren't buying it.

Here are some potential catalysts for what happened in the markets:

- ***Inflation is Coming, Inflation is Coming!***

  This view isn't totally out of left field, but we don't subscribe to it. The argument goes that inflation is accelerating and so the Federal Reserve will have to hike rates more aggressively as a result. Those who think we are facing a late-cycle surge in inflation will likely cite higher commodity prices, an expected fiscal stimulus from the tax bill and last Friday's wage growth data[1] as evidence that we are on the precipice of stronger inflation. While we expect the tax bill will be positive for both equity and fixed income markets, we do not think it will provide much of a boost to economic growth or inflation. As for the 2.9% average hourly earnings growth figure released last week, it doesn't look quite as good when you look under the hood and kick the tires. For starters, the number of hours worked fell, goosing Average Hourly Earnings growth up[2] (this also means that, barring a jump in productivity, GDP growth in the first quarter is likely to be weak). Looking at who benefitted from wage growth, it was mainly supervisory workers, accounting for only about 20% of the work force. Finally, there were minimum wage hikes in a number of states in January, which may have added some lift to this figure. Beyond this, there are some disinflationary pressures in the economy.

  We have been talking about the drag of global drivers (demographics, a globalized work force) and disruptors (the gig economy, new technological developments) on inflation. In addition, we have had positive supply shocks in the form of the tax bill and deregulation. We have also had a negative demand shock as monetary accommodation has been withdrawn – and this will only grow in scope as the Fed rolls more assets off its balance sheet and as other central banks globally withdraw monetary stimulus. All of these factors are disinflationary. Is disinflation our central theme of 2018? Definitely not! We expect inflation to continue to creep up slowly, with the second quarter looking particularly (and temporarily) robust as cell phone plan repricing[2] and US Dollar moves fall out of the year-on-year comparison. But we do not expect a late-cycle surge in inflation either.

[1] US Department of Labor Statistics: Employment Situation Summary (January), February 2, 2018.
[2] For more context, read this article from the Wall Street Journal, published May 19, 2017.

- **Uncertainty (and the Term Premium) is Higher**

The temporary rise in yields and the correction in equity prices since Friday could instead reflect a higher term premium as a result of greater uncertainty. One driver of this can be attributed to a massive shake-up in the personnel driving the monetary policy train globally. The Fed, European Central Bank (ECB), Bank of Japan (BoJ) and the People's Bank of China (PBOC) may all have new policymakers at the helm a year from now. In addition to a new Chair, the Fed will also have a new Vice Chair and regional president in New York (two of the most critical positions in the institution) in the next year. In Europe, the ECB must fill not only the President's chair, but three other seats in the next two years as well. In Japan, BoJ Governor Haruhiko Kuroda's term ends on April 8[3] (we expect him to be re-appointed, but it is not a foregone conclusion). And over in China, PBoC chief Zhou Xiaochuan is expected to step down in the next few weeks.[4] Collectively, they were all architects of the incredibly easy monetary policy environment in which we have operated throughout this entire business cycle. Their successors may not pursue the same policies; in particular, the 'Fed put'[5] may look different under Jerome Powell's stewardship than it did under that of Chair Bernanke or Chair Yellen. Many investors have assumed that Chair Powell is just a "Yellen-light" policymaker, but we do not know how he would respond to a spike in inflation, market meltdown or a dip into recession. He was against QE3[6] and is market savvy, and so is likely to be more wary of asset price bubbles than his predecessors. On the other hand, the Fed could potentially dampen the effectiveness of the administration's policies – for example, the tax bill and deregulation – if it were to adopt a hawkish tone. It would be difficult to imagine that the White House would not have an opinion should this happen. One thing is for sure: we believe the market correction that we have seen thus far is insufficient to trigger any kind of reaction from the Fed. We continue to expect the Fed to raise interest rates in March and follow that up with two further hikes this year.

Another source of uncertainty is the looming deadline for a spending bill at midnight on February 8. Additionally, the Congressional Budget Office had said the Federal government will hit the debt ceiling in March, earlier than markets had expected as a result of the recently introduced tax bill. We know for sure that the tax bill will significantly raise our budget deficit, but we are not clear on how exactly we will pay for it.[7] That could also be pushing up the risk premium on yields.

- **Stock Sell-Off Momentum-Driven**

As Citibank pointed out in a recent note[8], the relationship between equities and central bank liquidity has broken down recently, as has the relationship between equities and earnings. This suggests that sentiment has been supporting equity prices more than anything else. With so much complacency among investors, downside protection had diminished and so it arguably only took a small macro move like Friday's jobs data to trigger panic selling.[9]

In addition, a number of algorithms programmed to sell off assets are likely to have sparked an increase in market volatility. The role that automated trading could have played in the last few days is encapsulated in a tweet shared by a journalist, suggesting banks of computer hard drives have replaced traders.

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[3] Bank of Japan: About the Bank – Governor – Mr. Haruhiko Kuroda, as of February 6, 2018.
[4] Bloomberg: China Central Bank Governor's Retirement Seen in Absence from Top Advisory Body, January 25, 2018.
[5] The 'Fed put' refers to the monetary approach adopted by the Fed in the last few decades, which preliminarily entails supporting financial markets and boosting economic growth by cutting rates and injecting liquidity into the financial system.
[6] According to transcripts released by the Fed recently, Mr. Powell voted for QE3 but voiced his lack of enthusiasm for the program.
[7] Joint Committee on Taxation: Macroeconomic Analysis of the Conference Agreement for H.R. 1, The "Tax Cuts And Jobs Act", December 22, 2017.
[8] Citigroup, February 5, 2018.
[9] Bloomberg, as of February 5, 2018.

When volatility spikes, these algorithms ratchet back their equity exposure, pouring fuel on the fire of the market correction. Certain strategies, such as Risk-Parity and Managed Volatility strategies, have allocations that are tied to volatility and so also may serve this function.

Where Do We Go From Here?

Our fundamental view that we are stuck with growth moderately above potential GDP in the US and core PCE inflation stubbornly below the Fed's target (it has been at 1.2% for three months running now) remains.[8] While we do not think that red lights should be flashing that the economy is overheating, we do not think this is a weak growth story either. We still have not baked a recession into our five-year forecast, though the risk of that has gone up – particularly since the 2018 Federal Open Market Committee seems much more hawkish in nature than the 2017 FOMC and so the Fed could end this party.

The mini-correction we've seen in equities has been caused in part by higher bond yields. Some investors expect yields to blow through the 3 – 3.5% 'pain mark' and rise to 4% or even 5%. We are highly skeptical of this view. Historically, the risk premium investors demand over inflation to hold 10-Year Treasuries has tended to be the average over the previous cycle – in this case 100 basis points. If we expect inflation of 2% and a risk premium of 1%, we might get to a 10-Year yield of 3%.

While central banks globally will be pumping out less liquidity to flow into the US Treasury market, the Fed's quantitative tapering should put an upper limit on yields in the US as well. The Fed's QE corresponded to a huge increase in bank reserves that should be partly reversed as the Fed shrinks its balance sheet. Treasuries have a zero risk-weighting, and so banks will be incentivized to replace those deposits with Treasuries to please the regulators. This demand for Treasuries could push yields down.

Silver Lining

Because we have been trading in a 'low vol' world for so many years, the 6.1% fall in the S&P 500 index over the last few days[8] has come as a shock to some investors. But this kind of drop has happened on average once every two years since 1964. This recent stock sell-off has brought the S&P back to the top of its long-term trading range after it went bananas in January of this year, as first noted by Financial Times journalist John Authers.

In our view, this stock sell-off does not represent the beginning of a major bear market. It should serve to clear out some of the froth and leverage that had been built up in the equity markets. While scary and painful, these market moves can serve to avoid even larger corrections in the future.

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