More Trouble for the Equity Markets Ahead

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All last year, we were waiting for the 10% correction in the United States equity market that never came. By the fourth quarter, many investors were beginning to think stocks would never go down, especially with real GDP growth picking up to 3% in the U.S. and spreading to other economies globally. All this was reflected in the data for market enthusiasm. The indicator I look at most closely is the Ned Davis Crowd Sentiment, which I like because this tool is based partly on transaction activity. When the reading gets into the 70s, it's warning that investor optimism is excessive. At the beginning of February, it was close to 80, where I had never seen it before. Investors were euphoric, making stocks vulnerable to a correction should any piece of bad news appear.

The employment report for January proved to be the trigger. The 200,000 jobs created was a sign the economy was still showing strong growth. The problem, however, was with average hourly earnings; they rose from 2.5% during the last year to 2.9%, suggesting that the labor market was tightening. It was becoming hard to hire workers at all skill levels and companies were being forced to pay more to employ the people who would enable them to provide the goods and services demanded in an accelerating world economy. Steve Einhorn of Omega drilled down on the unemployment report and concluded that the aggregate change in labor income was negative year-over-year because the average workweek has shortened and pay increases were concentrated among supervisory workers. As a result, wages may not be as big a problem as the market seems to believe. If wages were rising, however, inflation, which had been basically dormant, might start moving higher. If inflation were starting to pick up, that might be reflected in interest rates. In fact, the 10-year Treasury note has risen to 2.90%, fifty basis points higher than just a few months ago. Stocks compete with bonds as investment alternatives. In several years in the recent past (2013 and 2016-17), the yield on the Standard and Poor's 500 was higher than the 10-year Treasury, an unusual condition that made equities especially attractive. Now, the yield on government securities is rising and bonds are becoming more competitive with stocks. This condition, coupled with the euphoric sentiment data, precipitated the decline in stock prices and gathered momentum quickly. It took less than two weeks for equities to drop 10%.

Now what happens? Let's take a look at the fundamentals, and they are in good shape. Profits are still rising. With the tax cut, S&P 500 earnings should be $160 this year and the index is selling at about 16 times earnings. This is not an excessive price by historical standards; they could be $170 in 2019. The leading indicators for the overall economy are still moving higher. They usually begin to roll over a year or two before a recession begins and they are not showing signs of that yet. While average hourly earnings increases have reached 2.9% and may go higher, trouble has not occurred in the past until they had approached 4%.

The market usually begins to buckle when the Federal Reserve is aggressively tightening. We know that the new Fed Chairman Jerome Powell wants to "normalize" interest rates which would mean bringing the Fed funds rate up to 2.75%, about double where we are now. He is likely to do that slowly, beginning in March with a quarter-point hike and he may not do even that if the decline in equities continues. The Fed is unlikely to move rates higher abruptly because there are too many cases in the past where the consequences of sharp increases have created dire circumstances for the economy. Powell was selected by President Donald Trump because he was basically in the dovish Janet Yellen model and not likely to deviate significantly from her policies. Trump wanted to have his own person in the job, but he opted against the extreme alternatives.

The condition of credit is a critical part of the background for the equity markets. In 2007, credit conditions were weak with sub-prime mortgage lending threatening the solidity of the banking system. Banks in the United States are much stronger now and senior loan officers are actually easing lending standards. The tax cut is encouraging employers to be generous with bonuses to employees and larger paychecks as a result of reduced withholding taxes should be reflected in consumer spending, boosting first quarter GDP. In spite of low operating rates (78%), capital spending is increasing as companies are using rapid depreciation allowances to modernize obsolete equipment.

Throughout this cycle, the lack of inflation has surprised economists favorably, and the Fed has failed to reach its 2% target. Various reasons have been put forth to explain this, but the most compelling ones for me are the impact of globalization and technology. The continuation of these trends since the 1980s has resulted in high-quality goods and services being produced at low cost around the world and shipped to developed markets everywhere. With wages going up in major industrialized countries, we can expect inflation to rise somewhat, but the likelihood of a virulent rise is small. I would expect the peak to be above 3% in the United States sometime in the next two years. Recent data on the Consumer Price Index (CPI) confirm that likelihood. Like wage rates, real estate prices can be a major factor contributing to inflation, but I would expect the gains to be modest given the surge in construction and the run-up in prices already experienced.

The CPI report for January added to inflation concerns by showing a rise of .5%, rather than the .3% that economists had forecast. Even the core measure, which excludes food and energy, was up .3% rather than the .2% that economists had estimated. Apparel costs rose by the largest amount in 30 years and this may have been due to the weak dollar because so much of our clothing is imported from abroad. Owner's equivalent rent (housing) also contributed to the increase. Retail sales came in below expectations for January. Major expenditure items like motor vehicles and building materials turned out to be disappointments, causing some analysts to trim the GDP estimates for the first quarter. I still think real growth will, however, be about 3%.

While inflation has a strong upward influence on interest rates, low yields in Europe and Japan should have a dampening effect, holding back rising yields on government and other quality fixed income instruments in the U.S. Over the last 60 years, the spread between the yield on the 10-year U.S. Treasury and CPI averaged approximately 230bps, implying that the yield on the 10-year excluding these dampening effects could reasonably go over 4%. I expect the 10-year U.S. Treasury yield to exceed 3% this year, but perhaps not go too much beyond that.

One factor likely to have some influence on interest rates this year is the U.S. budget deficit. It had been running below $700 billion annually, but the tax cut and increases in other government spending should push it close to $1 trillion. This additional borrowing should put upward pressure on the yield on Treasurys and other high-quality securities. While I don't expect a surge in interest rates, I do believe the bull market in bonds, which started in 1982, is essentially over. Although the Federal deficit is increasing, tax receipts at the state and local level are rising sharply. Still, there are many municipalities that will have trouble meeting their pension and other obligations going forward.

Economic conditions abroad remain favorable. The Eurozone Composite Performance Market Indicator (PMI) has exceeded its 2010 high. China's PMI is above the 2012 level, although not at the heights reached in 2007 and 2010 before and right after the global recession. Data from around the world confirm the synchronized global economic expansion is continuing. The Australian manufacturing PMI has risen above its 2011 level. South Korean exports are surging and Japanese industrial production is at a post-recession high. Strong economies abroad should benefit U.S. companies with large export components, especially since the dollar has been weak and our products and services are attractive.

Some skeptics believe all this good news about the prospects for the economy supports the bearish, not the bullish, case for the equity market. They argue that the economy was already doing well before the fiscal stimulus provided by the tax cut. With unemployment at 4.1% and headed to 3.5%, the economy did not need any stimulus. It was already at full employment and the additional federal spending would cause the economy to overheat, resulting in higher inflation to and rising bond yields. They argue that those who are bullish on the market should hope for slower growth. My view is that this is an earnings-driven market and the improving profit forecasts will offset rising inflation and interest rates.

Some observers believe a 10% correction is enough, at least for a while. Valuations have come down to reasonable levels, the market is no longer excessively overbought and intermediate-term interest rates are showing signs of stabilizing. The Crowd Sentiment indicator has moved from close to 80 down to 61, putting it in "neutral" territory where we could see a short term rally. It would be nice if investors had to endure only two weeks of pain before the market headed higher again.

I believe the positive sentiment that provided the background for the decline has only partially been corrected. Consumer confidence is high, reaching levels not seen since the late 1990s, but the savings rate has dropped to 3.4% as consumer net worth has increased. The last time the savings rate was this low was two years before the 2008-9 recession. We know that the Federal Reserve is moving toward a more restrictive monetary policy and the European Central Bank is talking about tapering. Less accommodative monetary policies are generally not good for the equity markets. Consumer debt has risen sharply since 2009 as confidence has increased, but federal debt may be the real problem. According to Doug Kass and Larry McDonald, that debt was $9 trillion in 2007 and carried a cost of servicing of 4.75% or about $425 billion a year. (In 2000 it was only $6 trillion with a cost of servicing of 6% or $360 billion, but with a tax cut and two wars to finance, debt soared in the new millennium.) Today it is $20.5 trillion with a debt service cost of 2.25% or $460 billion, slightly more than in 2007. Think of what interest rates going above 3% would do to the budget deficit.

None of these issues make me bearish but they do make me think the correction is not over. I am bothered by the role that quantitative algorithmic trading and leveraged Exchange Traded Funds played in accentuating the rise in the market and its decline. These are basically trading tools, not investment strategies, and while it can be argued that traders contribute to market liquidity, I fear that these mechanical techniques have produced a certain level of instability in frenetic periods such as the one we just experienced.

I also worry about the short-term focus of most of the programs being developed by the current administration in Washington. While the basic agenda of tax cuts, deregulation and infrastructure spending may be good for the economy, I am concerned about the lack of focus on longer-term issues. The Olympics and the possible summit meeting of North and South Korea may defuse the near-term threat of a military confrontation in that part of the world, but the cooling of tensions may only be temporary. Recalling Donald Trump's complaint that "China is stealing our lunch," our trade deficit with that country last year was the largest ever and further tensions on trade are likely. I also am apprehensive that an economic slowdown in China might affect world financial markets. Political turbulence in the Middle East, particularly between the United States and Iran, may push oil prices higher, and there is internal strife between factions within Iran itself. Finally, the administration seems to have assigned a low priority to education reform, support for scientific research and environmental improvement. All of these areas are critical for the continued long-term health of the economy.

I still expect that the Standard & Poor's 500 will close above 3000 sometime in the second half. Even so, these longer-term issues, together with market internals, make me think that there is undue investor optimism and a further down leg lies ahead.