Scoring the Market Negatives

October 25, 2018
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When the February market correction ended, I had the lingering feeling that not enough damage had been done to investor complacency to provide for a sustained move higher. In spite of that, the major indexes continued to plow ahead. After Labor Day, the market was selling at fair value and investors were optimistic that nothing could go wrong in a strong United States economy with real growth in excess of 3% and unemployment at a 40-year low. A perfect set of sentiment conditions for a market decline was in place. I had been expecting a post-midterm election rally, but for that to happen the market needed to have a sell-off in order to make valuations more attractive and investors less complacent. The sharp recent rise in 10-year Treasury yields from 3.0% to 3.23% was the trigger, but there were other negatives in the market background that had an influence on the thinking of portfolio managers. With respect to these negatives, we will explore each one's relative importance. Let me be clear, however. I do not believe we are beginning a bear market. We are in a correction in an ongoing bull market that probably has a year or more to run. Our strategy team does not expect to see the next recession until 2021 at the earliest. A more serious market downturn may occur sometime before then, but not now.

When the 10-year Treasury yield was below 3%, real yields were less than 1% and the market seemed comfortable with that. Now with real yields above 1% and the prospect of the Federal Reserve continuing to tighten further, investors have become increasingly concerned that higher rates will stifle economic growth. According to my dividend discount model, the market was fairly valued before the sell-off based on 2019 projected earnings and 10-year Treasury yields at 3%. Now the market is undervalued. My view is that inflation will increase somewhat, but remain generally subdued. I have a hard time seeing the core Consumer Price Index rising much above 2.5%. Average hourly earnings are rising at a 2.8% annual rate now. Perhaps yields will go to 3.5%, but that would still be below the 4% level that usually accompanies a slowdown in the economy. The current spread between the three-month Treasury bill and the 10-year note is a positive 86 basis points.

Wage costs continue to be the most important factor in the inflation outlook. Although the unemployment rate is at a record low and Blackstone's private equity portfolio companies are complaining about the difficulty of hiring qualified workers, I nonetheless expect wage pressures to remain modest because of the reduced need for humans in the work force due to the greater use of technology and artificial intelligence.

The price of oil is also an important factor in the inflation outlook. It has moved from $60 a barrel (for West Texas Intermediate) to over $70 this year, and its rise from here may be gradual. As for other commodities, my view is that the slowdown taking place in both developed and emerging market economies will dampen prices for most industrial and agricultural products. I expect us to see somewhat higher inflation and interest rates but I do not expect a sharp increase in either over the next year.

A look at 15 indicators that have an influence on market valuations shows that they generally fall in the range of 1.0 to 1.2 times their 20-year average, not a sign of over-valuation. The current Standard & Poor's 500 operating price earnings ratio is about 16.5x. The average since the 1950s has been 16x, but the 10-year Treasury yield since the 1950s has averaged 5.6% and it is 3.1% now. The dividend tax rate since the 1950s has been 53%, but under the new tax code it is now 24%. We are also growing nominally at a 7.6% rate compared with 6.5% since the 1950s. At 2700 the S&P is not overvalued.

Concern about a trade war with China is on every investor's mind. We import over $500 billion in goods and services from China and sell only about $130 billion to them. Putting high tariffs on Chinese goods will surely increase costs for both American consumers and corporations, but our trade negotiators are right to be tough. China enjoys a current tariff schedule that was implemented when it was a developing economy, and it is the second largest economy in the world now. There is a broad political consensus that the Chinese have been using American technology without authorization, taking advantage of their partners in joint ventures and flouting World Trade Organization rules. I believe we will work out a trade agreement with China sometime next year. China is currently experiencing a greater-than-expected slowdown and is likely to be anxious to eliminate friction with its most important trading partner. One point the Chinese will never agree to, however, is slowing down their technology research effort, the "Made in China 2025" program. We should stop pushing for that.

The Chinese equity market has been declining all year as the S&P 500 has been rising. Emerging markets have also been suffering, partly because of a strong dollar and increasing oil prices. While the fundamental background for U.S. equities remains strong, there may be better relative values in China, India and the emerging markets. These countries have an expanding middle class with growing consumer buying power. If a worldwide recession is several years off, a buying opportunity is developing in the equities of these depressed markets.

One of the problems that could have an impact on the world economies and their markets is the Italian financial situation. The new government, responding to populist pressures, has proposed reducing taxes and providing a guaranteed annual income for its citizens. In spite of these initiatives, the country's budget deficit is projected at only 2.4%. The International Monetary Fund and the European Commission are not buying it. The yield on the 10-year Italian bond is 3.6% compared to 0.52% on the 10-year euro bond. A number of French and Spanish banks have substantial Italian debt on their balance sheets. If these loans become non-performing, the financial stability of Europe could be threatened. In addition, the leadership status of Emmanuel Macron in France and Angela Merkel in Europe has been diminished. A recent regional election in Bavaria weakened Angela Merkel's coalition further. These developments, in addition to a still unresolved Brexit, add to the ambiguity in the outlook despite Europe's expected growth of between 1% and 2% in 2019. The current slow growth and financial uncertainty in Europe is not good for the U.S. equity market, but I do not expect the situation to worsen. The European Union will remain intact and Europe will continue to "muddle through" as it has in the past.

The apparent murder of a Saudi journalist in Turkey could have important market significance as it marinates. We still import oil from Saudi Arabia and consider it, like Israel, an important ally in the Middle East. While many in the United States have applauded Mohammed bin Salman's reform policies at home, this event could cloud America's relationship with the new regime and affect both trade and investment. The current situation could also turn out to be a serious setback that impacts oil prices.

The high level of debt throughout the economic system has continuously worried investors, but low interest rates and strong growth have diminished the importance of this factor. At the end of September, the Federal Reserve revised its method of calculating the pension obligations of state and local governments, thereby increasing the future burden from just under $2 trillion to over $4 trillion. Corporate debt is off its peak, but still high. Because of tax cuts and additional spending, the U.S. budget deficit is increasing from $700 billion to $1 trillion. All this is happening while the Federal Reserve is raising short-term interest rates and shrinking its balance sheet. If rates continue to rise, the cost of servicing debt will increase at the same time that liquidity in the system is decreasing. As the Federal Reserve buys fewer Treasurys in pursuit of "normalization," Japan and China will also be participating less vigorously in Treasury auctions because of tariff issues. This is not good for the outlook for equities. Of all the factors influencing the market, this could turn out to be the most important. For the market to move higher, it will be dependent on earnings to overcome the impact of shrinking liquidity.

Credit spreads have been widening but they are not yet at a level to cause alarm. The junk bond and Baa spreads are at 265 basis points, up 27 basis points recently. At times of crisis, such as the recession of 2008-9, the Eurozone financial strains of 2012 or the drop in oil prices in 2016, the spread has exceeded 500 basis points. The spread usually begins to rise before any recession, but it is pretty close to normal now. In February, the S&P 500 declined 10% and 10-year Treasury yields rose 20 basis points. So far in October, the S&P 500 has declined as much as 7% and 10-Year yields decreased 4 basis points. Average hourly earnings, which increased sharply in January to start the sell-off, were actually down modestly in September. Inflation is not an apparent problem. The growth in the economy is expected to decelerate in 2019 from 3.5% real to 2.5% while S&P 500 earnings are increasing from $165 to $175. A slower economy should restrain the growth of inflation. All of this is part of a debate about whether the next phase of the market will favor growth or value. If S&P 500 earnings growth were going to slow from 20%+ this year, I believe those companies with the potential for open-ended earnings increases would continue to be in favor. If the economy itself were slowing, this would be a problem for value stocks.

No market can move higher without leadership, and a small group of technology stocks have certainly been the outstanding performers in the market before the sell-off began. The so-called FAANG stocks, Facebook, Apple, Amazon, Netflix and Google (Alphabet) had returned 38% annually since 2014. These stocks have been hit hard in the recent decline. At this point, technology stocks appear more reasonably priced than in 2000. Then, tech was selling at a 200% premium to the general market; today the premium is 30%, according to Barron's. Any forecasts have become confused by the revelation that Chinese operatives had inserted spy chips inside the servers used by Apple, Amazon and others, requiring costly surveillance going forward. In spite of this, the FAANG stocks are still expected to show strong growth next year ranging from a high of 56% for Netflix to a low of 12% for Google (Alphabet). Barron's has assigned a risk rating to each of the FAANGs, based on factors such as trade, supply chain, valuation, privacy and regulation. On this basis, Facebook and

Google are ranked worst and Netflix best, which is the opposite of my risk assessment.

The February and October market corrections reflect the volatility risk stemming from the proliferation of passive and computer-driven programs. One such strategy, Risk Parity, popularized by firms like Bridgewater and AQR, has amassed over $400 billion in AUM. This approach makes allocations based on risk, rather than traditional stock and bond weightings. When volatility in one asset class increases, the portfolio is shifted to less volatile assets in order to maintain optimal risk levels, typically without much human intervention.

Similarly, recent research suggests that 60%–90% of daily equity trading is now performed by algorithmic trading, up from 25% in 2004. Meanwhile, passive exchange-traded funds have directed trillions of dollars into equity markets since 2009, and the percent of the U.S. equity market share captured by passive strategies has increased from 26% at the start of 2009 to 47% as of 3Q'18. All of these trends are likely to increase volatility moving forward. One result is to discourage investors who base decisions on fundamentals like earnings, but feel that the market is being controlled by professionally run, computer-based forces which they do not understand and, in some cases, fear.

Taking all of these factors into account, I believe we are going through a necessary correction prior to the next upleg, which should occur after the mid-term election, regardless as to whether the Democrats take control of the House of Representatives or not. Earnings will continue to drive the market and the prospects for earnings growth in the U.S. for 2019 remain strong in spite of what is happening elsewhere in the world.