The New Vigilante

The stock market rallied vigorously off December lows with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite posting 13.07%, 11.15% and 16.49% first quarter gains respectively. As we predicted in our Market Outlook 2019 newsletter, the market seems to be pricing in our base case "that recession will be averted thanks to a more patient Fed and successful conclusion to trade negotiations with China". While the much hoped-for deal with China has yet to be finalized, both sides have telegraphed growing optimism and a final meeting between Presidents Trump and Xi to mark a successful conclusion to negotiations appears to be imminent.

Not only did the Federal Reserve pause its rate-hike campaign, they also announced that they were ready to stop shrinking the central bank's $4 trillion asset portfolio this year. With quantitative tightening and rate hikes now off the table for 2019, market participants have become decidedly more cheery about the economy and prospects for the stock market. The recent Fed decision marks a stunning pivot for Chairman Powell whose hawkish remarks sparked a 20% correction last Fall. The new mantra for the Fed is "patient" and the market has already priced in a 50% probability that the Fed's next move will be an interest rate cut.

In part, the Fed's abrupt change in course can be attributed to muted inflation. The Fed established a 2% inflation target in 2012, but inflation has run below that target for most of the decade-long expansion. Core inflation measures that exclude volatile food and energy prices have averaged 1.6% since the target was adopted in 2012. Core inflation unexpectedly eased in February amidst falling prices for autos and drugs and the annual 1.5% gain in the broader CPI was the smallest rise since 2016. Low inflation is giving the Federal Reserve the cover it needs to be patient. Meanwhile, Chairman Powell and the Fed are considering whether future policy ought to allow inflation to rise above their 2% target more often as they grapple with the probability that interest rates are likely to remain much lower than in the past.

With the Fed on hold, bond prices have rallied along with stocks and the yield on ten-year Treasury bonds has plummeted to 2.4% from the recent high yield of 3.2% reached last Fall. With bond yields so low, dividend yields are once again an attractive alternative for income investors. Indeed, negative yielding foreign government bonds have increased 25% since October and now stand at more than $11 trillion due to ongoing stagnation in Europe and Japan. Negative yielding bonds peaked at roughly $13 trillion in 2016 and had steadily declined until the most recent spurt. Demand from yield-hungry investors around the globe has no doubt contributed to the recent decline in Treasury yields.

Plunging bond yields and rising equity prices are giving divergent signals. Typically, lower bond yields are associated with a weakening economy and higher stock prices with a strong economy. With the 10-year to 3-month Treasury yield curve having recently inverted, a key indicator of looming recession, investors are rightfully pondering whether the stock market rally may have come too far, too fast.

We continue to believe that no recession is imminent for 2019 and that other factors ought to be considered. First, as stated above, the world is awash in negative yielding sovereign bonds which inevitably makes Treasury bonds much more attractive. Second, the 10-year to 2-year Treasury yield curve remained positively sloped (even as the 10-year to 3-month curve inverted) and research suggests this may be a more important indicator to watch. Also, it is difficult to quantify how the Fed's surprising policy pivot may have altered investor demand and the subsequent slope of the yield curve. And, if previous yield curve inversions are any guide, the actual economic decline consistent with recession does not arrive for 12 to 18 months after the inversion. Moreover, U.S. economic indicators may be decelerating but by no means are they flashing any imminent warning signs. Very recent U.S. manufacturing and employment data offer further evidence that the Fed seems to have successfully engineered a soft landing. The slope of the yield curve has again turned positive across all short-to-long-term maturities and fears of recession have declined markedly.

With an increasingly growing chorus of liberal Democratic Presidential candidates, the bond market may be grappling with potential disruption to the economic status quo should President Trump lose the White House. While such widely bantered proposals such as a tax on net worth over $50 million, a ban on stock buybacks, Medicare-for-all and tuition-free education would be virtually impossible to legislate unless Democrats sweep in 2020, campaign rhetoric alone is likely to be a market mover in the coming months.

This prolonged era of low interest rates has been accompanied by a surge in global debt issuance. Stunningly, global credit-market debt (which includes all government, corporate and consumer debt) reached $244 trillion in 2018, compared with worldwide economic output of $85 trillion, a ratio of nearly 3 to 1. In the United States, total credit-market debt is estimated at $70 trillion, compared with $20 trillion of GDP, a ratio of 3.5 to 1. With the world inundated with debt, markets have never been so sensitive to changes in interest rates. This helps explain the sharpness of the stock market correction last Fall and may have forced the Fed's hand in finding its newfound patience. While so-called "bond vigilantes" used to fear inflation, today's vigilante fears the economic impact and propensity for recession associated with rising interest rates. After all, rising rates put pressure on corporations and consumers to reduce investment and consumption and could ultimately lead to defaults, asset sales and downward pressure on asset prices. Indeed, massive global debts ensure that the new vigilante has the potential to drive economic policy for the foreseeable future.

The S&P 500 trades at 17x expected earnings for 2019 and 15x expected earnings for 2020. These valuations appear reasonable to us, especially with interest rates having dropped so precipitously.