Weekly Market Commentary

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My doctor is an old-fashioned and conservative physician. Occasionally, I will tell him that I have diagnosed some ailment of mine by surfing the web. His normal response is to say something rather cutting about self-diagnosis over the internet and then order some tests to discover what, if anything, is actually wrong with me and, then, what to do about it. I must admit that, over the years, he has been proven right in this more than once.

In a similar vein, when markets turn volatile, the internet bubbles over with articles diagnosing the problem and prescribing a course of action for investors. The problem is that much of the mainstream analysis is flawed and much of the investment advice from the fringes could be seriously damaging to your long-term financial health. A better course of action, when faced with market volatility, is to treat the media narrative with skepticism and run some simple tests on fundamentals, valuation and positioning (or FVP for short) to decide on what action, if any, should be taken.

The reactions to last week's stock and bond market selloffs make a good test case. The broad narrative, particularly on Friday, was that the stock market was tanking because of higher interest rates that, in turn, were rising because of higher inflation, as evidenced by strong wage growth in a better-than-expected jobs report.

The problems with this narrative are:

1. The jobs report was not better than expected,
2. Wage growth was not particularly strong,
3. There is little evidence of higher inflation overall,
4. Most of the recent increase in interest rates is not due to higher inflation expectations, and,
5. The increase in interest rates, from very low levels, is not a good reason for stocks to fall.

Taking these assertions in order:

First, the jobs report was not better than expected: Going into the report, economists had forecast a gain of 175,000 in non-farm payrolls, a 4.1% unemployment rate, a 2.6% year-over-year increase in average hourly earnings and an average workweek of 34.5 hours.

In the event, payrolls rose by 200,000. However, monthly job gains for November and December combined were revised down by 24,000, so the three-month job gain was right in line with estimates. In addition, the unemployment rate, while unchanged at 4.1% to one decimal, actually rose from 4.09% to 4.15% taken out to two decimals. Meanwhile, despite a higher-than-expected increase in average hourly earnings for all workers, the average workweek fell by 12 minutes relative to a forecast of “unchanged”. Overall, the report could best be described as neutral.

Second, wage growth was not particularly strong: It is true that average hourly earnings for all private sector workers rose by 0.3% in January and is now up 2.9% year-over-year, the strongest year-over-year gain since May of 2009. However, two issues make this a little less impressive. First, the week in which the January survey was conducted was pretty harsh from a weather perspective, with the number of people forced to work part-time rather than full-time due to bad weather running about 70% above its average January level. This simultaneously pushed down the average workweek and boosted average wages, since workers in industries that suffer weather-related disruptions generally receive lower-than-average wages. Second, average hourly earnings for the 82% of private workers in the production and non-supervisory category were up just 2.4% year-over-year in January, unchanged from December and showing no real acceleration from recent months.

Third, there is little evidence of higher inflation overall: Last week’s data on personal consumption deflators were not particularly strong, with headline inflation rising by just 0.1% in December with the year-over-year gain falling from 1.8% to 1.7%, still well short of the Fed’s 2% target. The core rate rose 0.2% but was just up 1.5% year-over-year. The first quarter may see some upward pressure on inflation from a lower dollar and higher oil prices. However, oil prices are unlikely to move much higher from here and disinflationary trends among many areas of consumer goods and services remain entrenched.

Fourth, most of the recent increase in interest rates is not due to higher inflation expectations: Since New Year’s Eve, the yield on the 10-year nominal Treasury bond has risen by 44 basis points, from 2.40% to 2.84% on Friday. However, over the same period, the 10-year Treasury Inflation Protected Security (or TIP), has seen its real yield rise by 26 basis points, from 0.44% to 0.70%. In other words, 59% of the increase in 10-year nominal bond yield was due to an increase in real yields, not inflation expectations.

Finally, rising interest rates from very low levels is not a good reason for stocks to fall: History shows that rising Treasury yields, from these levels, are not normally associated with falling stock prices. Indeed, as we show on page 15 of the *Guide to the Markets*, since the 1960s, the stock market has generally been hurt only when rates rise from higher levels. The reason is clear enough – rising rates from high levels is a sign of inflation; rising rates from low levels is a sign of improved economic growth.

But if there are flaws in the standard narrative, why did both the bond and stock markets sell off last week? The somewhat untidy, but nevertheless more plausible explanation is that both the bond market and stock market were overdue for a correction after a remarkably placid two years.

So what should investors do? Three things:

- First, they should remember that, while corrections in markets are uncomfortable, they are very common and do not necessarily imply the need to take any action at all.
- Second, they should appreciate that, even after last week's selloff, real bond yields are relatively low and P/E ratios are relatively high which should limit long-term returns from bonds and stocks, and,
- Third, they should check fundamentals, valuations and positioning to see if they should make any adjustments.

On Fundamentals, both the U.S. and global economies are expanding at a strong pace in 2018, with relatively low inflation and interest rates. It is true, that U.S. growth will likely slow in 2019. However, there are no particular risks of recession at this stage. In addition, an excellent earnings season so far has seen 77% of companies beat expectations on earnings and 70% beat on revenues. Moreover, the tax reform act has significantly reduced the tax burden on U.S. corporations, suggesting the possibility of a 20% gain in year-over-year EPS for 2018.

On Valuations, real bond yields remain below their historic levels. However, the bond market selloff since the end of last year has boosted the real ex-post 10-year Treasury yield to almost 1%. This is still below its 2%+ level of before the financial crisis. However, slower economic growth across the developed world suggests that real yields could permanently remain below their long-term historical average. As for the stock market, the S&P500 ended January with a forward P/E ratio of 18.1 times, actually lower than the 18.2 times with which it entered 2018, despite a January surge in stock prices. This is testament to the impact tax reform is having on estimates of future earnings. Moreover, with Friday's selloff, the forward P/E ratio is now roughly 17.7 times. This is still higher than its 25 year average of 16 times. However, provided real interest rates remain significantly below their 25-year average, stocks still look like good value in comparison.

Finally, on Positioning, investors need to recognize that, if they do not rebalance, market movements may leave them in a very different position from where they intended. A portfolio that has not been rebalanced over the past year will by now be even more overweight equities relative to bonds, even though the relative attractiveness of these two asset classes has actually converged somewhat over the past year. A portfolio that has not been rebalanced over the past five years is probably even more overweight domestic stocks compared to international, even when valuations and trends in earnings and currencies are strongly pointing to the advantages of an overweight to international.

In summary, the week ahead could be a bumpy one for global financial markets with corrections either intensifying or reversing. But as the markets move and commentary becomes extreme, investors would do well to maintain some skepticism about what they read on the web and focus more on the basics of fundamentals, valuation and positioning.

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