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2018

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A Rude (Early) Wake-up Call

J. Patrick Bradley |

The markets just got a wake-up call. Participants realized that the Federal Reserve (Fed) was on a course of higher interest rates and the first employment report of the year contained a surprise: wages moved sharply higher. Apparently, markets were woken out of slumber by a 4.1% U.S. unemployment rate, 200,000 more nonfarm payroll jobs, and a 2.9% annual increase in average hourly earnings—the first signal that maybe inflation could be awakening. U.S. equity markets have fallen 5% since the end of January, based on the S&P 500, and the Dow Jones Industrial Average recorded a greater than 1,000 point, single day swoon. Volatility returned with a vengeance. Interest rates are well above the lows of last September and seem likely to move higher. Markets appear to have regained their footing but should we be worried about the economy?

Stay Calm…For Now

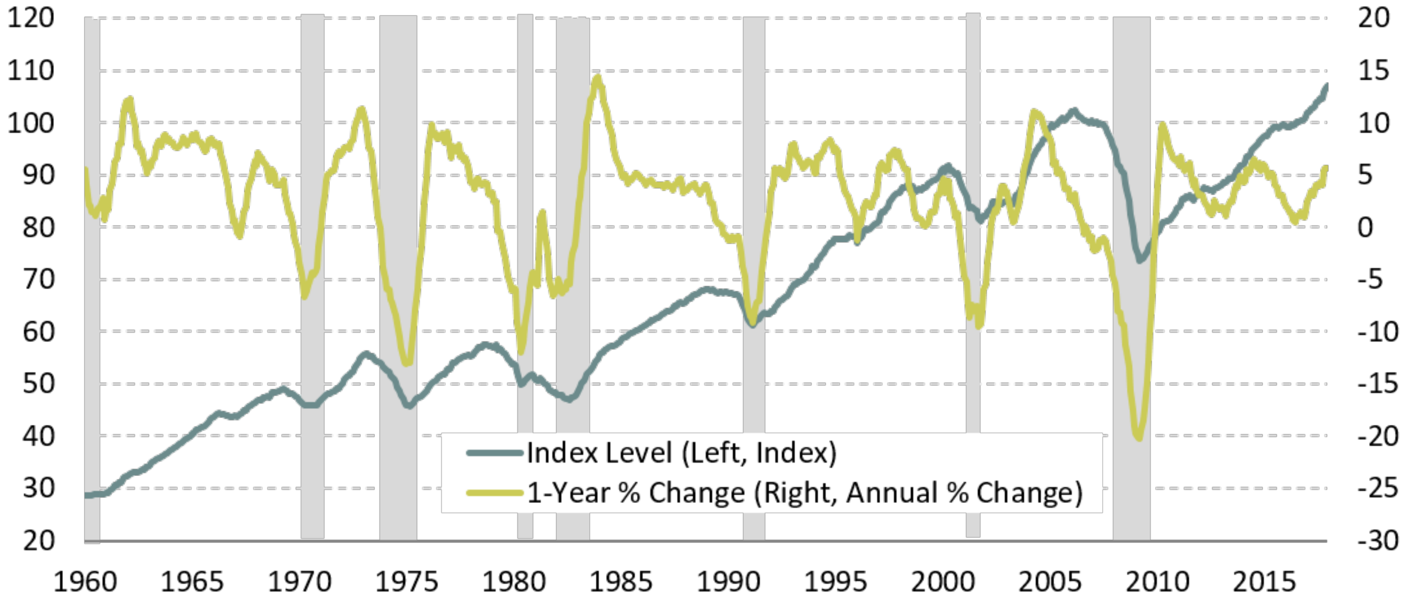
Let's take a look at what some indicators are telling us (See: Recessionary Fears, Dark Clouds That Won't Fade).

The Leading Indicators

A tried and true arrow in the analysts' quiver has been the Conference Board's Index of Leading Indicators, which consists of 10 different indicators, the best known of which are stock prices and the interest rate spread via the treasury yield curve. Chart 1 shows the index level and its annual percent change, against recession shading. The leading index is telling us that the U.S. economy should continue to expand. Where we'd become concerned is if the index rolled over and started to decline. To minimize the "false" calls of the index we would look for the index to fall over several months. The green light is still flashing.

Chart 1: US: Conference Board Leading Economic Indicators

As of 12/31/2017



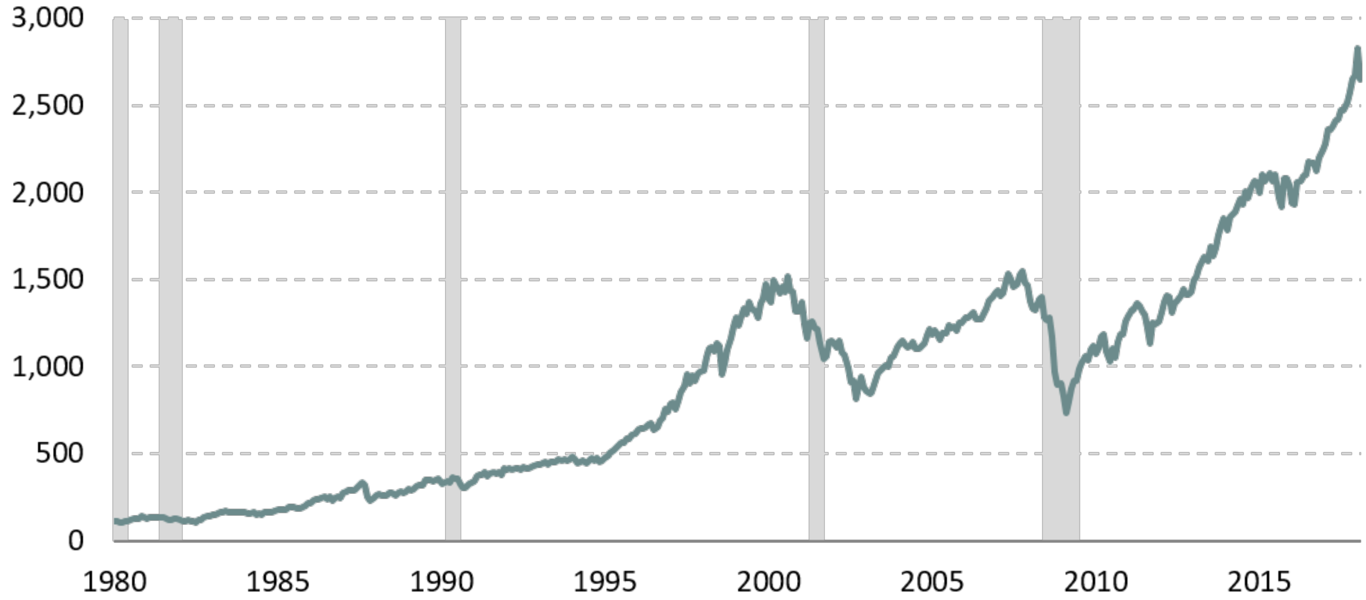
Source: Bloomberg (© 2018, Bloomberg Finance LP)

Stock Prices

Chart 2 shows the S&P 500's performance over each business cycle since 1980. Stock prices have a tendency to foreshadow recession and economic recovery, although the record is far from perfect. Hence, Paul Samuelson's famous quip that the stock market predicted nine of the past five recessions. Higher stock prices, though, do reflect confidence in an economy. The current bull market has been on a steady march higher since March 2009, without a meaningful correction. Investors shouldn't be surprised if the market experienced a correction following its long climb higher. Higher asset prices are partly a product of the Fed's unconventional monetary policy. And that is ending. The hyperbolic stock market rise is probably ebbing but the economy remains solid. A correction should provide somewhat of a relief, but even the market swoon isn't a harbinger of a deteriorating economic outlook. Valuations, however, remain a concern. High price earnings multiples do suggest a rich market (See: Is the End Near?). And, based on Chart 3, the equity market looks overvalued using a model that tries to assess what the "correct" price-to-earnings (P/E) multiple should be based on economic variables such as industrial production, consumer prices, and interest rates. That overvaluation looks to be between 15 -20%. A pause that refreshes valuations would be welcome.

Chart 2: Stock Price Index: Standard & Poor's 500 Composite

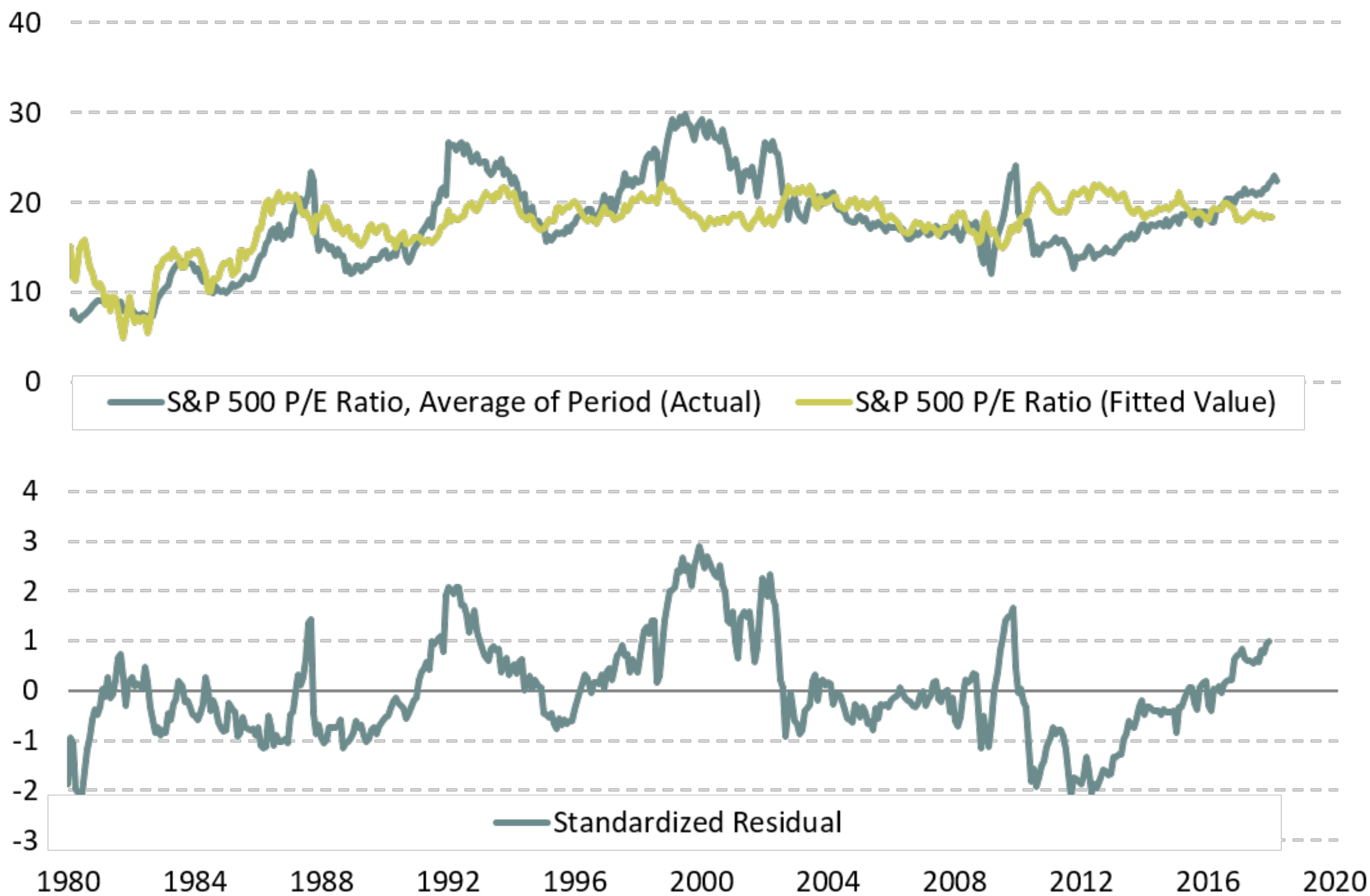
Index, As of 02/05/2018



Source: Standard & Poor's/ Haver Analytics

Chart 3: P/E and Macroeconomic Variables

Percent, As of 02/05/2018



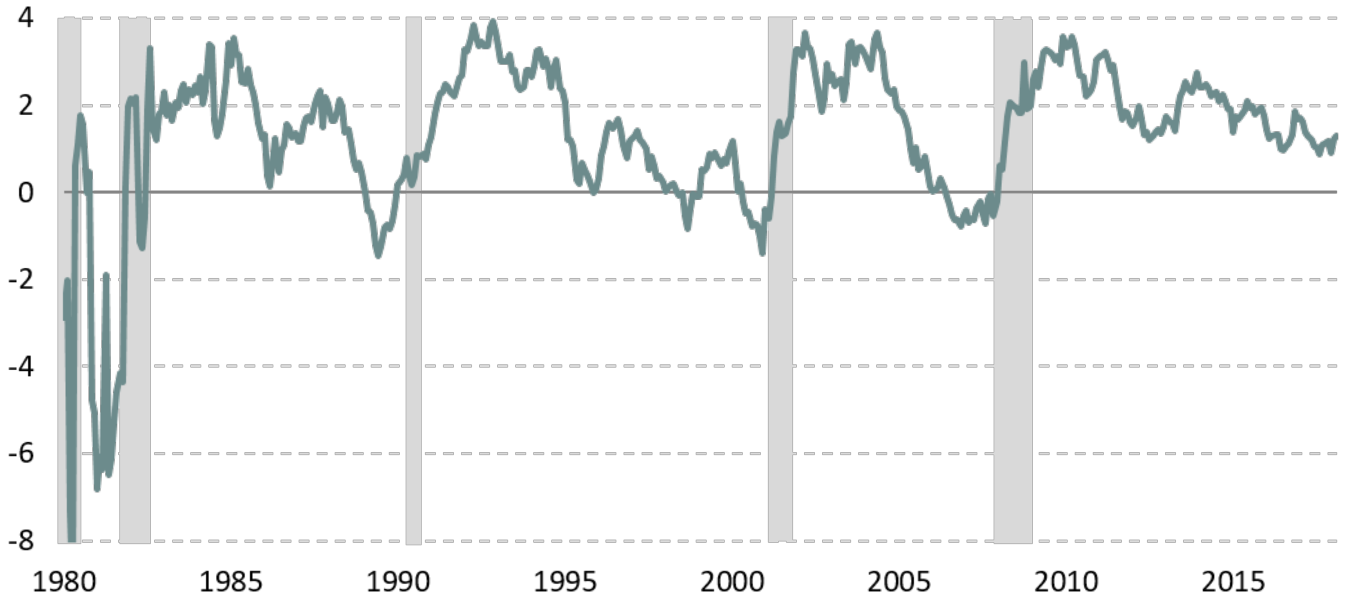
Source: Thomson Datastream

Yield Curve

Another analyst favorite is the slope of the yield curve, usually depicted by the simple difference between a long and a short interest rate. Like equity prices, the yield curve is a component of the leading economic indicators. It is defined here as the difference between a 10-year Treasury note and the federal funds rate—the Fed's policy rate. As the yield curve steepens this indicates liquidity moving into the financial system and is typically taken to be a favorable environment for banks: a steeper yield curve leads to improving bank profit margins. On the other hand, a flattening of the curve coincides with higher interest rates, as the central bank raises the policy rate to staunch inflation. Long rates can rise too, but usually not as much as the shorter end of the curve. Warning bells sound as the curve approaches inversion and the short rate exceeds the long rate, which has typically presaged recessionary periods. The Fed has been raising interest rates and, despite the movement of longer rates higher, the yield curve has flattened. The slope has flattened from 277 basis points (bps) in August 2013 to right around 100bps currently. Chart 4 shows this time series and is some cause for concern. The spread continues to flatten. As the chart shows, the spread did turn negative prior to each of the last three recessions. While a cause for concern, the spread isn't an infallible predictor of recession. The indicator gave two false calls before the 2001 recession and it remains positive. Keep watching this one though.

Chart 4: Interest Rate Spread: 10-Year Treasury Bond Less Fed Funds Rate

Percent, As of 02/05/2018



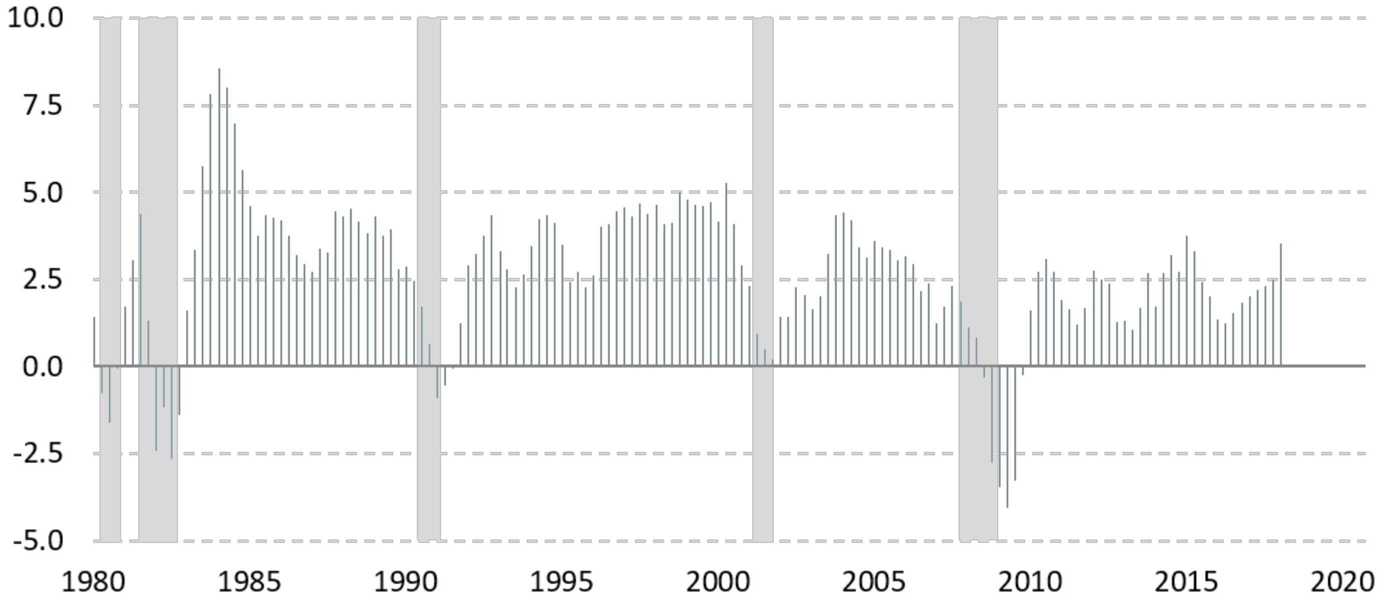
Source: Federal Reserve Board/Haver Analytics

The Economy

Despite the "nerves" investors have been showing, the economy looks to be performing well. Chart 5 shows the rate of economic growth since 1980 and the recessions that occurred during that span. After the Great Financial Crisis (GFC) the economy has continued to grow, helped by the Fed's easy monetary policy. An economy in recession is one in which the overall level of economic activity is contracting. In fact, the economy now appears to be accelerating. (See: Trump Program Could Be Icing on the Economic Cake) We believe that the employment picture is bright; confidence is on the rise; the economy is set to benefit from a reduction in both individual and corporate tax rates. Businesses are dusting off capital spending plans. The Trump Administration is following up its tax reform success with an infrastructure package. Rather than slowing, the economy appears to be getting a second wind. That's what Chart 6 is pointing to—if you believe that strength in copper prices is a positive indicator for future economic activity. Dr. Copper appears to be saying the end is not near.

Chart 5: US: Real Gross Domestic Product

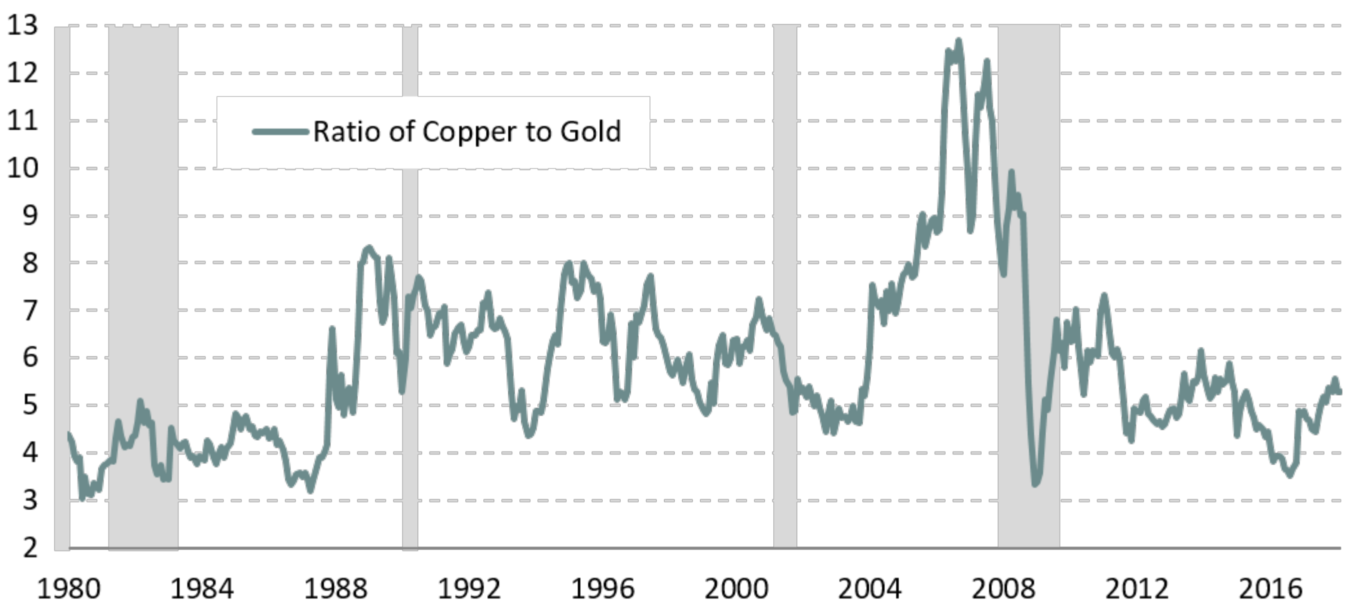
Annual Percent Change, Seasonally-Adjusted Annual Rate, As of 3/31/2018



Source: Bureau of Economic Analysis/Haver Analytics

Chart 6: Ratio of Copper to Gold

Ratio, As of 2/5/2018



Source: Thomson Datastream

Conclusion

Does that mean there is nothing about which to worry? Investors should never become complacent. The Conference Board's index of leading economic indicators points to further economic growth ahead. As for the recent downdraft in stock prices, a correction in share prices was long overdue, even as the market's advance seemed unstoppable. Market interest rates have been rising since early September 2017. Equity markets just noticed. A correction in share prices is healthy, especially as equity prices appear to have gotten ahead of economic fundamentals. The real worrisome sign though is the narrowing of interest rate spreads. A switch from a positive to a negative spread could be an ominous sign for the economy. A strong economy and assets will be competing for a dwindling supply of liquidity, as the Fed normalizes. Recent market action was a wake-up call for investors. The economy is late in its economic cycle. It will become the second longest economic expansion ever. The labor market continues to tighten and, maybe, we're finally seeing some wage pressure. Inflation is inching higher. That said, the problem arises when investors snooze through the alarm.

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