Commentary
Thoughts on recent market volatility

Key takeaways:

- Equities' recovery showed that markets still expect economic growth in 2018, with fundamentals remaining strong.
- Inflation will be a major concern, as markets fear the Fed will tighten policy if prices start increasing too fast.
- We continue to expect higher market volatility and higher yields than in 2017.
- Higher yields do not mean stock valuations should go down; in fact, history shows the opposite.
- If economic growth persists, equities will perform well, regardless of higher yields.

The first half of February has left many investors confused. The first week saw equities lose enough value to merit the term correction (a drop of at least 10% from a peak). Additionally, volatility, unusually low throughout 2017, spiked: the VIX (an index used to measure the market's volatility) even reached levels above 50 at some point. Many investors were left wondering whether a bearish market was coming. What followed was a week of huge gains instead, with the VIX index ending below 20 last Friday. On the other hand, the 10-year U.S. Treasury bond rate has been increasing consistently, and it is now at 2.9%. While many seem worried about the stock market's prospects in light of higher yields, we argue – based on historical data and market fundamentals – that this is not reason enough to worry. Higher yields and solid performance by equities can perfectly coexist.

A brief recap: monetary policy and equity markets

The last meeting of the Fed last year (held on December 12th and 13th) ended with an interest rate hike of 25 basis points (in the range of 1.25% to 1.5%), absolutely in line with what markets were expecting. Our view was that the Fed had decided to prioritize the "normalization" of interest rates, attempting to avoid economic overheating and the formation of bubbles at the same time, instead of focusing aggressively on meeting its inflation target.

The Fed's first meeting of 2018, the last with Janet Yellen at the tiller, ended with interest rates unchanged. The vote was unanimous. The Fed's press release after the meeting was very similar to the one it had put out in December. It sounded a confident note, stating short-term risks for the economy were balanced and solid growth was expected. It did warn, however, that inflation, although still below 2%, could pick up if the dollar continued to weaken or if oil prices kept creeping up. In spite of this optimistic forecast, that same week (Tuesday, January 30th) we saw the first signs of what was about to come. The Dow lost ground and the 10-year Treasury yields rose. Ms. Yellen's last day in charge of the Fed, Friday February 2nd, saw markets tremble, with stocks headed on a downward spiral that would last for five days.

On Monday, February 5th, Jerome Powell was sworn in as the sixteenth president of the Fed. The main question when he was nominated revolved around the pace he would set for the withdrawal of monetary stimuli, specifically low rates and the downsizing of the central bank's balance sheet. Still, markets seemed not very worried: unemployment and inflation were low, and the economy was growing, with tax reform expected to give it an extra boost. But things had changed that Monday, with markets continuing in free fall. Mr. Powell's message – stating he would work for stable prices and a healthy labor market, making reference to the Fed's double mandate – went largely unnoticed. With the VIX up by 115%, the outlook for the first few months of his four-year term was definitely looking shakier than expected.

The market, however, rebounded strongly. The five days of consecutive losses were followed by six days of consecutive gains. The week that ended on February 16th brought big increases for the S&P 500 (4.3%%, highest since January of 2013), the DJIA (4.3%, highest since November of 2016), and the Nasdaq (5.3%, highest since December of 2011).

What was the market concerned about?

In a nutshell, higher interest rates. That means the Fed would raise them more aggressively and/or faster than expected. We can focus a broader analysis around five factors, all of which could push the central bank towards tighter monetary policy:

1. Inflationary pressures in general

Until the end of 2017, underwhelming price increases preoccupied the Fed. Markets kept an eye on inflation, but nothing pointed to a pick up in prices. That changed at the beginning of this month, when a U.S. Department of Labor payrolls report showed that wages in January recorded the largest annual gain in more than 8 years: average hourly wages of private-sector workers rose 2.9% (the highest since June of 2009). This triggered worries of higher inflation (i.e., companies increasing prices to keep their margins intact), prompting the beginning of the five-day downturn. The market feared that the Fed would hike rates beyond what had been already internalized by the markets. As a consequence, bond yields rose – the inflation premium had gone up. Beyond the wage factor, a weaker dollar means the U.S. may start "importing" inflation (higher prices for imported goods). The weak dollar has been surprising, given that yields have risen in the past two weeks, and have done so faster than in other developed economies (e.g., Germany and Japan, usually viewed as close substitutes to U.S. Treasuries). This should push up the demand for the greenback, strengthening it. One potential cause for this decline could be that investors are expecting yields to go up even further, and thus have refused to buy bonds at this time.

2. Wage increases in particular

The main driver would be a labor market that is operating at near-full-employment levels. If productivity does not increase, we can expect inflation to rise.

3. Increased fiscal spending and its impact on economic output

The fiscal year of 2017 already ended with a fiscal deficit of more than $660 billion, the highest since 2013. President Trump's budget proposal, submitted to Congress two weeks ago, totals $4.4 trillion. After accounting for the recent tax cuts and the agreement that put an end to the last government shutdown, some estimates say the deficit could hit $1 trillion. The big question is whether this increased deficit will place upward pressure on inflation, forcing the Fed to act. Moreover, it is also questionable how much of a boost it can give to the economy at a time of very low unemployment. Competition for scarce workers could put lead to higher wages without necessarily increasing productivity, which again means inflation and tighter monetary policy as a response.

4. A growing fiscal deficit

Adding to the previous concerns, the national debt is closely approaching $20 trillion, and – since 2012 – stands at more than 100% of GDP. The Trump budget assumes a 3% annual rate of economic expansion for the next decade, a rather optimistic forecast. A larger debt, coupled with higher rates set by the Fed and more inflation, should translate into higher Treasury yields.

5. Equity markets

The Fed is always worried about potential asset bubbles that may result from an overheating economy. Ms. Yellen, before leaving her post, said that market valuations were a source of concern. With a new chairman, the markets are awaiting his first steps. However, he has signaled he plans to stay the course Ms. Yellen had set. The Fed will have to take its next steps very carefully. Timing and gauging the next interest-rate increases will be its main challenge. If they are too low, there is risk of overheating; if they are too high, there is risk of a recession. So far, the Fed has given no indication that it has modified its plan to increase rates thrice in 2018. But according to what we have seen lately, markets are giving approximately a 20% probability to at least four interest-rate hikes this year, versus just 10% at the beginning of the year (source: Bloomberg, extrapolating data from Fed Funds futures). Moreover, any particular increase could go above the 25 basis points that were expected at the end of 2017.

Higher yields and equities

After the turbulent first week of February, with the stock market suffering big losses and bond yields rising, some observers have wondered if stocks can thrive in a higher-yield environment. Two points can be made here. First, yields are inching closer to 3%, which is not high by historical standards. The extremely low rates we have seen in the past few years are the result of extraordinary monetary policies that were bound to end at some point. Second, past data show that a healthy equity market can perfectly coexist with higher yields. The great performance of equities the week after the correction, in the face of rising yields, is a good indication. The bad performance the week before that, in the presence of lower yields, further helps make this same point. Jodie Gunzberg, managing director and head of U.S. equities at S&P Dow Jones Indices, presented some interesting data recently to support this assertion: during rising-rate periods, the S&P 500 has gained 20% on average since 1971. Moreover, eight out of nine of these periods have been winners for the S&P 500. The one outlier only carried a loss of less than 4%. More importantly, if the economy is growing and inflation is positive, why would stocks not appreciate in value?

Summing up, the main point here is that if yields go up because growth is improving, then equities will do well. If yields move higher and growth declines, then equities could have a problem.

Conclusion

As we enter the tenth year of a bull market, it is understandable if some investors are on the lookout for anything that will put an end to it. Inflation – be it from higher wages or dearer imports – is what markets are most closely watching now. Other variables that will play a major role are economic growth rates, the size of the fiscal deficit, the targets of fiscal spending, and the pace at which the Fed scales down its securities-buying program (“quantitative easing”). But so far economic fundamentals remain strong, with nothing pointing in the direction of a bearish market. Important behavioral variables also look unaffected: the University of Michigan’s consumer-confidence index for February beat expectations, reaching the second-highest level in 14 years.

The week that followed the correction showed a market still confident that the economy will grow without stepping into overheating territory. The fact that yields have risen lately should not be taken as a cause for concern on its own. (In fact, they have not risen much in Europe, even in countries that were a source of worries only a few years ago, like Spain or Italy.) History teaches that a strong equity market can perfectly live in a higher-yield environment. If long-term yields ought to reflect the real rate of economic growth plus inflation, a level of 3% should not be surprising (and it could even be considered low). Finally, what we should expect to see is more volatility this year, both at home and abroad, opening up new opportunities for investors to seize.

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