# Market Recap

| | | Weekly Chg* | YTD Chg* |
|---|---|---|---|
| S&P 500 | 2,723 | +2.4% | +1.9% |
| Russell 2000 | 1,548 | +4.3% | +0.8% |
| EAFE | 63.36 | +3.1% | -9.9% |
| EM Equity | 40.83 | +5.6% | -13.4% |
| Global Stocks | 70.81 | +3.0% | -4.7% |
| | | | |
| Commodities | 23.37 | -1.6% | -4.3% |
| Gold | 1,234 | -0.1% | -5.7% |
| Bitcoin | 6,399 | -1.1% | -53.8% |
| | | | |
| Euro | 1.1396 | -0.1% | -5.7% |
| Yen | 113.176 | -1.3% | -0.9% |
| | | | |
| | Close | Last Week | 12/31/17 |
| Fed Funds | 2.00%-2.25% | 2.00%-2.25% | 1.25%-1.50% |
| 2-Year | 2.91% | 2.81% | 1.88% |
| 10-Year | 3.21% | 3.08% | 2.40% |
| 10-2 Yield Curve | 0.30bps | 0.27bps | 52bps |
| German 10-Year | 0.43% | 0.35% | 0.43% |
| | | | |
| Crude Oil | $62.88 | $67.70 | $64.39 |

***As of 10/19/18***

Global equity markets generally bounced this week, although they closed on a soft note Friday. For the week the S&P 500 advanced +2.4% while small-caps added +4.3%. The overseas markets were also solidly higher. The developed EAFE gained +3.1% while emerging was up +5.6%. China rallied +3.0% on hints of a trade thaw (and they were just hints, and Kudlow largely squashed them on Friday) while Brazil gained +3.2% after the election came to a close.

Bond yields moved higher on the week with the yield on the 10-year Treasury increasing +0.13%. Long-term government bonds lost -2.4% while intermediate-term governments declined -0.9%. High yield was up +0.6% and bank loans +0.2%. Finally, oil stands out with a -7.1% loss for the week.

## Wage Growth is Picking Up

The main economic news of the week was Fridays payrolls reports. It was solid in most respects. Non-farm payrolls rose by 250,000 in October, beating expectations by over 60K. Hiring was boosted by the healthcare sector which added 36,000 jobs and manufacturing, which added 32,000 jobs. The unemployment rate held steady at a multi-decade low of 3.7%, but hourly earnings rose 0.2% month-on-month and 3.1% year-on-year — the highest rate since April 2009, as you can see below.


The wage number was the center of attention on Friday. This report should ensure the Fed's meeting next week will be a prelude for a rate hike on December 19th.

## Rising Rates = P/E Pressure

The market moved swiftly after Friday's jobs report to price in both the better growth backdrop and the prospect for tighter Fed policy. For example, the yield on the 10-year Treasury pushed to its highest level since 2011 on Friday, as you can see below.

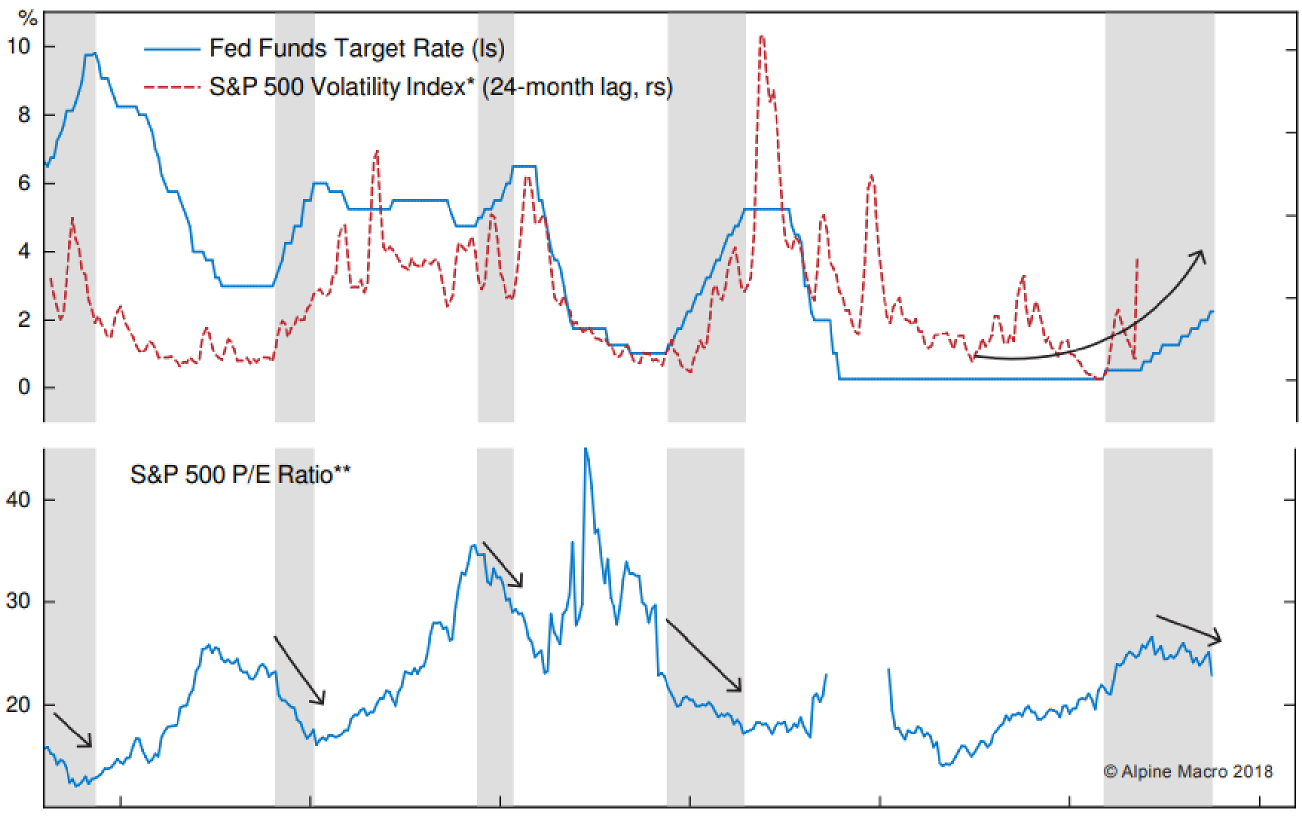

The odds of Fed hikes at both the December and March meeting also increased. While we're on the topic, it is worth noting that Fed policy is probably one of the big reasons the market corrected in October. It isn't just a coincidence that the S&P peaked essentially around the October 3rd interview Fed Chairman Jerome Powell gave with Judy Woodruff of PBS. His key comment was:

*"The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore."*

CNBC also reported that Powell said:

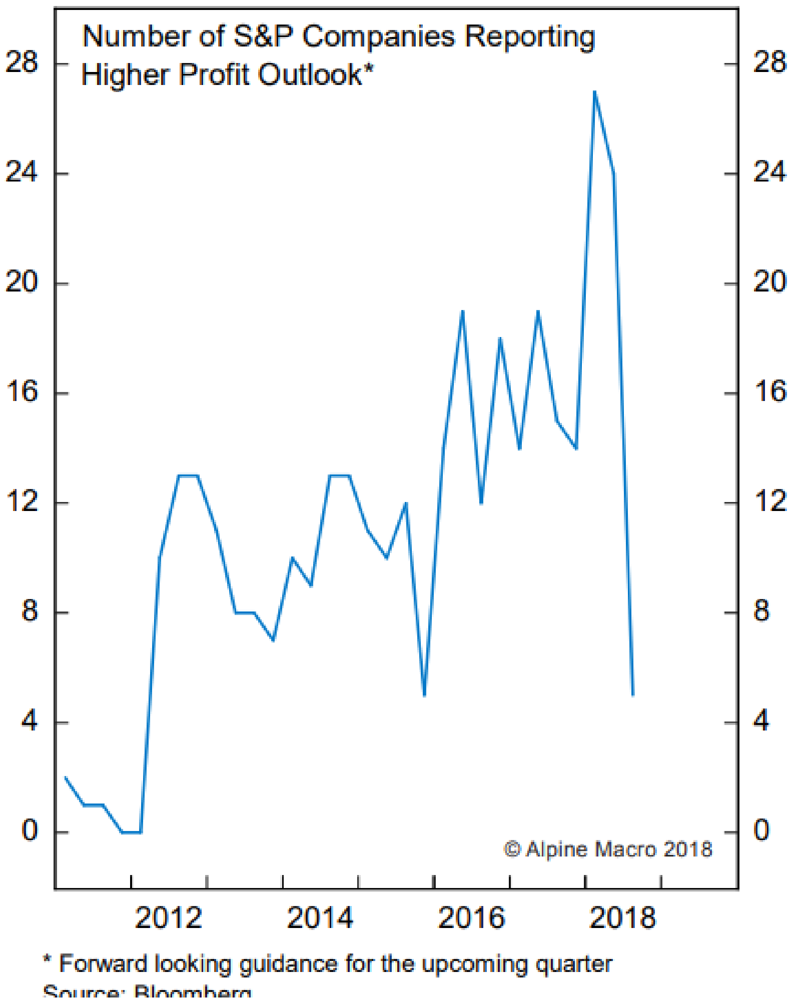
*"Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but we're a long way from neutral at this point, probably."*

Why does this matter? Take a look at the chart below. This plots how volatility in the S&P index tends to rise while the P/E falls whenever the Fed increases rates.

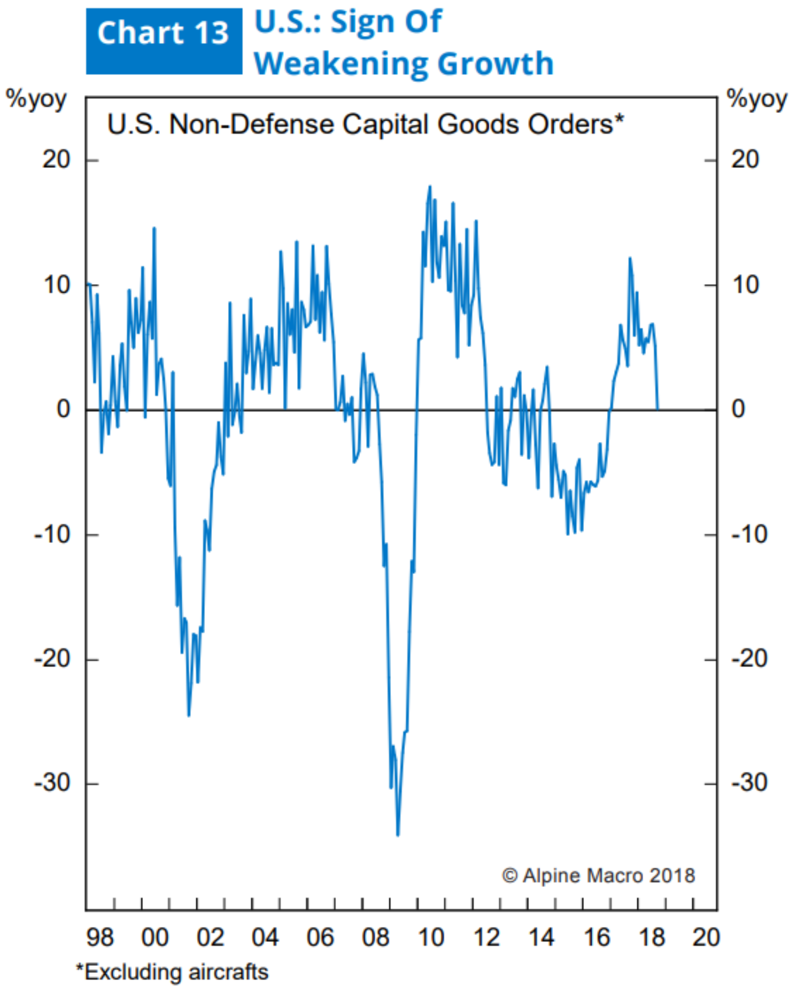



Note: shading denotes Fed tightening
*Shown as 3-month moving average except for the final data point and lagged by 24 months
**Data points removed from September 2009 to February 2010 when P/E spiked

This year the P/E on the market has fallen from 18.2X to under 15.5X. Each time expectations for Fed hikes ratchet up the multiple contracts. And the earnings tailwind we've had all year is moderating.  As you can see below, the number of companies in the S&P reporting higher profit outlooks has fallen dramatically. This doesn't mean earnings are falling, only that the outlook is getting less robust.




Earnings projections are softening in part because the tailwind of the tax cuts will fade in the coming quarters. This is to be expected. What is looking unusual though, is that despite an economy currently growing in the mid-3% range, corporate investment is starting to fade. The chart below shows capital goods orders before defense and aircraft spending. Year-over-year growth has flat-lined. This is surprising. You'd think robust growth would be driving higher orders.

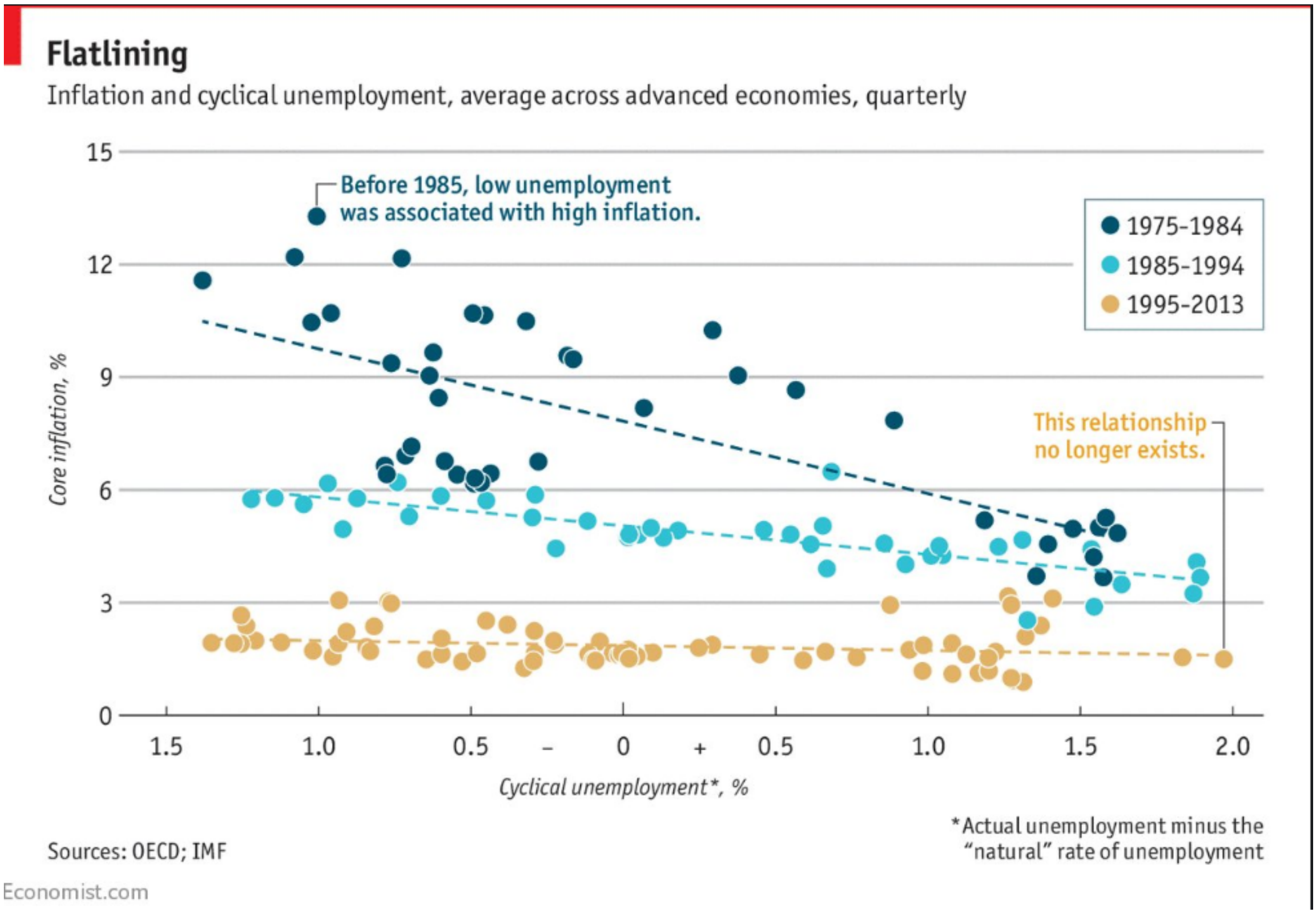



What's going on is fairly straightforward. Current trade policy is making corporations less willing to invest. A simple example is Harley Davidson. How willing are they going to be to order new equipment after China levied tariffs on their core product? But even companies not in the cross-hairs of the trade war with China are likely to be cautious. After all, they could get caught up in this evolving mess next.

Ironically, softening growth in 2019, due in part to the trade situation, could cause the Fed to take a pause as long as core inflation remains under control.

And what if inflation actually doesn't pick up. Cue my favorite chart.

By way of background, the Phillips Curve concept argues that the more unemployment falls the more inflation perks up, or alternatively, higher unemployment leads to less inflation. This chart from The Economist in 2017 says this relationship worked from 1975 to 1984, and sorta worked from 1985 to 1994. However, there was absolutely no relationship between the two variables between 1995 and 2013. The Fed's betting this relationship returns, but what if it doesn't by the middle of next year?




# Janet Yellen Shares Her Thoughts

Along these lines, former Fed Chairwomen Janet Yellen spoke at a conference

Mike and I attended earlier this week. She proved to be a fantastic speaker with a great sense of humor. Some of her comments are worth recapping here.

Even with the recent correction, the market's P/E and Shiller CAPE ratios are still "quite high by historical standards," she said. But stocks are not patently overvalued given that rates are still low and will normalize at a lower-than-average level, higher valuations can be justified.

U.S. recessions are usually due to excesses like in housing prior to the financial crisis and in tech stocks prior to the dot-com collapse. "I am worried about the buildup in debt in the non-financial sector," she said, but there are no buildups in other parts of the economy that concern her.

Most importantly, she said there are no financial trends that "spell the end of a long expansion."

She leans on the moderately hawkish side for the next few months. There is the risk that the economy could overheat given that unemployment is so low. But she thinks her successor, Jerome Powell, can still move in a slow and steady manner.

This was a key comment. She thinks at least a couple more interest rate increases are going to be necessary to stabilize growth and employment. After that she hinted there may be room to take a pause.

She's definitely in the new normal camp. Prior to the crisis the thinking was that a 'normal' fed funds rate was 2% above inflation. Therefore, a 2% inflation backdrop like we have now would imply a 4% fed funds rate. However, slowing productivity rates, a high demand for safe assets and an aging population means the spread might be down to 1%.

Of course, the Fed might need to move past 3% if inflation picks up. The Fed still isn't willing to let inflation run above this level because it might lead to runaway inflationary expectations and inflation could become a self-fulfilling prophesy.

Regarding next year, she thinks growth will slow to a little above 2%. Growth will still be above trend and unemployment will fall further and inflation will be 2.1% to 2.2%.

According to Yellen, if the U.S. economy's capacity to grow increases – for example from Trump's tax cuts boosting investment spending or if the population or labor force grows – then the sustainable growth level would increase. But, she said, what's happening with 3% growth is that unemployment is falling. "The economy can't grow without using up the slack in the labor market," she said.

She's not a fan of the current trade policies. There will be a small impact on inflation, but she is worried about the uncertainty of investment-related spending. Interestingly, she thinks the tariffs will be more deflationary than inflationary.

The national debt is a major problem, Yellen said. We are not facing a "debt crisis," but she said that we should not think of the debt as being low. It is "scary," she said, because as the population ages, the three entitlement programs will rise from 10.5% to 15% of GDP.

Yellen said that she is worried about the role of the U.S. in the global economy, specifically with respect to trade with China and the U.S. abandoning its stabilizing and constructive role on an international level. "The rules that at least avoided protectionism have worked and restrained other countries from damaging U.S. interests," she said. Most countries were part of that world order, she said. But, she said, we are “deep-sixing” those rules in favor of policies that she doesn’t understand.

Yellen said that President Trump views trade as a zero-sum game and not a win-win situation. But it was multilateral and not protectionist policies that have been good for the U.S. and the world, according to Yellen.

Yellen was asked if China could retaliate against the U.S. by selling its large holdings of U.S. Treasury securities. “There is a broad and deep market for Treasury securities,” she said. It is not in China’s interests to dump them. “It would hurt China more than it would hurt us.”

No real surprises in her comments. She’s certainly conflicted on the number of future rate hikes. At one point she suggested two more, but shortly after she stressed the risks of overheating and a 3% neutral rate (which implies four more hikes). But this is almost certainly reflective of the inherent uncertainty of monetary policy. Her view that the tariffs are more deflationary than inflationary is interesting, and this view is starting to be borne out in the capital goods orders. To the extent this is right this could slow growth materially next year, especially if housing continues to soften. But in essence, she sees few risks of recession next year and doesn’t think inflation picks up much either.

Have a good weekend.

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