



The Next Handle

Market Viewpoint: December 6, 2018

Summary: Stocks and bonds have struggled over the last year as yields have risen strongly, but MRP believes this is only the beginning. Further tightening of monetary policy is expected to continue delivering upward pressure on yields as slowing earnings and GDP growth begin to bite.

Capital markets have become grudgingly used to medium and longer-term interest rates having a three handle. Moreover, as indicated in the latest Fed dot plot (September, 2018), short rates will soon have one as well. It wasn't too long ago that the handles on funds and 10-years were zero and one, respectively. But as unfamiliar as a three handle may be to so many of today's investors and traders, it won't be long before they have to get used to and even higher one.

As the year winds down, stock prices are basically flat, compared to where they were at year-end 2017. After rising about 10% to an all-time high in September, markets have been simply jogging in place. Meanwhile, the VIX has doubled and many individual stocks are down over well over 20% from their highs.

Indeed, while pundits cite tariffs, elections, and caravans, the tumult of the past year has clearly been more related to the rise in rates across the curve which has largely offset the spectacular earnings reports from corporations.

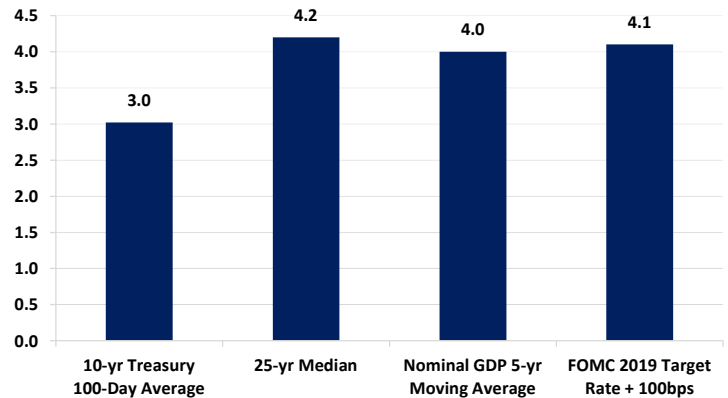
Earnings, however, have been growing well above historic norms. The S&P 500's earnings in 2017 increased 16% YoY. Meanwhile, 2018's are projected to jump 29% from the prior year, clearly illustrating a rapid acceleration of earnings. Over the long run, the average nominal rate of YoY growth in S&P 500 earnings is about 16.3. However, that gain shrinks to 8.5% when outliers are accounted for.

The record earnings this year are the result of a strong economy and the impact of historic tax cuts being compared with year ago numbers when a tax cut was only a hope and the economy had not yet begun to accelerate from its long malaise.

In addition, a previously weak dollar vs the prior year boosted earnings comparisons in the last few quarters as a result of the currency translation effect. Essentially, due to other major currencies' weaker exchange rates versus the dollar, US companies that did significant business overseas saw inflated earnings growth when other currencies were translated into dollars. It is estimated that companies in the S&P 500 generated 44% of 2017 sales from non-U.S. operations.

As earnings growth rates recede towards long-term trends, the question remains where will interest rates go?

Next Handle Guideposts
10-yr T-Bond Yield



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They have already risen dramatically: fed funds are up from near zero to 2.25%; the 10-year treasury had more than doubled to over a three handle. In light of recent market turbulence, the yield has pulled back a bit, but still remains just shy of 3%

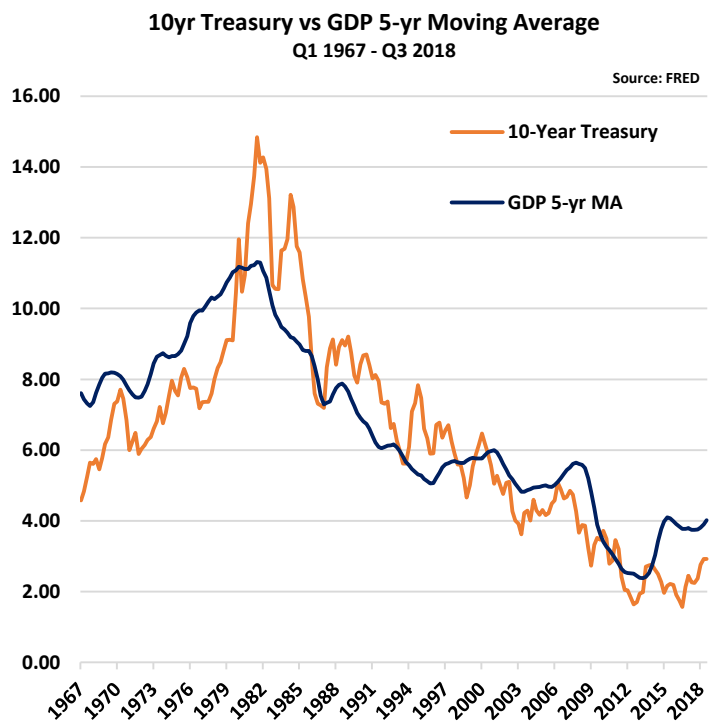
The question is, at what point will rates reach what could be considered normal levels? There are no simple answers to that question, but history can provide some guidance. Back in the 1960s, it was considered normal for the 10-year treasury to yield around 4%, and over the last quarter century, the 10-year averaged 4.2%. Aside from these simple historic benchmarks, there are other measures that provide some guidance.

For instance, there is the relationship of interest rates to GDP growth and inflation. A century ago, Irving Fisher pointed out that the normal level of rates should be the sum of the trend of real GDP growth plus a premium for expected future inflation. According to the most recent CPI, inflation has been reported at approximately 2.5%, with the fed's preferred measure, the personal consumption expenditures deflator, running steadily between 1.8% and 2% for the last several months. 2% is the current target set by the central bank, and we believe it is a safe, if not low, figure for future inflation. Real growth on the other hand has been subpar for many years but is now picking up, and the long-term trend is moving back towards its previous average of 2.5%. Thus, by Fisher's measure, a four handle on the 10-year bond is on the way.

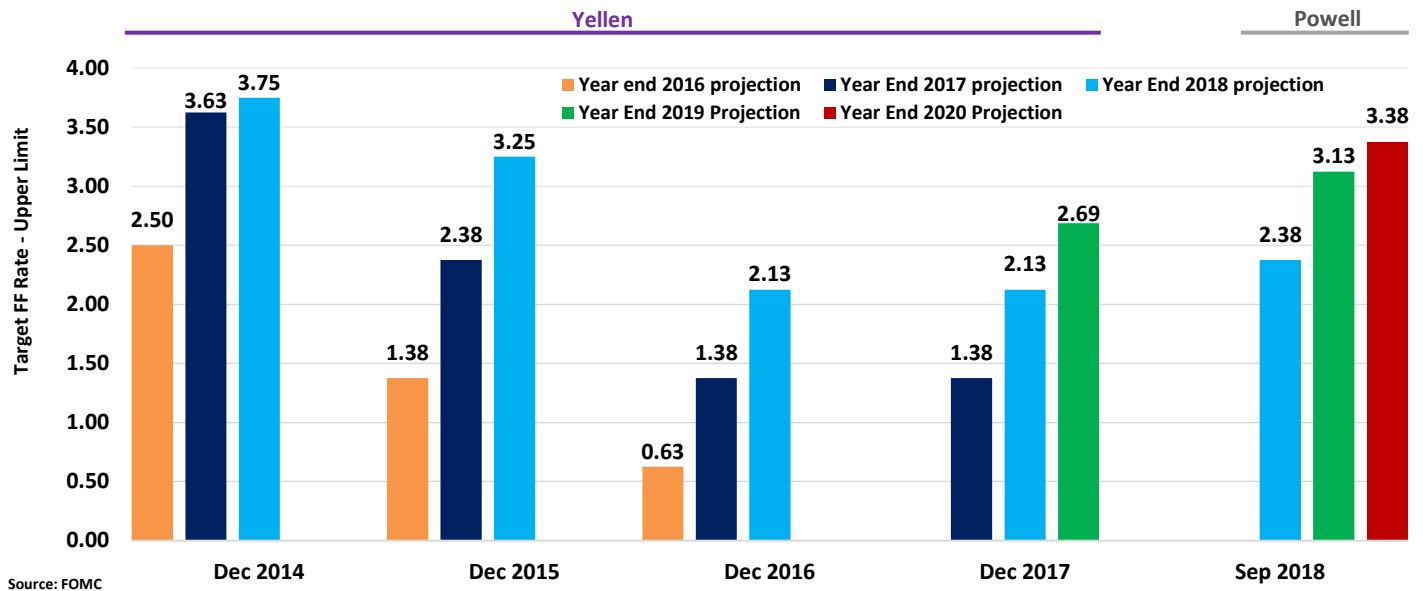
Given the importance of monetary policy and the fact that we know, as of September, where the FOMC expected its fed funds rate to go, looking at the relationship between fed funds and the ten year can provide additional direction. Historically, there has been a roughly 100 basis points spread between the fed funds rate and the 10-year. The FOMC's "Dot Plot" currently shows one more quarter-percent hike in December, for a total of four on the year, plus three more hikes next year and one more in 2020, raising the fed funds rate to 3.25% – 3.50%. Adding 100 basis points on top of that would mean a 10 year of 4.25% – 4.50%. Traders, however, have been skeptical, and are pricing in just one hike in 2019.

Optimism that the Fed wouldn't reach such a level was on the rise recently when many media outlets began reporting that Fed Chairman Powell remarked that interest rates were "just below" neutral, a seemingly dovish change in language from October when he characterized rates as "long way from neutral".

However, the market reaction, which initially saw stock indexes soar, might be a bit over the top considering Powell's full statement read "Interest rates are still low by historical standards, and they remain just below the *broad range* of estimates of the level that would be neutral for the economy"(our emphasis added). Not only does "below" still suggest more rate hikes will be necessary, but also being just below a broad range of estimates, which would imply that even the lowest estimates for a neutral rate were still higher than the current rate, and some would still consider neutral rates even higher – closer to the historic average. Moreover, just as Powell's tone toward the neutral rate has so quickly changed one way, it could just as quickly go the other way. The reality is, the FOMC voters respond to fluctuating inflation numbers in relation to their target, and if the tight labor market and rising wages manage to tick upward, they will respond accordingly.



Down the Up Staircase FOMC Target Rates

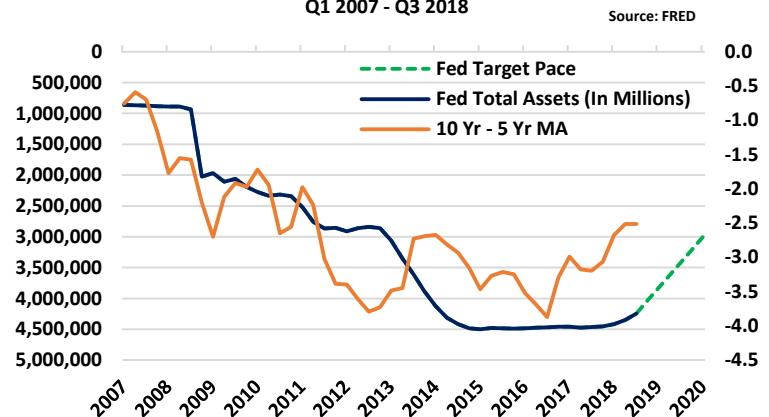


At the end of last year, MRP highlighted [4 disruptions](#) for 2018 which we believed would lead to higher bond yields: balance sheet shrinkage, rising short term rates, the changing of the guard at the Fed, and global growth expectations.

Most observers would attribute suppressed bond yields over the past decade to the unprecedented impact of quantitative easing distorting pricing in the fixed income markets, among other things. The 3 episodes of QE in which the Federal Reserve bought various government and other bonds, paying for them by printing new currency and expanding bank reserves, resulted in a more than four-fold rise in the Fed's balance sheet. In other words, new high-powered money created out of thin air appears to have been the primary force holding down yields from their natural level. Thus, plans by the Fed to begin shrinking its balance sheet last year, albeit gradually, marked a major turning point.

A little over a year on, the balance sheet shrinkage has been a mixed bag; the Fed has stuck to the plan but has been less aggressive than anticipated and fallen off their projected path. Last year, \$1.4 trillion of the \$2.5 trillion in treasuries had maturities of less than 5 years. By allowing these to perpetually mature, the Fed was expected to reduce total assets to less than \$3 trillion by 2020 from the massive \$4.5 trillion they had accrued during years of quantitative easing. In practice, the Fed has shed \$354 billion worth of assets since the beginning of October 2017, an average of around \$60 million per week. For the Fed to meet its stated goal, however, they should be dumping twice as much, approximately \$124 million per week.

Inverted Fed Total Assets vs 10yr Yield - 5yr Moving Average GDP



Regardless, the work they have already done played a part in sending the yield on the 10-year to 3.20% earlier this fall, its highest level since May 2011, and an increase of over 180bps from the July 2016 trough. However, recent doubt about the Fed's rate path from Fed Chairman Powell's aforementioned remarks have sent yields downward, but still within range of maintaining the psychologically important 3% mark.

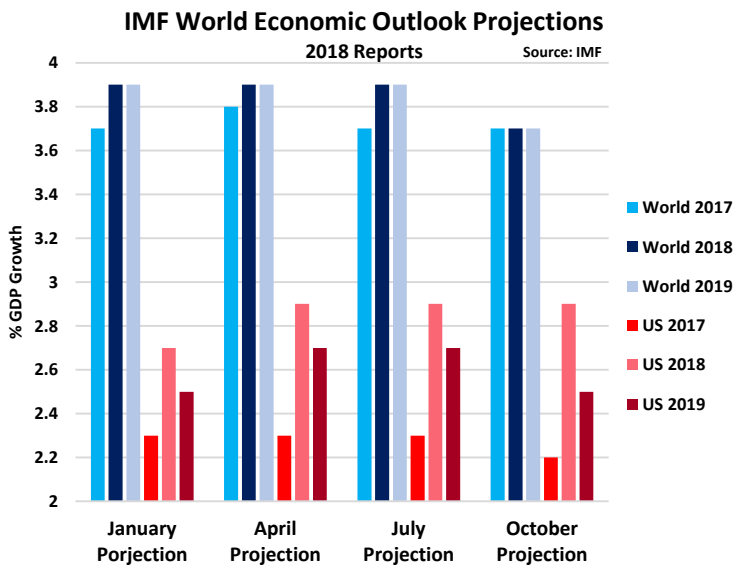
Another Fed-related factor that had kept long-term rates down has been the near-zero Fed Funds (FF) rate maintained for so many years after 2008. Since 1971, once a tightening cycle commences, the Fed has raised rates 6 times on average during the first two years. Between December 2015 and December 2017, the Fed raised rates only 5 times, indicating that

the early part of the tightening cycle was actually a bit dovish. Moreover, those five hikes had only brought FF upper limit back to 1.5%, compared with an average level of 5.30% over the past 50 years and a median of 5.25%.

Since Jerome Powell took over for Janet Yellen as Chairman of the Fed last February, things have been a bit more hawkish. As mentioned earlier, the Fed has already hiked rates 3 times in 2018, bringing the FF rate to 2.25%. That boost, according to the Fed's "dot plot", is expected to be followed by 1 more hike in December and 3 more hikes in 2019. When a tightening cycle commences, net hikes average about 3 per year since 1983; Chairman Powell's predecessor averaged less than 2 per year. If the FOMC adds the December hike, Powell will be more than doubling Yellen's average.

Powell's determination to stay on track has defied the pattern that investors were used to in the post-financial crisis era: strong rate-hike projections followed up by less optimistic goals as time went on. For instance, at the FOMC's December 2014 meeting, voters projected a median rate of 3.63% for year-end 2017. Suffice to say, they didn't even come close. Decreasing expectations, as well as strong skepticism in the futures market, followed.

However, Powell's first 8 months in office have not only reversed this trend, but revived confidence in the futures market. It remains to be seen, though, how the Fed will respond to slowing growth prospects. Investors will get greater clarity from the Fed meeting in the third week of December. Disclosure of the new dot-plot and remarks from Fed officials will be critical.



While the US has managed to stimulate economic growth to its fastest back-to-back pace in 4 years, the IMF has begun to reduce growth projections going forward. US Q2 and Q3 GDP growth tallied 4.2% and 3.5%, respectively, and until July, the IMF had been raising expectations for next year's growth as well. In the October edition of their World Economic Outlook, the Fund pulled back their expectations for 2019 from 2.7% to 2.5% on the back of the US's new trade duties, targeting imports from China and other countries that the Trump administration feels have taken advantage of the US.

The global economy as a whole is also feeling the squeeze, with the IMF pulling back their growth forecasts for 2017, 2018, and 2019.

A year ago, MRP highlighted the accelerating global economy as a weakness for the bond market, as stronger growth would encourage the Fed to continue raising rates. Even though growth expectations have begun slipping, the Fed has reiterated its desire to stay the course in their tightening policy. A survey of 58 economists by the Wall Street Journal also finds confidence in the Fed's path, projecting four more rate increases from December through the end of 2019. Therefore, it stands to reason that even a bit of a slower pace of growth would still be significant enough to continue pushing up rates.

Growth is only one part of the equation, however. The Fed's confidence in their rate hike schedule comes from the resilient inflation figures we have seen throughout the year. Although CPI growth has backed off a bit from its 6-year high of 2.9% in July, MRP believes that it is only the calm before an inflationary storm. YoY wage growth in October rose 3.1%, the fastest pace in a decade, largely due to the exceptionally strong labor market. With unemployment at a 49-year low of 3.7% and nonfarm payrolls just off a 19-month high, it would not be surprising to see wage growth continue above the 3% mark in the coming months, which in turn, could finally push PCE growth past the Fed's 2% target.

However, given the broad decline of oil and other commodity prices over the last couple of months, it's worth noting that these inflationary effects may be dulled for a few months going forward.

Over the past year, interest-rates have risen strongly, but so have earnings, exceeding expectations, and should continue to rise through the remainder of the year. With Stocks roughly flat on the year, the P/E for the market has fallen. In the face of higher interest rates, the result makes sense and is what one would expect based on the historical experience.

Most recently, markets have surged on news of a cease-fire in the so-called trade war between the US and China. This is undoubtedly good news and will be a positive force in the outlook and 2019. Nonetheless, in the year ahead, we expect to see interest rates climb even further, but earnings growth should slow down considerably. And in the valuations tug-of-war that would ensue, market prices will be the loser. The link, of course, is the relationship between bond interest rates and the earnings yield (the inverse of the price earnings ratio).

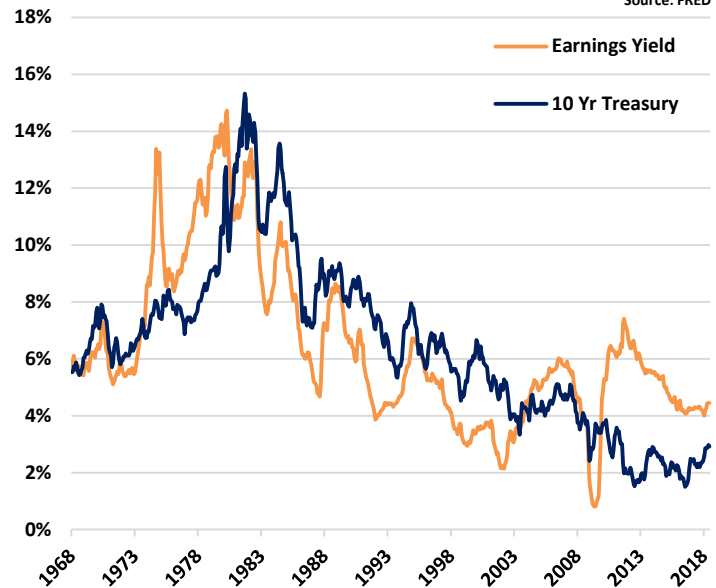
Shown in the accompanying graphic, interest-rates and the earnings yield of the S&P 500 have moved closely together over the years. At times when rates have risen, the discount rate applied to the future stream of earnings over time would logically have risen as well, pushing up the measured earnings yield. If earnings were not growing fast enough to offset that force, stock prices would eventually fall. With earnings growth likely to slow but interest-rates likely to rise further in the year ahead, equity market prices are likely to move lower.

Looking forward, MRP expects the trends which defined bond market performance in 2018 to continue through the next year. In addition, we believe that inflation will tick up even further, after a brief lull this month, to support action by the Fed in tightening monetary policy. Even if at a slower pace than originally projected, balance sheet shrinkage should continue. Following the Fed's stated path, which Chairman Powell has been adamantly supportive of, the next handle will be a four handle and the earnings yield will be adjusting further upward.

Earnings Yield vs 10 Year Treasury

Jan 1968 - Jun 2018

Source: FRED



Joe Mac

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