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MACROCOSM

Crash Without a Cause?

Tuesday, February 6, 2018

Donald Luskin

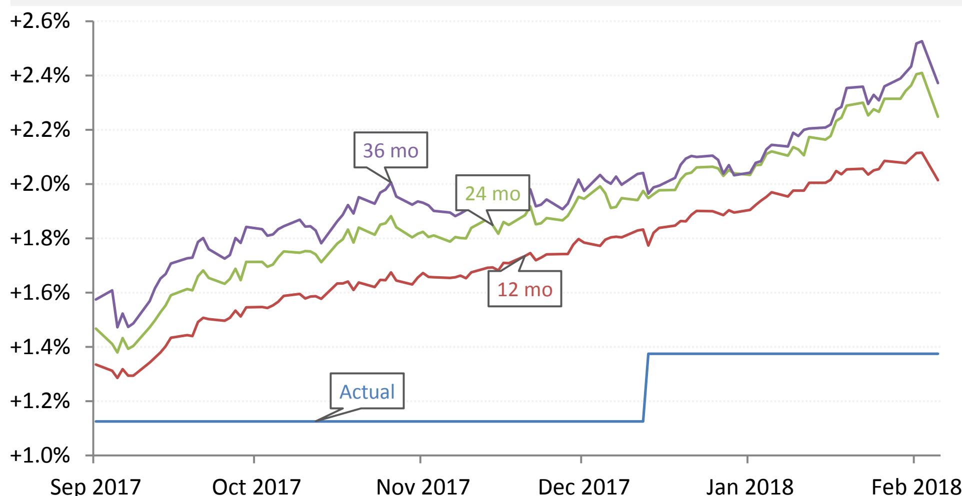
Stocks got cheaper because they got riskier, and risker because they got cheaper. That's all?

Obviously we were far too optimistic in yesterday morning's report – *we most definitely did not predict that the first equity market correction worthy of the name in a year-and-a-half would more than double its depth within a single day* (see "It's Just the Reflation Trade, People!" February 5, 2018). *Just as obviously, it leaves us wondering what Mr. Market knows that we don't know, and just how scared we should be about it.*

But what if there is no cause? What if it's just an inevitable and overdue random correction – maybe algo-amplified? What if there is nothing to be scared of? What if it's just another reflection of the perverse mass-psychology of cognitive dissonance that has informed this entire unloved bull market – the need to constantly back away from acceptance, and cling to denial that the world is finally pulling out of secular stagnation?

- It would fit, then, that it might be a tantrum for the education of new Fed Chair Powell (please see the chart below, and "On the January FOMC" January 31, 2018). But objectively the conventional narrative about yields and inflation and a tighter Fed doesn't wash (see "On the January Jobs Report, and the Yield Back-Up" February 2, 2018). It was bad form for departing chair Janet Yellen

Curve-implied forward fed funds rate versus actual



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, US FED, US MACRO: We can't identify a cause for this extremely violent correction in equities except to interpret it is further evidence of the cognitive dissonance that has informed this unloved bull market, the need to not accept that the global economy is pulling out of secular stagnation. We have a long list of things that didn't cause it, including all the conventional narratives about yields, inflation and the Fed. It may in fact be causeless, like the algo-fueled crash of 1987. The equity risk premium has blown out from near cycle tights to the post-crisis mean, so suddenly stocks are fairly valued. That's not in and of itself a buy signal. But with the first-order earnings bump from tax cuts almost complete, second- and third-order effects in the offing, and a synchronized global growth acceleration underway, it's a gift to be able to buy stocks at fair value.

[Strategy dashboard]

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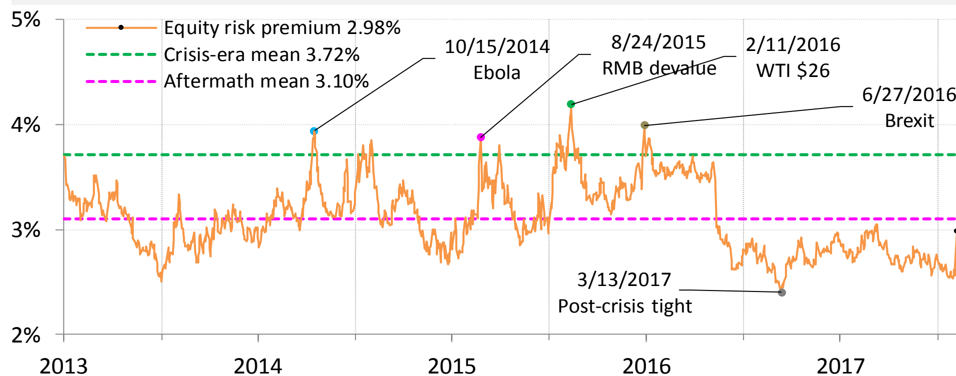
to announce sanctions against America's largest bank on her way out the door to do a PBS interview in which she said stocks were overvalued – but punishment for Wells Fargo was inevitable, and Fed chairs' views on equities are worthless (see "Bull Market, Meet Your New Fed" January 29, 2018).

- We suppose it doesn't help sentiment to have bitcoin collapse, but this isn't the first time, and it's a market much smaller than its publicity.
- *Several clients are adamant that this correction is about the risk of the GOP losing congressional control in the mid-term elections*, stalling or reversing the Trump growth agenda, or miring the country in an impeachment circus. At year-end we ourselves identified that risk as 2018's most salient (see "2018 Outlook: From Denial to Acceptance" December 29, 2017). We'll write more about this over the next several days. For now, we'll just say we don't see much in the way of *new developments* in that long-standing risk that would have triggered this correction. Remember, not everything is about Trump, his own views on that and the ludicrous *Washington Post* headline this morning "Is Trump driving the stock market selloff?" notwithstanding.
- *Other clients are adamant that his is an algo-fueled pathology.* We lived through the crash of 1987 *very* up close (we pushed the red button personally), so we know from experience that such things are possible. In such events bystanders wrongly infer information from price changes, further contributing to self-sustaining momentum. Stocks become cheaper because they are riskier, and they become riskier because they are cheaper. Like Seinfeld, it is about nothing.
- The only sense to it is the fear that hyper-volatile prices signal that some levered strategy is in its death-throes, and is about to take a systematically important bank down with it.
- *Meanwhile, in just a week, the valuation picture has profoundly changed.*
- We've been on correction-watch for three weeks (see "A Year of Upgrades in 16 Days" January 16, 2018), thinking it would be triggered when the S&P 500 equity risk premium challenged its post-crisis tight of 2.40%. It got within 14 bp, but we didn't pull the trigger. We should have.

S&P 500 equity risk premium in the crisis aftermath From July 2013



Source: Various, TrendMacro calculations

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ECB
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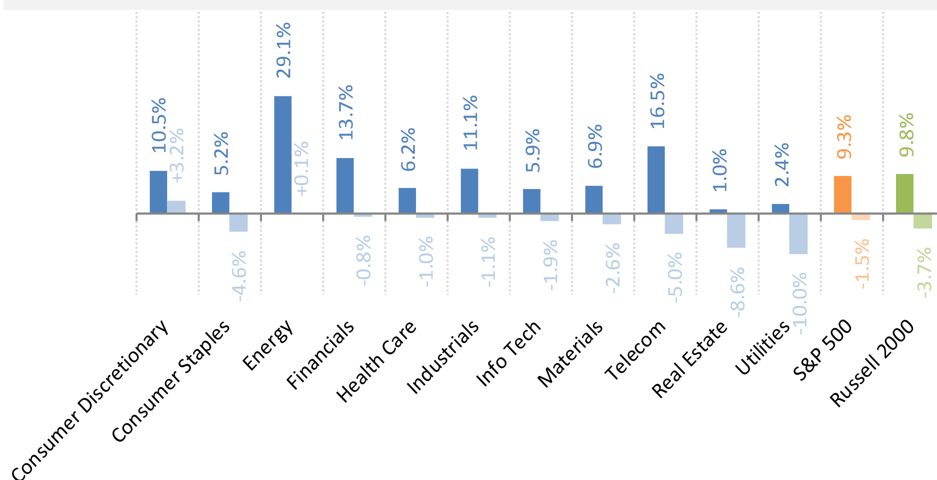
- This correction has been so violent that the S&P 500 ERP has now blown out to just 12 bp from the post-crisis mean. *US equities are fairly valued now* (please see the chart on the previous page).
- *To make a great market call, we like to see a confluence of valuation and event. We don't really have either one here.*
- "Fairly valued" is a comfort, but it isn't a buy signal. It's a neutral signal, a state of informationlessness.
- And, again, we're having a hard time seeing anything but a non-event here.
- The four great buy signals since the end of the Global Financial Crisis – one each in 2014 and 2015, and two in 2016 – were each associated with a peak equity risk premium above the crisis-era mean, and an identifiable event-shock (again, please see the chart on the previous page). Each corresponded with the climax of a large correction in equities, and TrendMacro published reports calling the bottom each time because of the convergence of *both* superior value *and* non-consensus insight into the event (for example, see "Something You Probably Didn't Know about Ebola" October 14, 2014).
- In this case, the value isn't compelling, except that it's better than it was. And we can't claim insight into the event, except to list all the things we're pretty sure it's not.
- But we can work with that.
- *If it is true that this correction is basically causeless – nothing but a random fright of the kind that markets typically stumble into from time to time, especially after prolonged quiet periods – this one possibly algo-amplified – knowing that truth is quite useful.*
- *It liberates us from having to guess what's going wrong (because surely something must be!) to focus on what's going right. A lot is, in fact, going right.*
- S&P 500 forward earnings are up 9.3% in less than two months since the Tax Cuts and Jobs Act was enacted, most of the way toward fulfilling our forecast of 11% growth (please see the chart below, and "Tax Cuts: Smells Like Victory (For Some more than

Change in ■ forward earnings and ■ stock prices from Dec 18, 2017



Source: Bloomberg, TrendMacro calculations

Others)" December 18, 2017).

- That's going to be a powerful stimulus to what is already a synchronized global growth acceleration – and that's just the first-order effect. Next comes the capital investment boom driven by new projects made feasible by lower tax rates. After that comes the race-to-the-top of global tax competition.
- And while stocks might not be cheap by historical standards, with forward earnings up 9.3% and stocks off 1.5% (again, please see the chart on the previous page), at least they're cheaper than they were. The forward price/earnings ratio for the S&P 500 has fallen from 18.5 to 16.7.
- *We're not putting that out as a value argument. And who know how to time this – it's in the hands of the gods, and the gods must be crazy (or the algos are). But if we're right, if this correction is fundamentally causeless, then just take that lower P/E as a gift.*

Bottom line

We can't identify a cause for this extremely violent correction in equities, except to think it is further evidence of the cognitive dissonance that has informed this unloved bull market, the need to not accept that the global economy is pulling out of secular stagnation. We have a long list of things that didn't cause it, including all the conventional narratives about yields, inflation and the Fed. It may in fact be causeless, like the algo-fueled crash of 1987. The equity risk premium has blown out from near cycle tights to the post-crisis mean, so suddenly stocks are fairly valued. That's not in and of itself a buy signal. But with the first-order earnings bump from tax cuts almost complete, second- and third-order effects in the offing, and a synchronized global growth acceleration underway, it's a gift to be able to buy stocks at fair value.