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MACROCOSM

Risk-Back-On in a Week of Tape-Bombs

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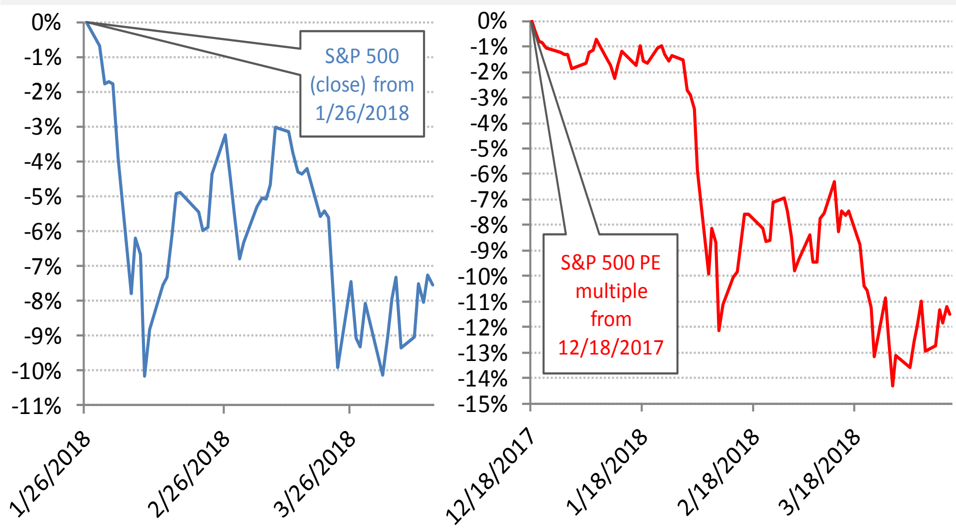
Donald Luskin

The February bottom has been tested, with valuations having fallen further than equities.

With almost precisely two years since the previous 10%-plus stock market correction, and 211 market days without any kind of correction at all, we naturally rebel against thinking that the S&P 500's 10.2% 9-day correction (from the late-January high to the early-February low) has been sufficiently painful for us to be able to declare it to be over.

- *But the correction has actually been deeper and longer than it seems.*
- *On an intra-day basis, the S&P 500 corrected 11.84% over 10 days. But the real correction has been in valuation. The S&P 500 forward price/earnings multiple peaked at 18.5 on December 18, and contracted as much as 14.3% to 15.9 on March 28, 68 market-days later* (please see the charts below).

Stock market correction: the price dimension, the valuation dimension



Source: Bloomberg, TrendMacro calculations

- *Why? Because while stock prices have been correcting lower, forward earnings have been marching steadily higher, with a rocket-powered burst in January as estimates took onboard the new lower corporate tax rate* (see "A Year of Upgrades in 16 Days" January 16, 2018).

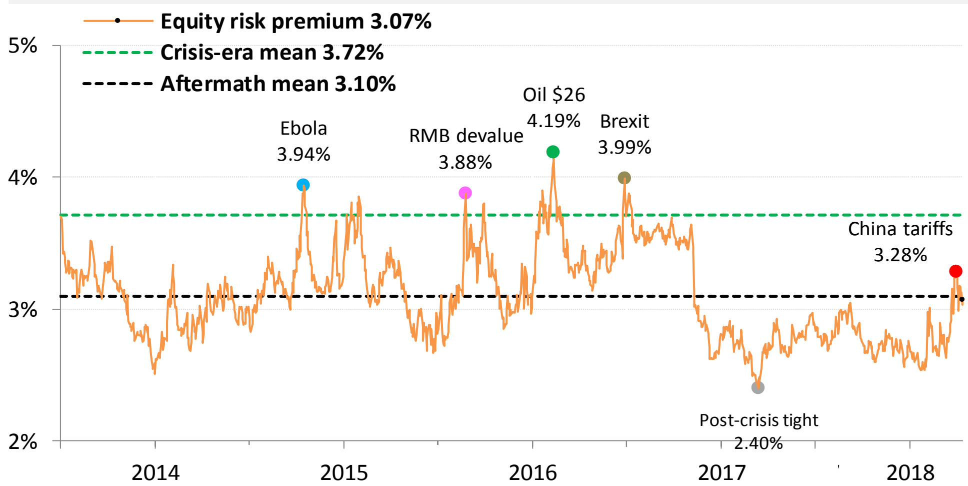
Update to strategic view

US STOCKS: The successful test of the February lows by risk-assets from the S&P 500 to Bitcoin, and last week's relative tranquility in markets, despite a challenging news environment, indicates that risk-tolerance is beginning to flourish again. We are marking April 2 as the high in the S&P 500 equity risk premium. The correction from the January top occurred as earnings surged, so valuations have corrected more than prices, creating a cushion under equities. We have probably seen the worst. The trade war-of-words has settled into a stable game in which negotiations can take place. Powell's FOMC minutes were a train-wreck, but markets have learned not to care. Zuckerberg's testimony shows that slavish fascination with Facebook is intact. Syria was never market-moving to begin with. The biggest risk factor now is the expanding scope and increasingly brutal tactics of the Mueller investigation, which seem designed to goad Trump into over-reacting.

[Strategy dashboard]

- So if hefty valuations in December and January meant stocks were working without a net, they have a nice cushion now.
- *The February lows were revisited and successfully tested in early April – across risk assets from the S&P 500 to the FANG stocks to Bitcoin. And the markets' response last week to a series of tape-bombs indicates that risk-tolerance is rebounding. Restoration of confidence can be a slow process, but we think we may have seen the worst.*
- *So we're going to mark – at least conditionally – the 3.28% equity risk premium for the S&P 500 on April 2 as the peak in this move* (please see the chart below).

S&P 500 equity risk premium Earnings yield minus 30-yr yield, from Jul '13



Source: Bloomberg, TrendMacro calculations

- *This would be consistent with our long-standing view that risk-preference has shifted to a new more tolerant regime, with peaks in the equity risk premium no longer occurring above the crisis-era mean, but instead above the lower post-crisis aftermath mean* (again, please see the chart above, and "2017: It's Bigger than The Donald" December 30, 2016).
- To be sure, there are very real risk-factors underlying the correction – among others, a trade war-of-words (see "Tariffs: How Scared Should We Be?" March 2, 2018), a new dilettante Fed chair (see "Chairman Powell, You Have Just Been Hazed" February 22, 2018) and a critical re-examination of market leaders Facebook and Amazon (see "DeFANGed" March 28, 2018).
- *But we think risk-factors is all they are* – and while they do represent increased expected risk, we don't think they imply lower expected returns. Indeed in some sense we think they improve them (see "On the China Tariffs" March 22, 2018). So the key, for us, is to judge how the market is dealing with the subjective indifference-curve that trades off higher risk and higher return.

Obviously, that judgment hangs on our premise that these and other risk-factors are not going to turn out to be objectively destructive, but only a matter of the markets' risk-tolerance while they play out. Let's take a look.

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THE CHINA TRADE INITIATIVE The strategic oscillations have damped down, as the counterparties settle into stable game-theoretic positions.

- When this all started, markets feared that President Donald J. Trump wanted tariffs for their own sake (again, see "Tariffs: How Scared Should We Be?"). *We said all along that tariffs were only a threat*, designed not to restrict global free trade, but rather to force China and other protectionists to open their economies more reciprocally, in order to actually improve global free trade.
- Within weeks, the conventional wisdom took that view onboard – to a fault, with a widespread belief that Trump was simply bluffing, to which China responded with counter-bluffs of its own (again, see "On the China Tariffs"). To re-establish negotiating credibility, Trump had no choice but to triple-down on his tariff threats (see "On the March Jobs Report, and New China Tariffs" April 6, 2018).
- *It speaks volumes that equity markets didn't need to make new lows on this in early April, but rather took the opportunity to successfully test the February lows. Apparently they are becoming risk-tolerant enough to realize that negotiations for peace only come when the risk of war is at its maximum.*
- Last week both sides offered substantive conciliatory messages. China's Communist Party Secretary General Xi Jinping spoke Tuesday not of reprisals, but of China's willingness to open its economy more fully and enforce intellectual property rights. The US, for its part, released the Treasury's semi-annual report on foreign exchange policies, and for the third time since Trump's inauguration, failed to brand China a "currency manipulator" (which Trump had repeatedly promised to do on the campaign trail). It wasn't even a close call. China was graded higher than Switzerland.
- *But the credible threat of war must be maintained.*
- So lower-lever sources on both sides planted stories – about China's willingness to "fight back," and about the US's intention to "focus on new tariffs." *We are encouraged that markets didn't worry about these tape-bombs, but instead interpreted them as just the next moves in what has become a stable game – one with high risk to be sure, but one that has the prospects of eliminating an imbalance that has been a drag on growth for almost two decades.*

THE POWELL FED The release last Wednesday of the minutes of the March FOMC was the fourth opportunity for markets to react to the work-product of new Fed chair Jerome Powell. *It was the first time that markets didn't react to Powell strongly on the downside* – as they had in response to the January FOMC minutes (again, see "Chairman Powell, You Have Just Been Hazed"), Powell's semi-annual testimony (see "On Jerome Powell's Testimony" February 27, 2018) and the March FOMC (see "On the March FOMC" March 21, 2018).

- *It's not that Powell has gotten any more coherent. Quite the contrary* – *the minutes portray his first FOMC as chair as a rudderless ship drifting randomly through a sea of conflicting notions* – at one moment advocating a "modest inflationary overshoot," and then at another advocating a "steeper path…for the federal funds rate."

- There was no way to tell how serious these and other musings might be. The support for them was characterized, variously, as coming from "participants" (11 times), "several participants" (4 times), "many participants" (4), "a number of participants" (4), "a strong majority of participants" (1), "a few participants" (10), "most participants" (2), "some participants" (2), "almost all participants" (2), and "a couple participants" (2 times). At least we know what "all participants (4 times) means – but when we figure out the difference between "a few" and "several," or between "almost all" and "a strong majority," we'll let you know.
- The good news is that markets' non-reaction to all this silliness means that they have taken on board what we have said all along – the words that come out of Powell's mouth, or under his aegis, should not be processed as though they came from a sophisticated economist such as Ben Bernanke or Janet Yellen, that is, as a kind of code, bearing important encrypted messages about future policy. We're not trying to be unkind to Powell as an individual – but he is what he is, and he isn't what he isn't. Good strategic market calls will only come from being realistic about him.
- *One more time: Powell is the first non-independent Fed chair since G. William Miller in the late 1970s* (again, see "On the March FOMC"). As such, his policy positions have no meaning outside the wishes of the Treasury Secretary and the President. *Therefore Powell is, by construction, a dove* – because there has never been a Treasury Secretary or a President who wanted to cause a recession.
- *For the purposes of today's analytical framework, Powell remains a higher risk than Yellen because he is an unknown – and the staffing of the many open Board of Governors seats is another lesser unknown. But alongside that higher risk is the higher expected return of having a captive Fed that is highly unlikely to make a contractionary policy error. That markets brushed off Powell's latest bit of silliness last week means that they are becoming willing to trade off that higher risk to get that higher return.*

FACEBOOK Not much to say here – but maybe that's the point. The crisis that drove last week's Congressional testimony of Facebook CEO Mark Zuckerberg never struck us as fundamental to his company's business model or future earnings – but only as a risk to investor confidence in the cluster of stocks that have provided market leadership for the last couple years (again, see "DeFANGed"). *If anything, the rapt fascination Zuckerberg's testimony commanded implies that confidence, if not slavish devotion, is very much intact.*

SYRIA We had a number of conversations last week with clients who were worried about the risks of a possible US attack on Syria, as punishment for a repeat use of chemical weapons. *We have never seen this as market-moving, except in the sense of extreme tail-risk.*

- Just to get it out there – widened Western involvement in Syria could trigger a military or diplomatic accident that would impinge on oil supplies. Or Trump's political needs to appear tough on Russia – Syria's patron – could drive further sanctions (against holding Russian sovereign bonds, say) that might interfere systemically with financial markets. *But these are not realities, only remote risks, once again implicating the markets' ability to tolerate them.*

THE MUELLER INVESTIGATION We can't point to any evidence that the ongoing Special Counsel investigation into Russia collusion by the Trump campaign has ever been specifically market-moving. Perhaps that's because markets assume that it is absurd on the face of it that such collusion could have taken place (that's certainly how we feel). *But in our view that changed last week with the FBI raid on Trump's attorney Michael Cohen*, which shows both that Mueller's limited remit has expanded into unrelated investigations targeting Trump, and that Trump's antagonists are willing to take extraordinarily harsh measures to bring him down.

- *What concerns us most is that the raid on Cohen is both so tangential and so heavy-handed that it seems deliberately calculated to goad Trump into exercising the risky "nuclear option" of firing Special Counsel Robert Mueller, Attorney General Jeff Sessions, Deputy Attorney General Rod Rosenstein or FBI Director Christopher Wray.*
- *It's getting to where Trump's base must be beginning to wonder why we doesn't just man up and do it.* Trump's pardon of I. Lewis "Scooter" Libby was a suave holding action – a display of power with little political cost (or, more cynically, a signal to Trump's associates that he will reward their silence). Clever either way.
- *Either firings on the one hand, or criminal charges on the other – especially if those charges seem peripheral or technical, yet are nonetheless real – would bring on a period of existential uncertainty about regime-stability that would, at least at first, be very challenging for markets.*
- *For us, this was last week's biggest tape-bomb, and for the first time we are now concerned that it won't just fade away. But the fact that markets were so insouciant about it tends to confirm our thesis that risk-tolerance is beginning to flourish again.*

Bottom line

The successful test of the February lows by risk-assets from the S&P 500 to Bitcoin, and last week's relative tranquility in markets, despite a challenging news environment, indicates that risk-tolerance is beginning to flourish again. We are marking April 2 as the high in the S&P 500 equity risk premium. The correction from the January top occurred as earnings surged, so valuations have corrected more than prices, creating a cushion under equities. We have probably seen the worst. The trade war-of-words has settled into a stable game in which negotiations can take place. Powell's FOMC minutes were a train-wreck, but markets have learned not to care. Zuckerberg's testimony shows that slavish fascination with Facebook is intact. Syria was never market-moving to begin with. The biggest risk factor now is the expanding scope and increasingly brutal tactics of the Mueller investigation, which seem designed to goad Trump into over-reacting.