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MACROCOSM

That Quarter, Those Yields, This Correction

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Donald Luskin

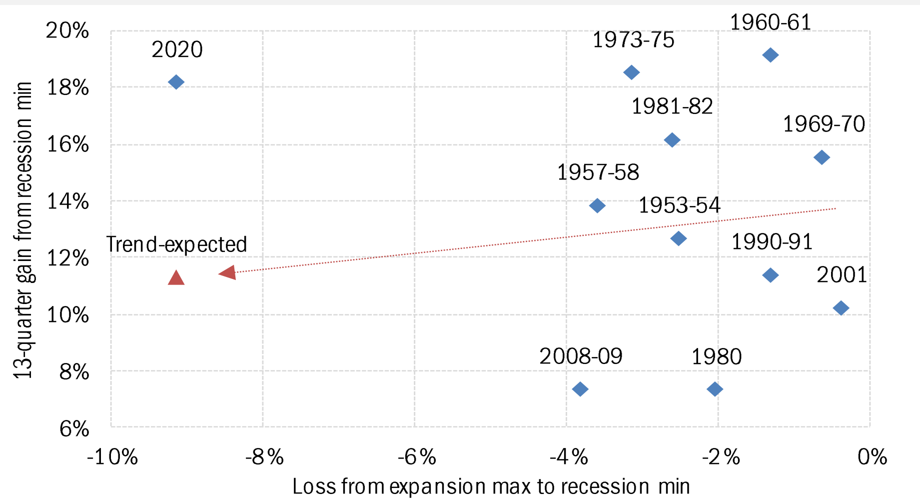
A sharp equity correction when there should have been a blow-off top. What happened?

The present correction in US equities is troubling, down more than 10% at yesterday's lows from the highs of July 27. It's weird, happening against the backdrop of an astonishingly strong Q3-2023, confirmed in yesterday's report of 4.9 real GDP growth (see "Data Insights: GDP" October 26, 2023).

- Just to put this in context, it is amazing to see a number like that 13 months after a recession trough, with the exuberant "V-shaped recovery" dynamic far in the rear-view mirror.
- Q3-2023's 4.9% is more than twice the average 2.4% in the prior expansion following the Global Financial Crisis.
- Based on the norms of the post-war business cycle history, given the extreme depth of the pandemic recession – a brief depression, really – we would expect real output to have grown 11.3% cumulatively over 13 quarters from the June 2020 trough. In fact it has grown 18.2% (please see the chart below, and again "Data Insights: GDP").

At the same time, S&P 500 consensus year-ahead earnings estimates have recovered to a new all-time high at $2.14 trillion – or $237.9 per share – after an 8-month recession following the Fed's first 75 bp rate hike in June 2022 (see "What you're not hearing… five fun facts about the US economy"

Relation of subsequent GDP growth to recession depth



Source: BEA, NBER, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO, FEDERAL RESERVE, US BONDS, OIL, GOLD: US stocks are in a 10%-plus correction. We'd expected a sharp correction, but we'd also expected a run to new highs first, which hasn't happened. We expected the Fed to recognize that inflation, properly measured, has already more than achieved its target; instead, it has doubled down on a "higher for longer" strategy. A boom in Q3-2023 only makes it worse, because the Fed wrongly believes that growth causes inflation, and has said it is on the alert for upside growth surprises. But that means this correction has taken "peak hawk" on board already, and has probably run its course. High long-term yields are a fear factor for systemic risk, since even lower ones were enough to take out Silicon Valley Bank. While they represent risky "regime change" as the economy matures out of the post-GFC era of "secular stagnation," it is a good thing to move to a higher growth epoch. We don't expect a surge to new highs in yields, because we don't see…

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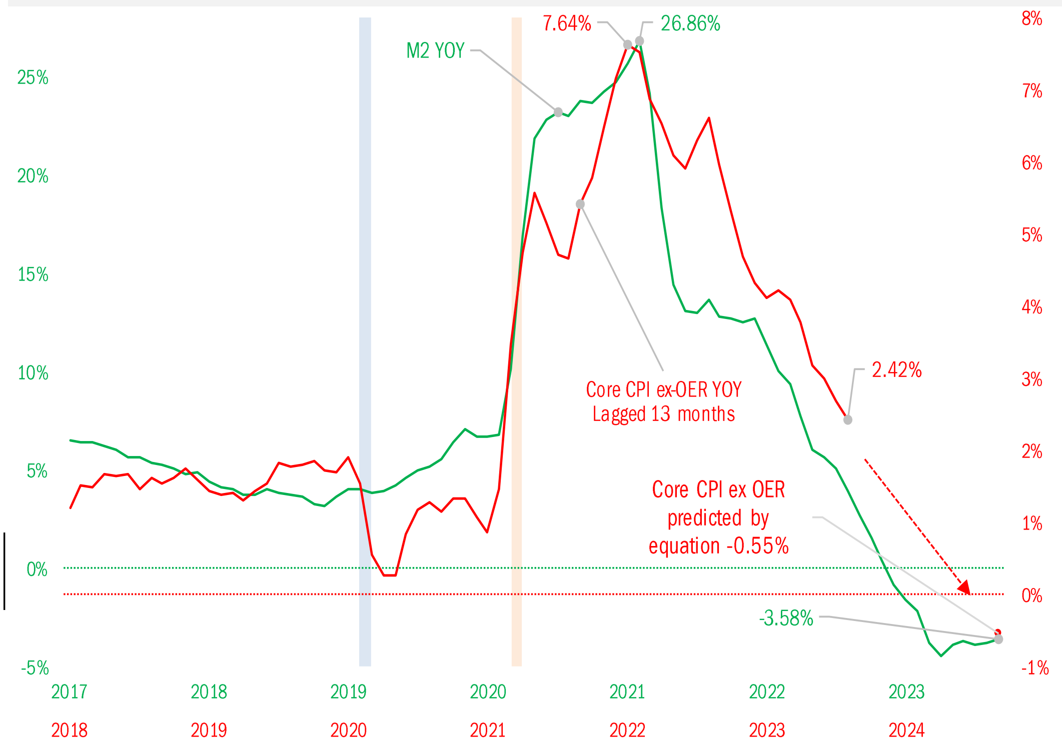
October 18, 2023). So it's not like Wall Street thinks the big Q3-2023 GDP number is a head-fake.

We've been calling for a big correction since June (see "Video: What you're not hearing about the coming deflation" June 23, 2023). *But no victory laps for us. We thought there'd be a new high first, a blow-off top – and that hasn't happened*. We have already reflected that it might be because China's lapse into deflation is sending an early signal of the rocky monetary road that all the large economies are on (see "It Can Happen There (China)" August 18, 2023).

- But more likely, it's because we have been wrong yet again about Fed Chair Jay Powell's ability to simply look at the statistics and realize that last year's intense inflation threat has already been conquered – all the way back to the Fed's target – and with no recession.
- What? You didn't know that inflation is already back to target? *It's actually below target, and deflation is the next likely step*. As of the most recent data, for September, core CPI ex-OER is at 2.42% year-over-year – as predicted by our monetarist model (see, among many, "Inflation Has Peaked -- Get Ready for Deflation" May 24, 2023).
- That's the true measure of the inflation signal, filtering out components that are too volatile or too laggy. For any CPI-based index, the Fed's target is 2.5%. *So this is more than a win*.
- The problem is that it's Powell who uses an idiosyncratic inflation gauge. *He clings to his own personal private secret inflation index –*

Monetarist model: M2 year-over-year growth versus CPI inflation, 13-month lag



Source: Federal Reserve, BLS, NBER, TrendMacro calculations

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… how the economy could accelerate from what is already a boom in Q3. Research tentatively shows that high yields do influence subsequent output growth – but surprisingly, they help it. We are mindful of black swan risks in the current Israel situation, but so far risk-sensitive markets like oil and gold are showing nothing to worry about.

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core PCE services ex-shelter, comprising a minority of the index weight. At 4.30% year-over-year, he worries that it remains "sticky," when in fact it is only laggy (see "Data Insights: PCE Inflation" October 27, 2023, and "Video: What you're not hearing about the big lie of 'sticky inflation'" July 31, 2023).

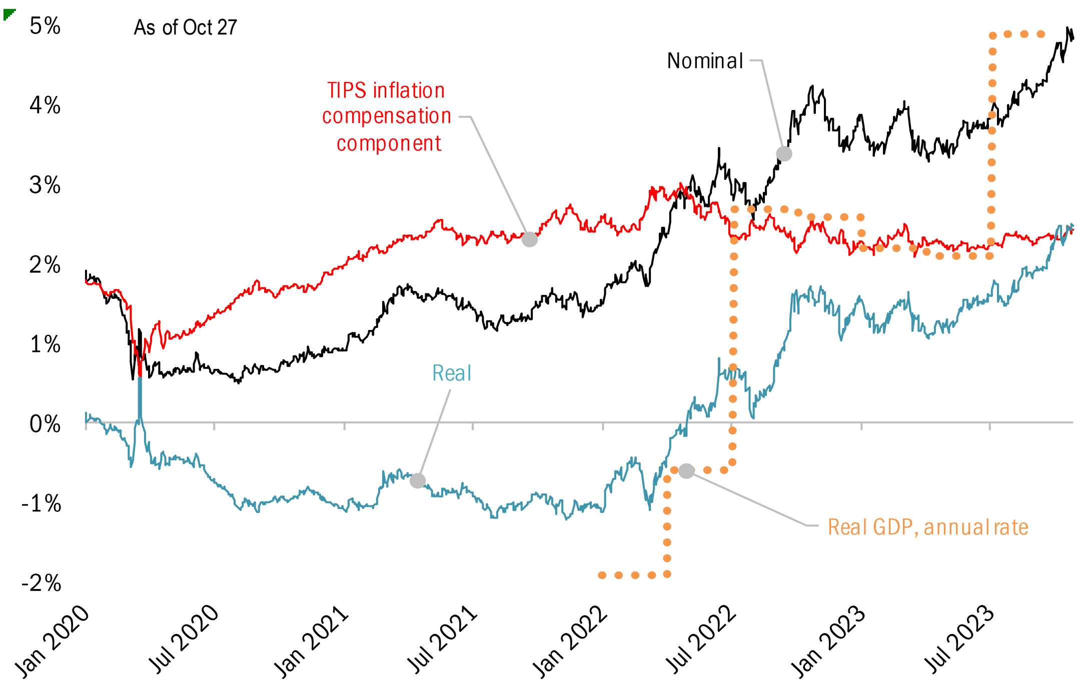
- *The blow-off top we expected was to come from the Fed's sin of pride, a self-congratulatory triumphalism based on recognizing victory over a severe inflation threat without a recession. That would ignite animal spirits in the stock market. But Powell refuses to be prideful, or even acknowledge he has anything to be proud of.*
- He continues to be a man who self-identifies as a crisis manager more than a policy maker – so should we be surprised when, given the opportunity, he confabulates crises to manage (see "Video: TrendMacro conversation with Nick Timiraos on Powell's crisis response and the inflationary aftermath" March 28, 2023)?
- *Whatever his motives, he and those around him continue to promote the canard that growth causes inflation.*
- Powell and influential vice-chair Phillip Jefferson have warned in recent speeches that growth surprises on the upside "could put further progress on inflation at risk and could warrant further tightening of monetary policy" (Powell, October 19) or that "a restrictive stance of monetary policy may be needed for longer than previously thought" (Jefferson, October 9).
- *So it was unhelpful to get a growth surprise on the upside yesterday, with Q3-2023 real GDP coming in at 4.9% versus consensus expectations of 4.5%* (again, see "Data Insights: GDP" October 26).
- Our original call for a sharp stock market correction was based on the idea that the market would suddenly see a conquered inflation threat curdle into a new deflation threat. The Fed's intransigent insistence on maintaining a wartime footing when victory is already achieved is raising the specter of deflation for anyone with eyes to see the actual inflation statistics that are sitting there in plain sight. We don't think that deflation will actually be a bad thing – but we sure think the market will initially think it will be a bad thing (see, among others, "Video: What you're not hearing about the coming deflation" June 23, 2023).
- To be sure, the blow-off top we expected hasn't happened. But there's a case to be made that this correction is about a coming deflation scare after all.

Or. On the other hand. That could be overthinking it. Intuitively, based on our daily conversations with clients and what we sense in the atmosphere, *the proximal explanation for this correction is simply the rise in long-term yields to levels not seen before the Global Financial Crisis, with the 10-year Treasury briefly trading above the attention-getting 5% level.*

- We sense, and we experience within our own minds, the high anxiety around every day's seemingly volatile trading in the 10-year. Reflexively we feel relief when yields fall. We feel fear when they rise – letting our imaginations run wild as we wonder, dear God, how high might they go!?

- As we've explained, the reality is that high long-term yields – that is, high long-term real yields like we have now – are in fact normal, and are in fact associated with robust growth (see "Video: What you're not hearing about why a 4.5%-plus 10-year Treasury yield is actually a good thing" September 28, 2023). We've all forgotten that, after so many years in the "new normal" and "secular stagnation" following the Global Financial Crisis. A 10-year Treasury at 5% nominal and 2.5% real is actually what's normal. The previous decade-plus below those levels are abnormal – as was that period's low growth, weak jobs market and low productivity.
- And it's not like we just suddenly got to these yield levels. It's been a steady march from the all-time lows in early 2020, although we hear in almost every client conversation the general perception that it just happened out of the blue (please see the chart below). It did not.

10-year Treasury yields in the pandemic and its aftermath



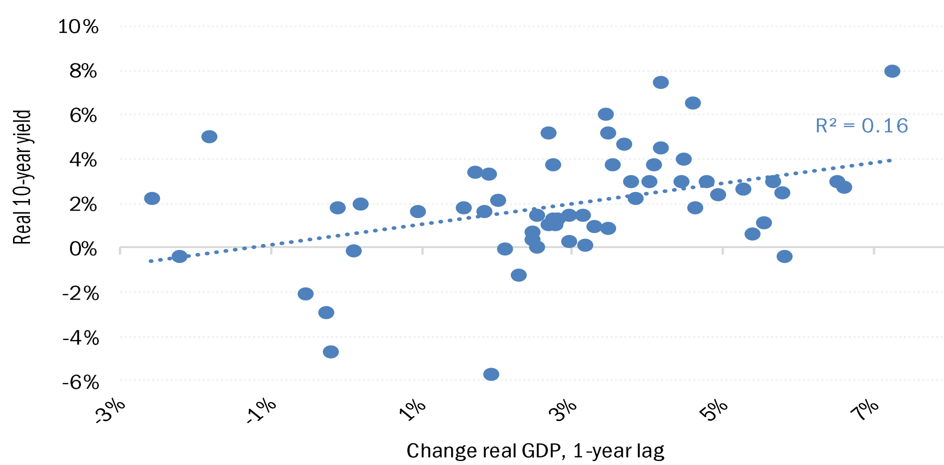
Source: Federal Reserve, BLS, NBER, TrendMacro calculations

- Can yields go even higher, as it seems we all fear? Sure, but we don't see why they would. They've been tracking the economy's recovery from the two negative GDP quarters in H1-2022. Unless you think growth is going to accelerate from the last quarter's extraordinary level, why should yields move much higher – at least, assuming that they are the product of endogenous growth
- *We think the sense of fear with yields at these levels come, quite sensibly, from the reality that the global economy had more than a decade of "secular stagnation" in which to get used to – indeed, to capitulate to – a "new normal" of low yields. A return to a previous regime – even if more truly normal, indeed even if objectively better for growth – is nevertheless a dangerous change from the*

environment to which everyone had adapted. Look what happened to Silicon Valley Bank at long-term yields lower than they are today.

- SVB's failure was an *effect* – and one of its several *causes* was the rise in long-term yields (see "It's Over For SVB – And the Fed" March 13, 2023).
- Investors rightly worry that there will be other *effects*. That narrative is so pervasive we can't doubt it is contributing to the present stock market correction.
- But we have been making the case over the last several weeks that these yields are themselves effects, and growth is their cause (again, see "Video: What you're not hearing about why a 4.5%-plus 10-year Treasury yield is actually a good thing").
- To be sure, in economics it is difficult to isolate just two relevant factors and figure out which is the cause and which is the effect. There are almost always many other factors, one or more of which would be the shared cause of the first two or could be confounding variables. The messy reality is that equilibrium dictates that multiple factors are both cause and effect. Markets are recursive, self-referential, and reflexive.
- It's too simplistic to be sure, but it is nevertheless useful – at least to help overcome the simplistic assumption that high yields are everywhere and always a threat – to look at the history of real yields versus real output growth.
- Over fifty years, there is no correlation (r-squared 0.03) between the level of real yields (the 10-year Treasury minus CPI inflation) and real GDP growth, on a contemporaneous calendar year basis.
- Lagging real yields by one year, we can test whether output growth in year one precedes – potentially *causes* – levels of yields in year two. They do not (r-squared of 0.0). *This argues against our claim that growth is the cause and yields are the effect* (axiomatically, if simplistically, on the basis that cause comes first, then effect).
- Conversely, lagging GDP growth by one year, we can test whether yield levels in year one precede – potentially *cause* – output growth in

Year real GDP versus real yield, lagged one year (1963 to 2022)



Source: BEA, BLS, Bloomberg, TrendMacro calculations year two. They do – at least some correlation is revealed (r-squared 0.16 – please see the chart below). *<u>It's far from the strongest econometric finding we've ever seen, but it does support the idea that yields are the cause and output growth is the effect.</u>*

- But wait! The direction of the correlation indicates not the conventional belief that high yields cause low output growth, but just the opposite: *<u>if this exercise really suggests anything at all, it is that high yields cause high output growth.</u>*

And of course, there are all the other narratives that could explain the present stock market correction. You've heard them all, and none of them would be making the rounds if they didn't have some core credibility about them.

- Especially, in every client conversation now, we are asked for our views about economic risks arising from the Hamas terrorist attack against Israel and its aftermath.
- Staged on the 50th anniversary of the Egyptian/Syrian invasion, it invokes memories of the catastrophic oil embargo that came after. Doesn't history repeat itself?
- No, it normally doesn't. The economic and geopolitical positions of the important Middle East oil exporters couldn't be more different today than they were then – in relation to the West, and to each other. We see little chance they would band together – given their internal divisions – and throw the global economy into a sharp oil-shock recession – given how intertwined their elites are with it – like they did 50 years ago.
- Oil markets agree – crude prices are lower today than they were before the attacks.
- Other indicators of possible global instability, especially gold, are quiet.

So where do we end up?

- *<u>It makes sense to us markets would be disappointed that the Fed isn't acknowledging the good news on inflation – indeed, at the September FOMC they clung to a year-end 5-5/8% funds rate target, and raised their targets for the out-years, even as inflation is collapsing.</u>* We'd wrongly expected a blow-off top, because we'd wrongly read Powell's mind.
- *<u>This disappointment is real – it objectively lowers growth expectations, all else equal, and raises risks. But it is over. Here we go, reading Powell's mind again – but we really think, from here, all the Fed surprises can only be on the dove-side. This correction has now absorbed "peak hawk" – which implies it has probably run its course.</u>*
- It makes less sense to us that the markets would be so fearful of long-term yields back to levels not seen since 2007. Yes, there are potential systemic risks that arise in any regime-change. But we think the overwhelming reality is that these yields are intertwined with a resurgence of growth and productivity also not seen since 2007.
- So in that sense, the correction could be said to impound a premium against possible systemic risk – but we sense it has also wrongly

impounded a growth penalty out of the false belief the higher yields cause slower growth (if they act on growth as a cause, it appears they help).

We'll know more after next week's November FOMC. See you then.

Bottom line

US stocks are in a 10%-plus correction. We'd expected a sharp correction, but we'd also expected a run to new highs first, which hasn't happened. We expected the Fed to recognize that inflation, properly measured, has already more than achieved its target; instead, it has doubled down on a "higher for longer" strategy. A boom in Q3-2023 only makes it worse, because the Fed wrongly believes that growth causes inflation, and has said it is on the alert for upside growth surprises. But that means this correction has taken "peak hawk" on board already, and has probably run its course. High long-term yields are a fear factor for systemic risk, since even lower ones were enough to take out Silicon Valley Bank. While they represent risky "regime change" as the economy matures out of the post-GFC era of "secular stagnation," it is a good thing to move to a higher growth epoch. We don't expect a surge to new highs in yields, because we don't see how the economy could accelerate from what is already a boom in Q3. Research tentatively shows that high yields do influence subsequent output growth – but surprisingly, they help it. We are mindful of black swan risks in the current Israel situation, but so far risk-sensitive markets like oil and gold are showing nothing to worry about.