MV CAPITAL MANAGEMENT

Weekly Market Flash

The Cash Equivalent's New, Old Look

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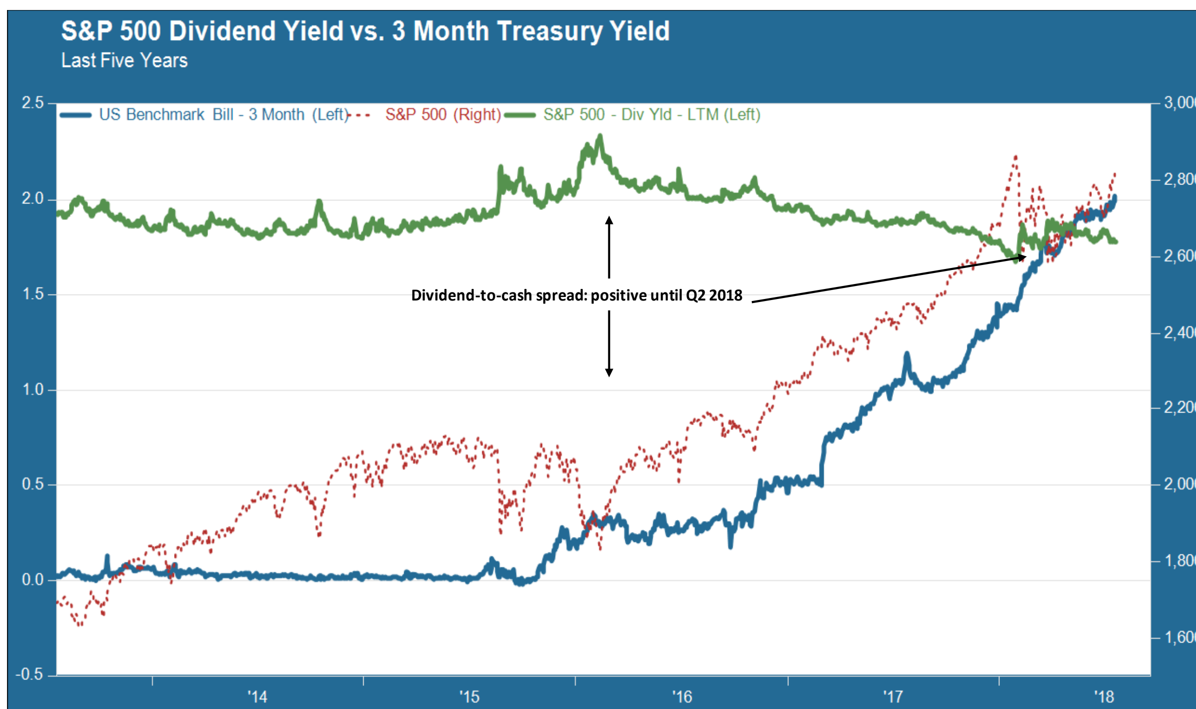
Something interesting happened earlier this week – well, interesting for those who like to read meaning into round numbers. The number in question is 2, as in 2.0 percent, as in the yield on the 3-month US Treasury bill reached on July 18, the first time this widely used proxy for "cash" breached 2 percent since before the 2008 recession. The practical impact of this round-number event, though, is that it extends a trend underway since April; namely, that the yield on cash is now greater than the dividend yield on large cap stocks. The chart below shows the spread between the S&P 500 dividend yield and the 3-month T-bill over the past 5 years. After a yawning chasm for much of the post-recovery period when interest rates were held close to zero, the Fed's monetary tightening program begun in late 2015 has now closed and reversed the dividend-cash spread.



Source: MVF Research, FactSet

Meet the New Spread, Same As the Old Spread

There is nothing unusual about cash returns exceeding the dividend yield; it is usually a feature of a recovery cycle. For example, over the course of the growth cycle from 2003-07 the yield on the 3-month Treasury bill was 3.0 percent, compared to a dividend yield on the S&P 500 of 1.7 percent. As we have often noted in these commentaries, though, this most recent growth cycle has been profoundly different. When short term rates started trending up at the end of 2015 the recovery was already five years old. It's unheard of for interest rates to stay so far below dividend yields until nine years into the recovery.

But, of course, this was no accident. Rates were kept low in order to stimulate risk appetite after the 2008 financial crisis. Essentially, the Fed induced investors to move into riskier assets by making it as

economically unattractive as possible to invest in risk-free securities. The European Central Bank of course went even further – they made investors actually pay – via negative interest rates – for the "privilege" of holding Eurozone credit obligations.

Welcome to the Jungle

Now that investors can actually get something in the way of a return on their cash allocations, however modest, market pundits are raising the chatter volume on whether this signals a potential cyclical drift out of equities into safer investments (similar to the very much related concerns about the yield curve we addressed last week). Another way to put the concern is this: can equities and other assets with higher risk properties still be attractive without the explicit inducement by monetary authorities? We're back in the market jungle and ready to test the survival skills of common shares in the wild, goes this train of thought.

As with any other observation made without the assistance of a fully functioning crystal ball, the answer to that question is "it depends." What it depends on, primarily, is the other component of value in a share of common stock beyond dividends: capital appreciation. In the chart above, the capital appreciation variable is the dotted crimson line representing the price appreciation in the S&P 500 over this five year period. While getting close to 2 percent each year from dividends, investors enjoyed substantial capital gains as well.

Goodbye, TINA

What the spread reversal between cash and dividends does more than anything else is to put paid to the "TINA" mantra – There Is No Alternative (to investing in stocks and other risk assets). The calculus is different now. An investor with modest risk appetite will need to be convinced that the dotted red line in that chart above has more room to move upwards. The dividend component of total return is no longer free money – there is now an alternative to that with a slightly better yield and less risk. The rest will have to come from capital appreciation.

Now, we have argued in recent commentaries that the growth cycle appears durable, given the continuity in macro growth trends and corporate sales & earnings. The numbers still would appear supportive of further capital appreciation. But we also expect that the change in the TINA equation will have an effect on capital flows at the margins. Whatever money is still on the sidelines may be less inclined to come into the market. At the very least, investors on the sidelines skeptical of how much longer the bull has to run will have a better reason to stay put in cash. If enough of them do so it can become a self-fulfilling trend.

The transition from summer to fall is always an interesting time in markets, as a consensus starts to form around what the driving trends of the fourth quarter will be. There's enough at play right now to make the stakes particularly high this year.

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