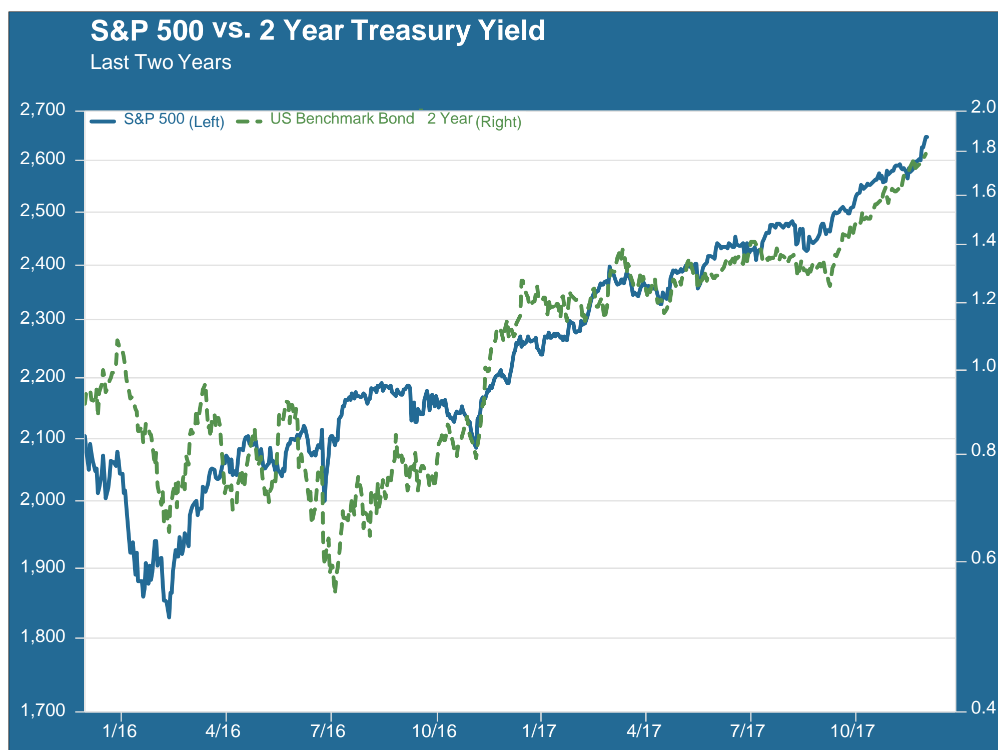
MV CAPITAL MANAGEMENT

Weekly Market Flash

Groundhog Day in December

December 1, 2017

Today is the first day of the last month of 2017, which means that predictions about asset markets in 2018 will be flying about fast and furious over the coming three weeks. As practitioners of the art and science of investment management ourselves, we know that quite a bit of work goes into the analysis that eventually finds expression in the "bonds will do X, stocks will do Y" type of formulations characteristic of these holiday season prognostications. A layperson might be excused, though, for concluding that all the market pros do is dust off last year's report, or the year before, for that matter, and repackage it with the same observations. "Rates will rise because of the Fed, stocks will rise because of a stable economy and good earnings" worked for 2016 and it worked for 2017. Here's visual proof: the price appreciation of the S&P 500 and the trend in the 2-year Treasury yield since December 2015:



Source: MVF Research, FactSet

It wasn't linear, of course. There was the technical correction in early 2016 when both stocks and rates pulled back. Still, though, investors positioned for rising short term rates and steady gains in large cap domestic stock prices would have had little about which to complain over the past two years. Which, of course, brings us to the point of today's commentary: is it Groundhog Day again, or does 2018 have something entirely different in store?

Macro Boringness

At the heart of this curious Groundhog Day phenomenon over the past couple years is the remarkable sameness in the broader macroeconomic environment. "Moderate GDP growth, with a healthy labor market and modest inflation" is a phrase you could have uttered on literally any given day over this period and been right. The only thing measurably different about 2017 was that this "Goldilocks" set of conditions was true not just of the US, but of almost any part of the developed (and much of the emerging as well) global economy. Adding the word "synchronized" to "moderate GDP growth" gives the phrase a distinct 2017 flavor. Thus, the good news for equities disseminated into non-US markets and finally gave investors some measure of reward for diversification.

But, Inflation!

There is almost nothing in the way of macro data points today suggesting a deviation from this "synchronized moderate growth" mantra. The major question mark, as we have discussed in other commentaries, is whether inflation will ever get in line with what the Fed's models call for and rise above that elusive 2 percent target. Now, if inflation were to suddenly go pedal-to-the-metal, that could change assumptions about risk assets and blow up the Groundhog Day framework. In particular, an inflationary leap would likely send shockwaves into the middle and longer end of the bond yield curve, where rates have remained complacently low even while short term rates advanced. The 10-year yield is right around 2.4 percent today, almost exactly where it was at the beginning of the year and in fact not far from where it was at the beginning of 2016.

The sideways trajectory of the 10-year, in fact, supplies the explanation as to why stocks could rise so comfortably alongside the jump in short-term rates. While short term rates are closely correlated to the Fed's monetary policy machinations, longer yields reflect a broader array of assumptions – including, importantly, assumptions about inflation. The flatness of intermediate rates suggests that bond investors expect economic growth to remain moderate, and inflation low. The bond market is not priced for a high inflation environment – which is reasonable, given the scant evidence that such an environment is imminent.

Can Stocks Keep Going?

So far, so good: the economic picture seems supportive of another Groundhog Day. What about stocks? There are still plenty of alternative paths for equities to travel in 2017 (and they are going kind of helter-skelter today on some breaking political news), but a solid double-digit performance would be a reasonable prognosis (the S&P 500 is up just under 20 percent on a total return basis for the year thus far). The current bull market is already the second longest historically, and valuations are stretched. Is there more room to run?

As we write this, the tax bill which has riveted the market's attention for most of the past two weeks has not formally passed the Senate, nor been reconciled with the earlier House version to a final bill to send to the White House. But the odds of all that coming to pass are quite good. As we have noted before, the market's obsession with taxes has little or nothing to do with fundamental economic growth. The non-partisan Joint Committee on Taxation said as much in the report it released late yesterday on the proposed bill's likely economic impact: at best, contributing no more than about 0.1 percent to annual GDP growth over the next ten years.

But the market's interest in the fate of the tax bill has little to do with long-term economics, and much to do with shareholder givebacks. To the extent that the bill results in tangible cash flow benefits for corporations in the next 1-2 years (and the quantification of such benefits remains quite variable), precedent informs us that the vast bulk of such gains would flow right back to shareholders in the form of buybacks and dividends. Buybacks and dividends don't help the economy, but they most assuredly do help shareholders. That fact, alone, could supply enough of a tailwind to keep the bulls running long enough to grab the "longest duration" mantle.

Everything's the Same, Until It Changes

So if you read a bunch of reports over the next couple weeks that sound incredibly similar to what you read a year ago, don't rush to the judgment that its authors are lazily phoning it in. There remain very good reasons for the Groundhog Day framework for yet another year. Gains in stocks, an increase in short term rates alongside monetary policy moves, and longer term rates tempered by modest inflation are all plausible default-case scenarios.

But never forget that any scenario is just one out of many alternative outcomes. Market forces do not pay heed to the calendar year predilections of the human species. There is no shortage of factors out there that could upend the benign sameness of today's conditions, and they will continue to demand our vigilance and readiness to adapt.

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