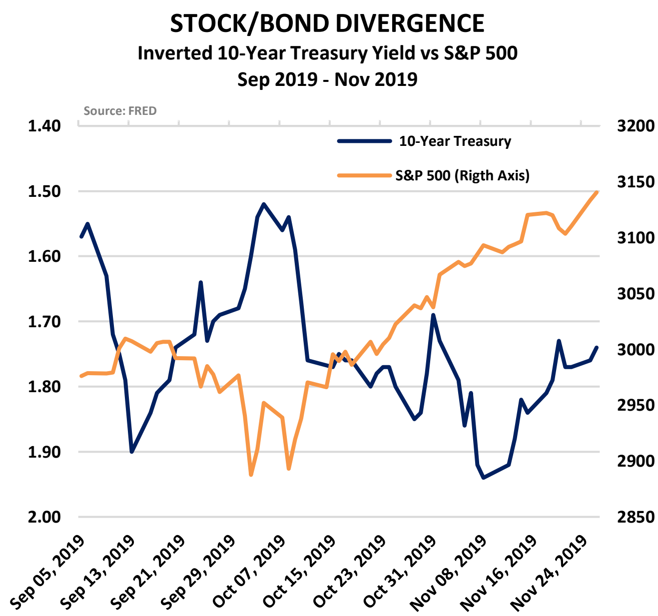
Emergence of Divergence

Market Viewpoint: November 27, 2019

Summary: Over the course of the last few months, Treasury yields have begun bouncing back from their Summer lows, pushing down bond prices. Simultaneously, the S&P 500 has risen strongly, reaching a new all-time high this week. This market phenomenon, wherein the price of stocks and bonds head in opposite directions, known as "divergence" can often be observed in the latter half of business cycles. That historical precedence can help investors build a roadmap for what to expect for both markets in coming months.



For the past three months, stocks have risen while bond prices have fallen, and that divergence could be a harbinger of things to come. The likely course of monetary policy and business conditions data would suggest to MRP a continuation of the recent divergence through the election year. The S&P 500 has been breaking new highs on a regular basis, but bond yields have been rebounding. Earlier this month, the 10-year yield rose as high as 1.97% in its biggest one-day move since the 2016 presidential election, and some 50bps higher than its September low, a 1/3 rise in yields while stocks were roaring. Even when equities hit a 3-day losing streak last week, yields followed them down, continuing the broader trend of divergence. While this divergence is seemingly counter intuitive, it is not unprecedented. A closer look at the shifts in price trends for the two major asset classes over time is instructive.

The data for typical business/market cycles show that those cycles can be divided into 2 parts: an early stage where stocks are rising with the help of falling rates (rising bond prices) and a later stage when stocks still rise in the face of rising rates (falling bonds).

Sometimes this process can be abetted or reversed by temporary intra-cycle reversals in monetary policy. Often, stocks fall or flatten in the early days of monetary tightening. If the tightening continues, supported by strong trends in growth and inflation, stocks will firm and continue climbing in spite of rising interest rates. Bond yields also usually rise in periods of tightening, depressing prices.

However, things get more complicated when temporary easing measures come into play – as they are now, with the Fed cutting short-term rates by 75bps in the last few months and initiating a new round of "QE-lite" to provide adequate liquidity to money markets. At this point, yields nearly always trend downward, as they did from November 2018 to September 2019, but the stock market can go one of two ways. Equities either fall

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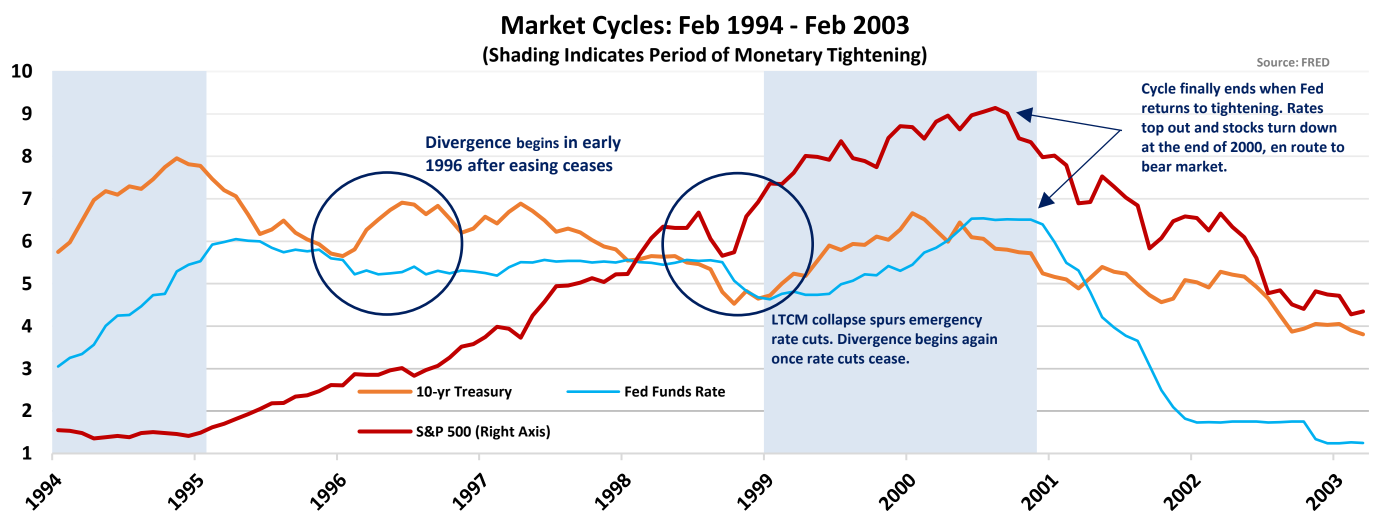
strongly, interpreting this as a signal of a weaker economy and an oncoming recession, or it can rally on the prospect of stronger earnings down the line, as they did this time around.

Fed Vice Chairman Richard Clarida recently pointed to 1995 and 1998 as two instances where the central bank reduced rates as insurance against a weakening of the economy, even though it didn't see a recession lurking.

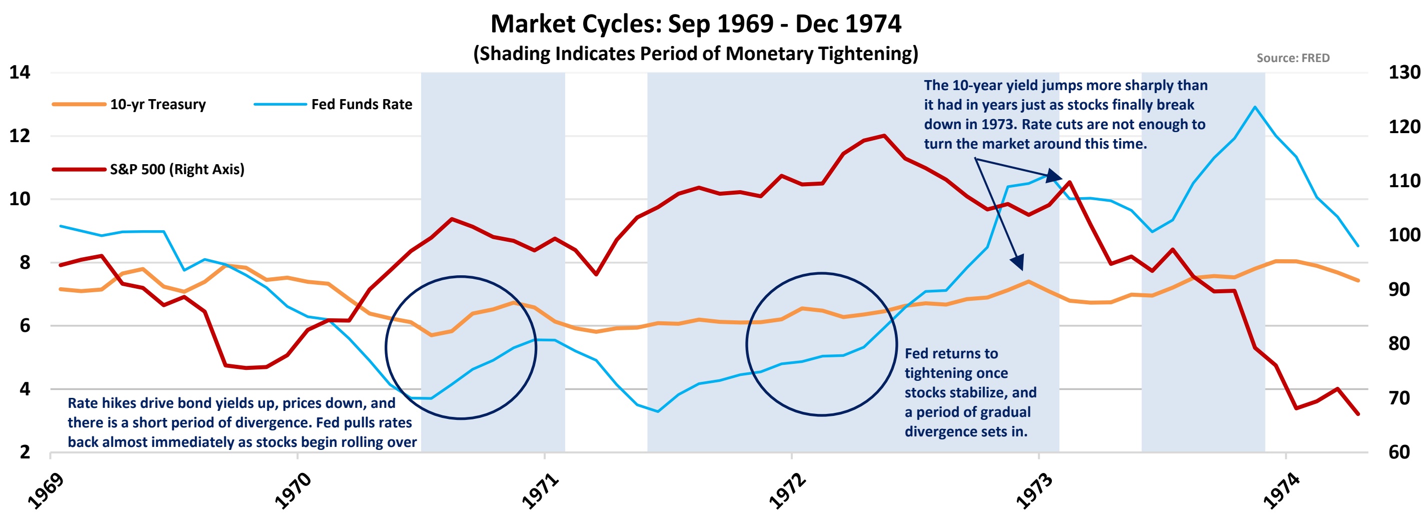
In 1995-96, weaker inflation spurred another instance of 3 consecutive rate cuts. While stocks rose and yields slipped at first, the 10-year yield eventually rose about a fifth to near 7%, up strongly from below 6%. This pushed bond prices down, but stocks rallied, creating a divergence that lasted all the way into 1997.

MRP noted the similarities of 1998 to today all the way back in July as part of our [Spiking the Punch Bowl] viewpoint. Three consecutive cuts of 25bps in September, October, and November of that year likely extended the market cycle, sending stock prices higher just when it looked like they were heading off of a cliff in August. These events were eerily identical to the last 3 months in the here and now. However, at that time, the cuts were completely situational, staving off an economic crisis in the aftermath of the late 90s' emerging market currency collapse, resulting in Long Term Capital Management's meltdown. There was no divergence of stocks and bonds in 1998 until tightening returned at the end of the year. Once the dust settled and the Fed recommitted to tightening, divergence returned, and stocks reached their peak right around the same time the 10-year did. When the Fed became too restrictive yet again, the boost in bond prices dissipated.



JP Morgan also believes we could be looking at a replay of the '95-'96 cycle. According to Bloomberg, JPM strategist Nikolaos Panigirtzoglou wrote this implies "5% or so upside for equities over the next six months, very big 100bps upside in the 10-year U.S. Treasury yield, steepening of the UST curve, and little change in the dollar or credit spreads". While this scenario assumes that the U.S. macro picture remains consistent with a mid-cycle adjustment, with resilience in employment and consumer confidence, as well as a rebound in manufacturing, none of those prerequisites are unattainable.

We can observe a similar market cycle in the early 1970s. The Fed enters a period of tightening and a divergence of stocks and bonds ensues. It's short lived, however, as stocks begin flattening out and rolling over. Therefore, the Fed has to jump in and pull back rates – but it's only a temporary measure. Once stocks begin rising again, rate hikes and divergence return. This divergence was not especially steep, but the yield on the 10-year rose more than 160bps over the course of almost 2 years. Stocks began falling rapidly in 1973, but temporary rate cuts were not enough to fight off the market cycle again.



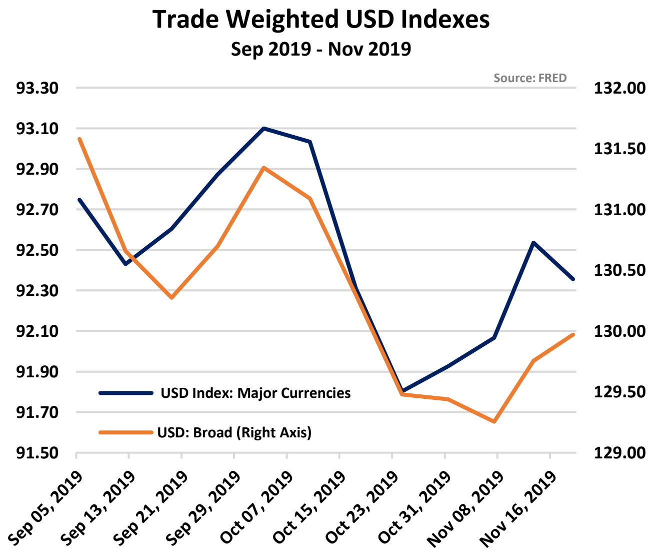
Comparing the current circumstances with these examples, we are in the temporary easing period that often takes place in the midst of a broader round of tightening; the eye of the storm. The Fed is already beginning to signal a return to rate hikes next year, which could be driving the divergence we've seen this month. While a broad downturn in equities seems unlikely at this point, a return to rate hikes would not only intensify divergence in stocks and bonds, it could even signal the last leg of the current business/market cycle.

In the intermediate term, a broader economic downturn seems unlikely. For all of the doom and gloom that was being pushed in the financial media (until very recently), the data never really broke down to levels we hadn't seen before in the last decade of continued economic expansion. Real GDP growth did fall to 2.0% in the 3rd quarter of 2019, a 3-year low, but that figure is just shy of the 2.1% average over the last decade. Additionally, the ongoing "manufacturing recession" is actually the 4th time over the same period that the ISM Purchasing Managers Index (PMI) fell into contraction territory. In fact, according to IHS Markit's PMI Index, the data has yet to enter contraction territory. By contrast, it actually reached a 3-month high in November.

MRP noted last month that retail data and other measures of consumer confidence remain resilient. The University of Michigan's index of U.S. consumer sentiment rose to 96.8 this month, from 95.5 in October, the highest since July. As for employment, Initial jobless claims continue to trend downward, even with the unemployment rate still near the 50-year low it cracked in September.

With all of these trends, it shouldn't be any surprise that recession fears appear to have been overcooked. The inversion of the yield curve, though, was the nagging recession indicator that wouldn't stop blinking. Until the Fed decided to begin expanding their balance sheet again, that is. Since September, Reuters notes the spread between yields on 10-year and 2-year Treasury notes has climbed by nearly 30 basis points, from around negative 5 to around positive 25 now.

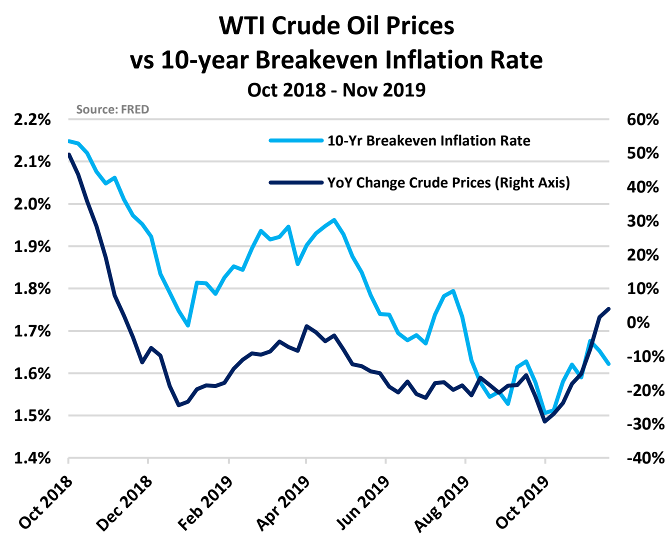
Aside from the manufacturing slump, it appears that US growth is set to bottom out, if it hasn't already. The first read of Q3 GDP came in at 1.9%, but was revised up to 2.1% in late November. Barring any major escalations of the ongoing trade war with China, which was the strongest catalyst in 2019's economic slowdown, growth could remain more resilient than expected, and even start to rebound on the back of lower rates and a weaker Dollar.



[As MRP forecast at the end of August](), declining interest rates and a moderate inflation rebound have begun to push down real rates (the difference between the Fed Funds rate and YoY change in the headline CPI), initiating a bout of sustained weakness in the Dollar for the first time since June.

A declining USD can now be observed versus both major and global currencies since September. We expect inflation to rise further in coming months, pushing down US real rates even further. Not only will lower Fed Funds rates continue to feed through to price levels in coming months, but stable crude oil prices through the Holiday season should provide a positive base effect for the CPI.

Last year, heavily elevated crude prices experienced their steepest sell-off of all time through November-December. Because crude prices suddenly dove all the way to below $43 per barrel, well below the price level of the previous year, the energy component of the CPI created a negative shock in the headline number. That effect will likely be reversed this year, barring another meltdown in crude markets, and could actually give the CPI a moderate boost through the end of the year. Last week marked the first time since April that the YoY change in crude prices reached positive territory.



If stronger inflation does indeed push real rates down, weakening the dollar further, investors should also expect more favorable pricing of US goods and a consequential uptick in US exports. The US's balance of trade has already narrowed by nearly 6.5% since May, reaching a 2019 low in September (the most recent month data has been reported for). Although we are still awaiting data on US service exports, the deficit in goods has already declined to a 17-month low in October. Combined with easing trade tensions, this could set the stage for an industrial comeback, a shot in the arm for US GDP.

Stronger inflation, though, would also cause the Fed to at least remain neutral on rates. However, a stronger rebound in inflation could cause FOMC members to consider another phase of tightening. Either case, at this point appears to be bearish for bond yields that are already rising on the back of enthusiasm about the economy and the aforementioned balance sheet expansion.

Fed Chair Jerome Powell is ostensibly pushing a neutral outlook for rates, noting that current policy is "likely to remain appropriate, barring "a really significant move up in inflation that's persistent". It stands to question what would count as a significant increase in inflation, but if we assume it means a rise above the Fed's 2% target, that's certainly not out of the question. In fact, the last time rates were this low, the CPI peaked higher than 2.8% in June 2018, and pulling the Core PCE up to 2.1%.

It is worth noting that, despite a Presidential election year coming up in 2020, policymakers likely won't be shy to make moves in short-term rates if necessary. In its quest to maintain political neutrality, the Fed appears to act oblivious toward elections, moving rates at least once in 9 out of the last 10 Presidential polling years; every election since 1980, save 2012.

As noted earlier, we are currently sitting in the valley between the early stage of a tightening cycle and an eventual resumption. This period can last anywhere from a few months to years, but MRP does believe we will see a return to rising rates well before the next major downturn in equities or a recession.

In the near term, we see the bond market struggling into 2020, with stocks diverging and rising, but more moderately than they have recently. Not only will most investors act cautiously and become more risk-averse as we approach the 2020 election, but the S&P 500 has already become somewhat richly valued according to the long-term average price to earnings ratio (P/E). Multiplying next year's expected earnings of $176.91, per S&P indices, by the long-term average P/E of 16.6 puts the fair value of the index around 2936.71. Therefore, the current price level of just over 3100 is roughly 6% higher than future earnings would suggest after the most recent run-up.

The Fed's rate cuts have certainly delivered an early Christmas gift to the economy and have likely staved off a broader downturn… for now.

Joe Mac

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