

Stocks and Bonds Pointing to a Goldilocks Scenario

Despite their apparent contradictory tales, equities and bonds are sharing the same message: we are moving towards a “goldilocks” scenario of a slower but still-growing U.S. economy. Despite investors’ wall of worry, it is premature to state that this cycle is near its end.

The case of U.S. exceptionalism provides a good opportunity to introduce the idea of a “not too hot, not too cold” scenario. So far, despite hopes early in the year that regions like Europe and EM could outperform U.S. growth, we are witnessing an economic and financial outperformance of the U.S. compared to the rest of the world. The MSCI USA Index is up 8% YTD, while the MSCI World ex-USA Index is down 6%.



The strengthening of the USD has contributed to such outperformance, yet it is only partly responsible for the differential. In local currencies, other major indices in Asia and Europe have underperformed the U.S. as well. Another partially contributing factor is the contrasting difference between U.S. interest rates and those of other developed economies. Yet, the most important explanation for the U.S. exceptionalism is about the quality of economic and corporate earnings growth, which investors recognize to be more robust in the U.S. than in the rest of the world.

Capital goes where it is treated the best, and it is not surprising that the U.S. exceptionalism has led to an increase in fund flows to U.S. securities. According to Bank of America Merrill Lynch, global fund managers have their biggest U.S. overweight since January 2015 – making U.S. stocks a very crowded trade. Recently, U.S. Treasuries climbed as inflation numbers didn’t match the improvements in wages seen in August’s employment report.

The Thinking Man’s Approach



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- Equities are saying “not too hot”. However, the growth story is still there. Earnings growth continues to be healthy and nothing points to “peak earnings”. The lower corporate tax lower regulation environment is creating a great environment for companies to increase capex, which should lead to a rise in productivity. This should help companies protect their margins.
- Treasuries are saying “not too cold”. Bond investors are not buying the boom story, but they are not expecting a recession either. This is reflected by the decrease in the risk premium component of yields.
- We believe some bricks in the “wall of worry” are premature. Although fundamentals still signal we are not yet the bull market’s top, we remain cautiously bullish.

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com



Investors are facing what appears to be two contradictory messages about the fate of this 9-year-old bull market. On one hand, U.S. equities have been hitting new highs – appearing to be supporting the sentiment of a new economic boom. On the other hand, Treasury yields have been failing to surpass the 3% mark – perhaps supported by pessimistic investors getting ready for the downturn. However, despite the apparent dichotomy, equities and bonds are conveying a message of a U.S. goldilocks environment: “not too hot, not too cold”.

What are equities saying?

Since February's correction, U.S. stocks have been juiced up by record M&A activity, stock buybacks, robust corporate earnings, and renewed confidence as the effects of tax reform spilled into economic and corporate figures. But for the past three months, defensive stocks have been holding up. According to Strategas, flows into the Consumer Staples sector remain aggressive. Nevertheless, this is not necessarily a bearish sign.

Amazon Distorts

Strip out Amazon and the highly-cyclical consumer discretionary sector has underperformed consumer staples in the past three months.

Source: WSJ



What this could mean is that investors are positioning their portfolios for an environment of unspectacular but fine growth prospects. JP Morgan explains that, while companies' earnings guidance supports a robust EPS growth for 2H 2018 (bottom-up consensus of 20% vs. the 25% seen during 1H), investors should expect lower earnings surprise during 2H (approximately 3% vs. 6% in 1H). It will also be normal to expect earnings to not grow as much going forward. Strategas alerts investors to not expect earnings growth in the 20% YoY range in 2019; yet, it reminds them of not being too worried if growth is half that rate. It is important to remember that there is nothing that suggests we are reaching “peak earnings”. There is something going on besides the strong supply-side effects of fiscal policy. How companies use their cash will be a key thing to monitor. The dream scenario would be an increased capital spending by corporations, and a subsequent improvement in productivity levels which should help reduce the inflationary impact of wage growth. This will help companies maintain their high level of profitability.

Despite emerging signs that both the market and economic cycle are maturing, we believe fundamentals are still strong to signal this bull market still has some time to run. Equities might be conveying a “not too hot” message, but the growth story is still there. Cyclical stocks, despite lagging defensive ones, are still in the green. One notable example is the performance of the Industrial sector, which has continued to improve – touching multi-month relative highs in the first week of September. Industrials' performance also highlights the U.S. exceptionalism. The S&P 500 industrial sector is up 9.4% YTD and 5.9% in the past three months. Meanwhile, in the rest of the world the sector has dropped: down 12% in EM, down 3% in the eurozone, and down 8% in Japan.

What are bonds saying?



The state of the U.S. Treasuries market is conveying a “not too cold” message. Bond investors might not believe we are on the prelude of a blowout boom, but they are not anticipating a recession either.

Treasury yields have two components: the expectation of where interest rates will be (underlying bond yield) and a risk premium for holding the bond until maturity. The graph on the right shows how the risk premium has fallen since February, pulling down the 10-year Treasury yield. The underlying bond yield carried up until three months ago, remaining steady since then. The message to read here is one of an economy that, contrary to being weak, is just coming along fine without much improvement in the last three months.

Looking Inside Bond Yields

Treasury yields can be split into the expected course of interest rates and a reward for holding the bond for the full term. The recent pull back in yields is all due to the term premium.



Source: Federal Reserve Bank of New York

[BSP View: there is still time in this cycle despite the wall of worry](#)

Many analysts label this bull market as one of the most joyless in record. The wall of worries among investors has remained high since February's correction.

Trade remains as one of the main sources of risk for equities and could have been driving some of the fund flows into U.S. government bonds. A J.P. Morgan report shows that during the last earnings season, 35% of companies highlighted trade risks – more than those discussing tax reform. However, we believe trade is more of a headline risk and should fade with time. Investors recently became hopeful with news of another possible U.S.-Sino trade talks that could soften the hostile tariff rhetoric. Most importantly, and as highlighted by the U.S. exceptionalism, the market seems to recognize the reality that the world depends more on the U.S. for faster growth than vice-versa.

Inflation is rising but at a slowly and manageable pace. Strategas explains this rise as “reflation before inflation”. The last reading of average hourly earnings growth stood at 2.9% YoY, an improvement but still far from the >3.75% threshold in which the metric begins to put major pressure on margins. In addition, a rise in productivity due to an increase in capital spending should help mitigate the inflationary effects of rising labor costs.

Lastly, the advent of a recession is investors' main concern. Nonetheless, we share Strategas' view that it is premature to believe this cycle is near its end. First, the yield curve is still flattening. Even if it inverts, there are on average 17 months between an inversion and a recession. Second, there has never been a U.S. economic recession when corporate earnings are growing. Finally, it is hard to get near a recession when the real Fed rate is close to zero. The Fed could raise rates and still preserve a 0% real rate due to its inflation target. If it does this, it could keep the yield curve from inverting.



We believe that these concerns are premature, and that it could be counterproductive to base investment decision on such fears. Fundamentals still remain indicative that we are not near this bull market's top. However, it is important to remain cautiously bullish. These factors should be monitored closely, especially as the process of quantitative tightening is beginning to take shape.



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