



MORNING BRIEFING

February 12, 2019

One & Done? Up or Down?

See the [collection](#) of the individual charts linked below.

(1) An old adage. (2) Yellen is a classic “two-handed economist.” (3) 2016: Déjà vu all over again. (4) 2-year Treasury divines the Fed’s future moves. (5) Flat yield curve is in none-and-done camp. (6) No recession in credit-quality yield spreads. (7) Will the buck stop here? (8) ECB and BOJ remain much more dovish than Fed. (9) Oil prices remarkably firm given gushing US oil wells. (10) EMs get a boost from Fed pause. (11) A deal with China could provide a short-term boost to Go Global investment strategy.

Interest Rates: Take Your Pick. In the old days, the old adage “Don’t fight the Fed” meant that if the Fed is raising interest rates, one should turn less bullish, or even bearish, on equities. These days, the Fed might have stopped hiking rates for a while. If so, then betting that the S&P 500 will swoon once again to test its December 24, 2018 low might not be such a good idea. That’s especially true if the next move by the Fed might be to lower interest rates.

Former Fed Chair Janet Yellen was among the first to suggest this possibility, though she did it as the proverbial “two-handed economist.” In a 2/6 [interview](#) on CNBC, she said interest rates could go up or down. “It’s not out of the question that the Fed may need to raise rates again,” she said. But then she added: “If global growth really weakens and that spills over to the United States, or if financial conditions tighten more and we do see a weakening in the US economy, it’s certainly possible the next move is a cut, but both outcomes are possible.”

She likened the current situation to what happened in 2016. Under her leadership, the Fed pivoted from projecting four rate hikes for that year to making a single rate hike in December. Fed Chair Jerome Powell recently recalled that experience to emphasize the importance of policy flexibility. On 1/4, in a panel [session](#) with former Fed Chairs Ben Bernanke and Janet Yellen, he said that the Fed could be “patient” with further interest-rate hikes, signaling a pause from the Fed’s formerly “gradual” trajectory.

So it could be one-and-done again this year, as in 2016—but will that mean a rate increase or a rate cut this time? Take your pick. Of course, there is another possibility: The federal funds rate could remain flat this year. That’s what Melissa and I pick as the most likely scenario. If it is one-and-done, then up is more likely than down, in our opinion. But like the Fed, we are data dependent.

So are the financial markets. Let’s turn now to how they are handicapping the three alternative scenarios starting with the US credit markets, then the other major financial markets:

(1) *The 2-year US Treasury yield.* As we’ve observed in the past, the 2-year Treasury yield tends to be the credit market’s forecast of the federal funds rate (FFR) one year into the future ([Fig. 1](#) and [Fig. 2](#)). Last year, it peaked at 2.98% on November 8, well above the 2.13% midpoint of the 2.00%-2.25% federal funds rate range (FFRR) at that time. It dropped to 2.39% ahead of Powell’s 1/4 comments, virtually matching the 2.38% midpoint of the current 2.25%-2.50% FFRR. It rose following the better-than-expected employment report released 2/1. Yesterday, it was at 2.48%. So it’s currently signaling

none-and-done for this year.

(2) *Treasury yield curve.* The Treasury yield curve spread is doing the same. The spread between the 10-year Treasury and the FFR was only 28bps yesterday ([Fig. 3](#)). That implies that if the yield curve remains this flat, a Fed rate hike could invert the yield curve. In other words, it's hard to imagine a scenario in which the yield curve is this flat and the Fed hikes the federal funds rate. Of course, stronger-than-expected growth with higher-than-expected inflation would widen the yield curve spread and trigger a resumption of Fed tightening. That doesn't seem very likely anytime soon.

(3) *Credit spreads.* The yield spread between high-yield corporate bonds and the 10-year Treasury is highly correlated with the S&P 500 VIX ([Fig. 4](#)). In the past more often than not, the widening spread reflected credit quality problems that raised fears of a credit crunch and a recession, which depressed stock prices and boosted the VIX. The latest widening late last year seems to have been caused by the plunge in stock prices. In our opinion, the epicenter of the bearish sentiment was in the stock market rather than the credit market this time ([Fig. 5](#)). In other words, stock investors feared an impending recession late last year, and are now less concerned. So while they may be expecting the Fed to pause rate-hiking, they probably aren't expecting a rate cut.

Strategy: Inter-Market Correlations. The S&P 500 touched its lowest point so far this year on 1/3, closing at 2447.89 ([Fig. 6](#)). Since then, the index has rallied over 10% to close at 2707.88 on 2/8. Not only has Powell's willingness to be patient impacted the stock market but it also has sparked movements that fit several textbook market correlations that Melissa and I track closely. Consider the following:

(1) *Will the buck stop here?* Predictably, the promise of a pause in interest-rate hikes has stopped the greenback's rise. The simplest reason is that lower rates make holding US dollar assets less attractive. Since 1/3, the US dollar's value as measured by the JP Morgan Nominal Broad Effective Exchange Rate has fallen 0.6% through yesterday ([Fig. 7](#)).

Contrary to the Fed's dovish turn, however, the US dollar has jumped 1.4% month-to-date, through yesterday's close. While we could see a retracement of these recent gains, global economic weakness will likely contribute to the choppiness of the nation's currency. Other central bankers around the world are more dovish than the Fed.

The proof is in 10-year government bond yields ([Fig. 8](#)). For comparison, the US 10-year government bond yield stood at 2.63% at Friday's close. The yield on the 10-year German bund fell to its lowest since October 2016, at 0.09%, as of the end of last week. It is down 49bps since a recent peak late last year. Japan's 10-year yield is holding near two-year lows of -0.03%.

And that may not be as low as they go. In a 2/7 [interview](#) with *Barron's*, the European Central Bank's (ECB) Benoît Coeuré said that eurozone risks "have moved to the downside." Coeuré explained that the central bank is ready to do more if the incoming data suggest it is necessary. On 1/24, the ECB decided to maintain its key interest rates: the marginal lending rate at 0.25%, the main refinancing rate at 0.00%, and the deposit rate at -0.40%.

On 1/22, the Bank of Japan decided to maintain its targets for the short-term interest rate at -0.1% and the 10-year yield (via yield curve control) near zero, but announced lower inflation expectations through 2019. As a result, this month to date, the euro and the yen have lost 1.2% and 0.8%, respectively, against the dollar ([Fig. 9](#) and [Fig. 10](#)).

(2) *Oil prices moving on up.* Oil prices tend to rise (fall) when the US dollar falls (rises) ([Fig. 11](#)).

Though the correlation isn't perfect, a weaker dollar makes oil priced in dollars less expensive to the rest of the world. So the overseas demand for oil priced in dollars tends to go up, leading to lower inventories and higher prices. Since 1/3, the futures price of a barrel of Brent crude oil has risen 12.0%, from \$54.91 per barrel to \$61.48 per barrel yesterday, against the dollar's 0.6% decline.

There have been recent periods, albeit brief ones, when oil and the dollar moved together. However, the trends in oil and the dollar so far this year have followed their historically negative correlation. The recent strength in the price of oil is especially impressive given that US oil production was almost at 12 million barrels a day at the start of this month ([Fig. 12](#)).

(3) *Emerging markets more attractive.* Emerging markets reliant on commodity exports and those that borrow in US dollars tend to perform better when the Fed is less hawkish. From 1/3 to the end of last week, the Emerging Markets MSCI Stock Price Index has risen 8.2% in local currencies and 9.1% in dollars ([Fig. 13](#) and [Fig. 14](#)). Both indexes are highly inversely correlated with the trade-weighted dollar.

Sentiment toward EMs could further brighten. Emerging markets may experience a double bang for a weaker buck: (1) lower interest rates reduce the demand for US assets, encouraging a flow to emerging markets, and (2) EMs' dollar-denominated debt is a significant portion of their outstanding debt. A weaker dollar makes it less expensive to service that debt.

(4) *Expected inflation on the rise.* Along with a weaker dollar and higher oil prices, expected US inflation has increased 12 basis points to 1.82% since 1/3 ([Fig. 15](#)). It's measured as the yield spread between the 10-year US Treasury bond and comparable TIPS. Offsetting the small increase in expected inflation has been a decline in the TIPS yield, reflecting expectations of slower economic growth. A lower TIPS yield has helped to modestly boost the price of gold, which may be a harbinger of higher commodity prices more broadly ([Fig. 16](#)).

(5) *Looking ahead.* So far, the uncertainty around the US-China trade negotiations has given more weight to the Fed's actions. But that focus could abruptly shift if the trade dispute is resolved with a mutually beneficial deal. If that happens, the dollar would probably resume weakening on hopes for better global economic growth. Equities around the world would likely get a big boost, especially those of emerging markets including China. Commodity prices, particularly copper and oil, could jump higher.

But all that momentum might be short-lived because of homegrown problems in China as well as Europe and Japan. Aging demographics are likely to keep a lid on inflation around the world, which should keep the Fed on a dovish course.

Back home, two other major factors could set the equity markets off course: the potential waning of earnings growth and a possible change in leadership for the 2020 presidential elections. Already, Democratic candidates are fighting for higher taxes on the wealthy and restrictions on share buybacks. But weak earnings could be outweighed by further monetary policy accommodation, and the 2020 election is still quite uncertain. For now, don't fight the Fed!

Valuation: FANGs Are Cheaper. Stock market history is replete with numerous examples of industries with extremely high valuations followed by crashes. They occurred in what were then brand new high-growth industries, ranging the gamut from radio in the 1920s, the Nifty 50 stocks in the 1970s, biotech in the 1990s, and the Tech sector and Internet stocks around Y2K.

Since the late 1980s, consensus forward P/Es have been available from I/B/E/S, allowing investors to assign valuations to companies and industries relative to their growth prospects. While revenues and earnings have varied widely, valuations have been much more volatile. The FANG stocks—Facebook,

Amazon, Netflix, and Google's parent Alphabet—are no exception.

The FANG fad began when the last member of the quad, Facebook, went public in May 2012. Each week, we update a market briefing titled the [FANG Stocks Overview](#), which compares the FANGs to the S&P 500 companies in terms of price performance, revenues, earnings, and valuations. Following Facebook's IPO, the group's aggregate forward P/E moved from under 60.0 times expected forward earnings to a record high of 71.8 during February 2014. The group then traded between 50.0-60.0 times earnings before rising to a peak of 65.1 during January 2018 and settling around 55.0 through the end of last summer.

Looking at the weekly data for the FANG index, we see that its aggregate forward P/E then fell steadily through the fall before plummeting to a record low of 41.1 on December 21. Since then, it has recovered to 46.5 through last Friday. At its low, the FANG index's forward P/E was down more than 20 P/E points from its late-January 2018 high of 65.1 and more than 30 points below its record high of 71.8 during February 2014 ([Fig. 17](#)).

The FANGs' aggregate market cap is now down 13% from its record high at the end of August. Despite the decline, the FANGs continue to make up a big portion of the S&P 500's market cap and its valuation. Their 9.6% share of the S&P 500's market cap remains close to the record high of 10.4% last July ([Fig. 18](#)). The group still contributes 1.1 points to the S&P 500's forward P/E of 15.8 compared to a record-high 1.3 points in mid-July ([Fig. 19](#)).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 103.0, Job Openings 6.95m, George, Mester. **Wed:** Headline & Core CPI 1.5%/2.1% y/y, Treasury Budget -\$12.0b, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report, Mester. (Econoday estimates)

Global. Tues: Japan Machine Tool Orders, Australia Business Confidence, Carney. **Wed:** Eurozone Industrial Production -0.4%/m/-3.3%/y/y, UK Headline & Core CPI 2.0%/1.9% y/y, Japan GDP (saar) 1.4% q/q. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for a fifth straight week for all three of these indexes, continuing the declines that began during October. LargeCap's forward EPS is now 2.3% below its record high of \$175.48 in late October, while MidCap's and SmallCap's are now 2.2% and 5.5% below their mid-October highs, respectively. LargeCap's forward EPS is the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since April 2016 and December 2010, respectively. The yearly change in forward earnings remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 23-month low of 8.0% y/y from 9.4%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change was down to a 23-month low of 9.4% from 10.9%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to a 13-month low of 14.5% from 16.4%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 4.4%, 11.8%), MidCap (21.7, 6.1, 11.8), and SmallCap (21.8, 10.8, 15.9).

S&P 500/400/600 Valuation ([link](#)): LargeCap's forward P/E ratio was steady w/w, but MidCap's and SmallCap's both rose. All these indexes are up now from multi-year lows in late December, with LargeCap at its highest level since early November and the SMidCaps their highest since early October. LargeCap's weekly forward P/E of 15.8 is up from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September and a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E of 15.2 is up w/w from 15.1 and from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E of 16.1 is up from 16.0 a week earlier and from 13.6 during December, which had also marked its lowest reading since November 2011. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). SmallCap's P/E was higher than LargeCap's P/E for a fifth week after being below for much of December for the first time since 2003.

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