COMMENTS ON THE STOCK MARKET CORRECTION

The stock market has fallen sharply in early October amid ongoing signs of strong economic momentum and higher bond yields. This is the third sizable market correction so far this year — one occurred in early February based on an inflation scare, one in March triggered by President Trump’s initiation of tariffs — but the S&P is still up modestly year-to-date. What’s going on?

As usual, there are a handful of factors contributing to the stock market correction. Our general assessment is that, while trends in the economy and profits are very healthy, the recent rise in bond yields and expectations that the Fed will continue its interest rate and balance sheet normalization have heightened market concerns about valuations. We do not attribute this correction to Trump’s trade policy negotiations, but we do see market jitters about the upcoming midterm elections ("Assessing the U.S. midterm elections: uncertain outcomes, uncertain implications," October 8, 2018). We also emphasize that market corrections are normal, and as the economy grows over time, so will profits and the U.S. stock market — but the market never moves in a straight line. Our key observations about the market correction are as follows.

**Stock market valuations** Higher than average P/Es underlie concerns of high stock market valuations. The P/E based on 12-month trailing earnings on the S&P500 is 20, higher than its longer-run average and the P/E on the NASDAQ is much higher, at 45. Whether these P/Es signal over-valuation depends on several factors, most prominently actual and expected profits and interest rates, but other factors like capital flows and risk preferences also matter. The average P/Es may seem high, but based on consensus estimates of profits, they are expected to recede. Yet the tech sector has been a major driver of the stock market, and its high P/Es are far more difficult to evaluate because the future trajectory of their revenues and profits are more uncertain. The markets are the arbiter of whether their valuations are appropriate.

A note on different measures of P/Es: we find the CAPE (Bob Shiller’s Cyclically-Adjusted P/E) uninformative and an unreliable measure of current valuations: calculated as a 10-year moving average, the sky-high P/Es during the 2008–2009 financial crisis and deep recession have elevated the CAPE in recent years, and the measure will recede significantly in 2018 and 2019 as the 10-year ago data roll off, but provide little insight to current valuations.

**The economy and profits have been growing strongly and do not seem to be a factor underlying the market correction.** The economy has broad-based momentum, with solid gains in consumption driven by strong gains in employment and moderate wage increases, strong business investment (up 7% year over year) and solid increases in exports, despite worries about President Trump’s trade negotiations. Business and consumer confidence measures are at or hovering near all-time highs. Corporate profits have been rising at a solid pace: operating profits (pretax profits adjusted for capital consumption allowance adjustments and inventory valuation adjustments) are up 7% year over year and after-tax profits received a boost from the Tax Cuts and Jobs Act of 2018. In labor markets, we have pointed out that the unanticipated rise in the labor force participation rate of prime working-age people suggests that labor supply is more elastic than is estimated in standard macroeconomic models, with several key implications: wage gains have been more modest than expectations despite the unemployment rate remaining far below standard estimates of the natural rate of unemployment (so-called full employment); the addition of employment is adding to household purchasing power and confidence; and there is more room for the economy...

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to grow. We expect the Federal Reserve to eventually acknowledge this and raise its estimates of sustainable growth (“Rising US prime working-age labor participation”, September 20, 2018).

Our forecast is that economic growth remains above the consensus view: we forecast 3.1% annualized growth in the second half of 2018 and 2.8% in 2019. This is a slowdown from the current pace but well above the Fed’s forecast and consistent with sustained momentum in business investment while some of the impact of the tax cuts for individuals begin to fade. Employment growth is expected to moderate. Nevertheless, such sustained economic growth will support continued increases in profits.

The rise in interest rates is clearly a factor underlying the market correction. Ten-year Treasury bond yields have increased roughly 40 basis points to 3.2% and the Fed has signaled that it will be hiking its Fed funds rate target further. The level of bond yields — the factor for discounting the present value of the expected future stream of earnings and provides alternative investment opportunities to the stock market — remains low by historical standards. Moreover, many market participants had expected higher rates as a reflection of moderate inflation and strong economic performance. Yet the speed of the rise in rates has proved to be a reality check for the markets’ assessments of valuations. Now that bond yields are receiving much more attention, market participants have a heightened sensitivity to any signs of inflationary pressures. Those expectations are factored into stock market valuations.

Like many others, we have forecast that bond yields would rise. We have also argued that the sustained low bond yields (and Fed funds rate), driven in part by the Fed’s policies and forward guidance, had led markets to buy into the notion that the “new normal” was far different than history — and that some aspects of the new normal would eventually look more like the old normal. The Fed’s normalization of rates and the rise in bond yields is part of that reality.

The Fed’s normalization and balance sheet unwind are contributing to higher yields and reducing risk-taking incentives. To understand the current impact of the Fed’s normalization, it is important to understand the Fed’s rationale for QEIII and its formal forward guidance beginning in late 2012: the Fed’s massive asset purchases and signaling that it would keep rates low for a very long time would push up asset prices and encourage risk taking, which would result in stronger economic growth and low unemployment rates. Fed Chair Bernanke referred to this as the “real balance effect.” In fact, while the economy was growing modestly and profits were rising, the Fed’s unprecedented policies did stimulate financial markets and supported higher asset prices (stocks and real estate) but did not stimulate economic growth. Our argument has been that economic growth was constrained by factors that were non-monetary in nature and beyond the Fed’s control, including the dampening impacts of the growing web of regulations in both the non-financial and the financial sectors and tax policies.

Now that the Fed is proceeding with normalizing interest rates and unwinding its balance sheet, it is unrealistic to assume that there will be no reversal of the impacts of the Fed’s sustained unprecedented monetary ease. The Fed has been worried about any adverse impacts of its normalization — those fears were accentuated by the taper tantrum of 2013 — and that’s why it has moved so timidly and gradually to raise rates and unwind its bloated balance sheet. The Fed has been very transparent about its intention to normalize rates and its strategy to gradually unwind its balance sheet. In a sense, most of the excess reserves created by the Fed’s massive asset purchases were loaned back to the Fed by the large banks, so the dramatic increase in the Fed’s high powered money (the monetary base equals reserves plus currency) was not put to work in the economy — in fact, money velocity declined. However, the Fed’s use of its balance sheet as forward guidance about its future interest rate policy and the long dated duration of its portfolio (while the Fed’s liabilities were of short-duration loans from large banks that were lending their excess reserves back to the Fed) kept bond yields lower than they would be otherwise.

So far the impacts have been seemingly muted. But as the Fed continues to unwind its balance sheet while the U.S. Treasury issues more bonds to finance increases in deficit spending, the rising outstanding U.S. government debt must be absorbed. The issue is, at what price? The Fed remains the largest holder of Treasuries ($2.3 trillion), but the Fed’s
scheduled unwind involves $30 billion per month runoff (it will also allow $20 billion of MBS to run off). In the next year, beginning this October, the Fed will reduce its Treasury holdings by a maximum of $360 billion. But this runoff is still fairly small relative to the total $15 trillion in outstanding publicly-held debt. Thus, the actual flows of U.S. Treasury bond holdings are likely having only a modest impact, but the markets correctly anticipate that the Fed’s unwind process will continue at the same time the Fed is responding to inflation that is at the Fed’s target and the economy is growing faster than the Fed’s forecasts. These perceptions support the tilt in expectations that bond yields will rise further.

In addition, the rise in rates is also dampening the incentives to take risks. This point was noted by John Williams, President of the Federal Reserve Bank of New York. At the IMF meetings in Bali, he referred to the Fed’s earlier QE and noted: “A very low interest rate environment for a long time does, at least in some dimension, probably add to financial risks, or risk-taking, reach for yield...Normalization of the monetary policy, I think, has the added benefit of reducing somewhat, on the margin, some of the risk of imbalances in financial markets.” The diminution of risk-taking presumably has weighed on stock valuations.

If the Fed’s interest rate normalization and balance sheet strategies have been clearly telegraphed and under way for a while, why has the stock market been sanguine until recently? Short-run market behavior is not predictable and equally difficult to explain. Perhaps the wisest observation about markets is captured by a famous quote by the brilliant economist Rudi Dornbusch: “In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.”

**President Trump's aggressive negotiations on trade policy have occasionally added to market jitters but do not seem to have played a major role in this correction.** Following the recent agreement between the U.S., Mexico, and Canada on modifications to NAFTA resulting in the new USMCA and the ongoing negotiations based on a general agreement between the U.S. and EU, the near-exclusive focus is now on trade policy negotiations between the U.S. and China. Certainly, there are large disagreements between the two. New York Fed President Williams notes that, while the negotiations between the U.S. and China are bruising and have led to uncertainty in the business community, so far the effects have not shown up in the government’s statistics on hiring and investment. Our strong hunch is China will eventually agree to cease and modify some of its unfair trade practices relating to intellectual property and investment in China, and open some of its markets to foreign goods and services. China relies heavily on the U.S. as a trading partner and, with its economic growth slowing more than the targets of China’s leaders, Trump’s tactics come at a bad time for China.

**The economic impacts of this stock market correction hinge critically on whether it jars confidence.** We have emphasized in prior research that, when confidence surveys are in the higher percentiles of historical readings, as they have been since early 2017, they boost economic activity (“US: “soft” data and “hard” outcomes”, March 9, 2017). We have empirically linked the elevated business confidence to the thrust toward easing burdensome regulations; presumably, tax reform has helped. While the extremely elevated confidence has lifted spending and investment, it presents a downside risk as well: a jarring fall in confidence, for whatever reason, would dent economic growth.

The sizable stock market corrections in February and then March did not harm confidence — all surveys have hovered near all-time highs. But, with valuations higher, the Fed normalizing monetary policy, and markets nervous about rising bond yields, along with ongoing uncertainties about Washington, DC and the future thrust of policies, it may be more difficult for the markets to rebound as quickly from this correction, and confidence seems a bit more vulnerable. We will be monitoring these measures closely.
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