Federated®

Market Memo: It's a healthy sell-off, not a harbinger of something worse

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Concerned that rising inflation and higher bond yields will lead to lower equity market valuations, investors are driving a sharp sell-off in stocks and a spike in volatility. But our work suggests their worries are getting well ahead of themselves. Historically, equity price-earning (P/E) multiples don’t start to compress until the 10-year Treasury yield hits 5%, its neutral point in a normal cycle. Given the lower-for-longer nature of this recovery, we think the neutral yield for this cycle is around 3.5%. Against that backdrop, a 10-year yield currently trading in the 2.75% to 2.85% range after the past week’s run-up is still well out of the danger zone.

Remember, to decrease the likelihood of having to use extraordinary measures during the next downturn, the Fed’s main objective is to refill the quiver of monetary policy tools that it used to help pull us out of the 2008 crisis. This would suggest two or three hikes in the target funds rate in the year ahead. Possibly four, if global growth continues to accelerate, inflation expectations rise, productivity improves on the back of tax cuts and fiscal reforms, and sovereign yields abroad start to climb. All of this could push the neutral rate above our 3.5% estimate, and could come *without* negatively impacting the economy and markets—an outcome the market hasn’t figured out yet, which is why we’ve seen downside pressure in the last several days. Frankly, we think it’s healthy to see some of the recent market froth blow off—January’s gains were unsustainable.

Sell-off prompts Federated to raise equity overweight

Federated’s PRISM® committee added a tick to equities in its stock-bond portfolio model at the close of trading yesterday, lifting the equity overweight position to 70% of maximum. The additional allocation went to large-cap growth stocks, which the committee believes offer attractive values after being beaten down in this sharp, largely technical correction. The committee also said it remains very optimistic about the economy, earnings and stocks this year.

Earnings growth remains very robust

Inflation is the key metric to watch. The market got spooked last Friday when wage growth hit 2.9% on a year-over-year basis, the highest level since 2009. But the core PCE price index continues to show inflation below the Fed’s 2% target, and wage gains tend to move in a one-step forward, two-step back fashion, taking usually a year to move a full percentage point higher when they start to move. This is consistent with our thinking that wages would rise from just below 3% to just below 4% by late 2018 or early 2019. Four percent is the key level. Historically, 4% wage growth tends to lead to a much more aggressive Fed, which in turn tends to lead to recession 12-24 months later. This scenario would push the next recession out to 2020 or 2021, also consistent with our view.

The bottom-line: earnings continue to grow strongly, with consensus S&P 500 expectations for 2018 now matching our forecast of $155, implying 20% earnings growth vs. last year. This means that the market is almost a full turn cheaper than it was at the start of the year on a P/E basis, trading just above 17 times projected 2018 earnings. Sure, the current sell-off has been dramatic, especially given systematic selling pressure from risk-parity funds that can move violently on changes in volatility, which has shot up in the past week and could remain elevated relative to historically low levels of the past few years. But if this earnings growth materializes, as we expect that it will, we continue to believe that markets are biased higher. We maintain this is a buy-the-dips, not sell-the-rallies market, are keeping our target for the S&P at 3,100 for the year and late yesterday added to our equity overweight in our stock-bond portfolio model (*see insert*) on the bargains being created by this rapid pullback.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Diversification and asset allocation do not assure a profit nor protect against loss.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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