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A Brief Risk Update: Recent price volatility

December 2018

Throughout the year economic growth fueled by tax cuts and accommodative monetary policy has been at or above trend, particularly in the U.S. While future growth is likely to slow due to rising interest rates and fading fiscal stimulus, data suggests near term recession risks remain quite low. Despite these favorable conditions, markets have been buffeted by a host of political and policy uncertainties, from trade concerns to the government shut-down, which may or may not ultimately impact underlying fundamentals. Like other times in history, the challenge is working to discern actual shifts in fundamentals versus temporary factors such as investor sentiment which may reverse quickly (e.g. 1994-95, and 1998). While policy uncertainty has been the primary catalyst for recent volatility, conditions have been made worse by a temporary deterioration in liquidity conditions - circumstances which also prevailed during the first quarter of the year. Markets currently appear priced for a host of adverse outcomes, outcomes that may not materialize. In the event fundamentals maintain the consensus trajectory, rather than a significant deterioration, markets will likely benefit from dissipating tail risks. Markets could be further bolstered by policy resolutions. As a result, we continue to recommend that investors work to maintain asset allocations close to policy levels, rebalancing when the opportunities present themselves. We anticipate maintaining this view if and until we detect a deterioration in underlying fundamentals. The charts which follow provide support for our view.

1. The implied equity earnings yield is high relative to less risky alternatives:

The chart below highlights the difference between the expected yield on 10-year Treasuries and the expected yield on equities. The equity yield is calculated by simply dividing the expected level of earnings, as measured by the consensus estimates of 12-month forward earnings for S&P 500 companies by the current price of the index (i.e. the inverse of the forward P/E ratio).

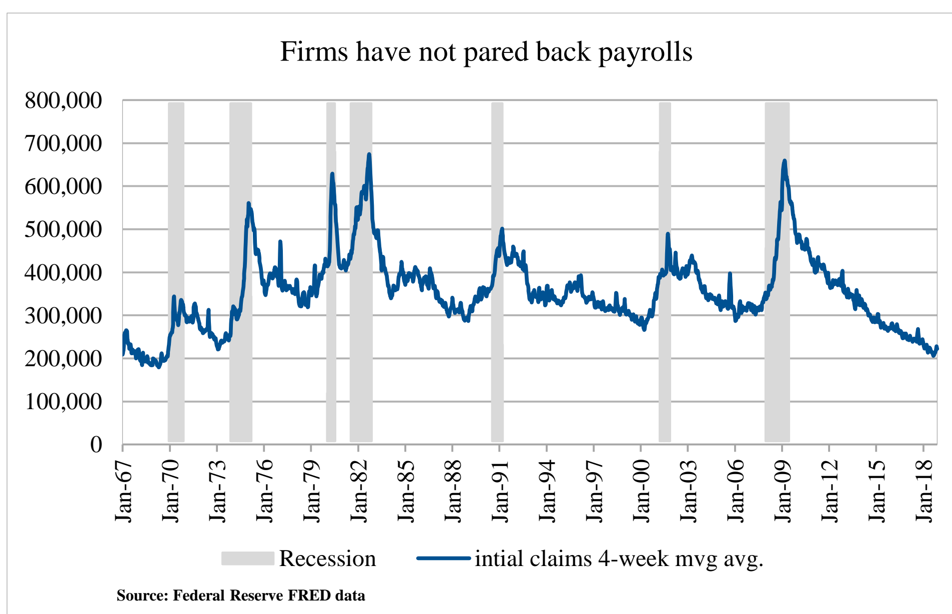
At the current level, the expected yield from equities appears extremely high relative to the yield on Treasuries. These conditions are not likely to persist indefinitely and can be remedied in three different ways (one or some combination of the three):

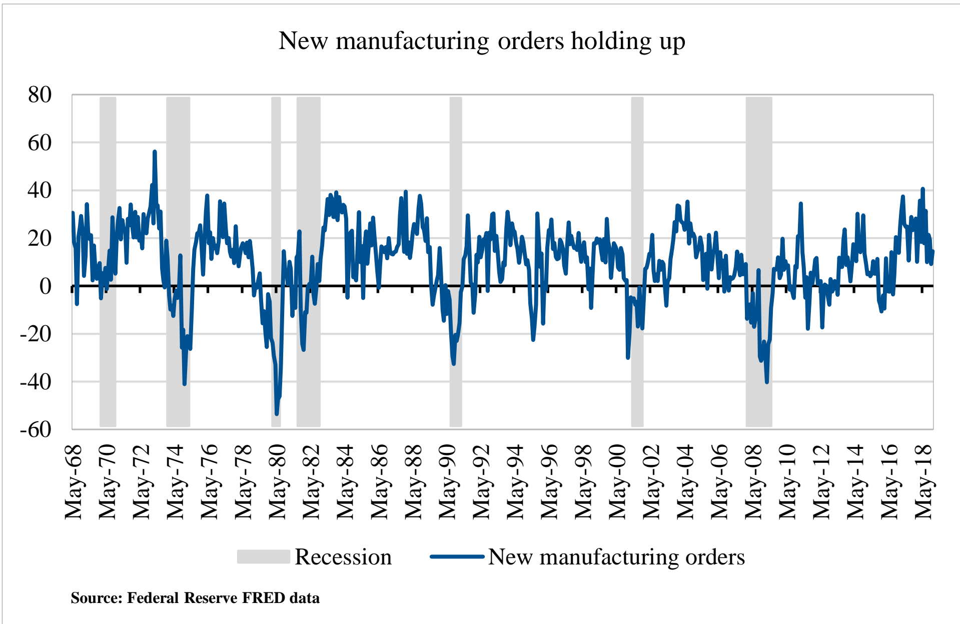
1. Earnings can decline
2. Treasury yields can rise
3. Equity prices can rise

Historically, analysts' earnings estimates are relatively accurate outside of recessions. Earnings growth will be close to 20% for 2018 and are expected to slow in 2019 to a more normal 7.8% rate per FactSet. (This is lower than the 10% 2019 earnings estimate forecast in September and October 2018, however, again per FactSet.) Current market pricing is suggestive of below trend, even negative, earnings growth in the near-term. Given that the prospects for recession over the next twelve months appear low, we would not anticipate a material decline in earnings. Additionally, while Treasury yields may rise, any increases will likely be modest due to subdued inflation and slowing growth. The bottom line is that while earnings growth will slow, and Treasury rates may increase slightly as the risk environment normalizes, we would expect some of the correction to come from equity price appreciation.

2. Long leading indicators aren't hinting at recession

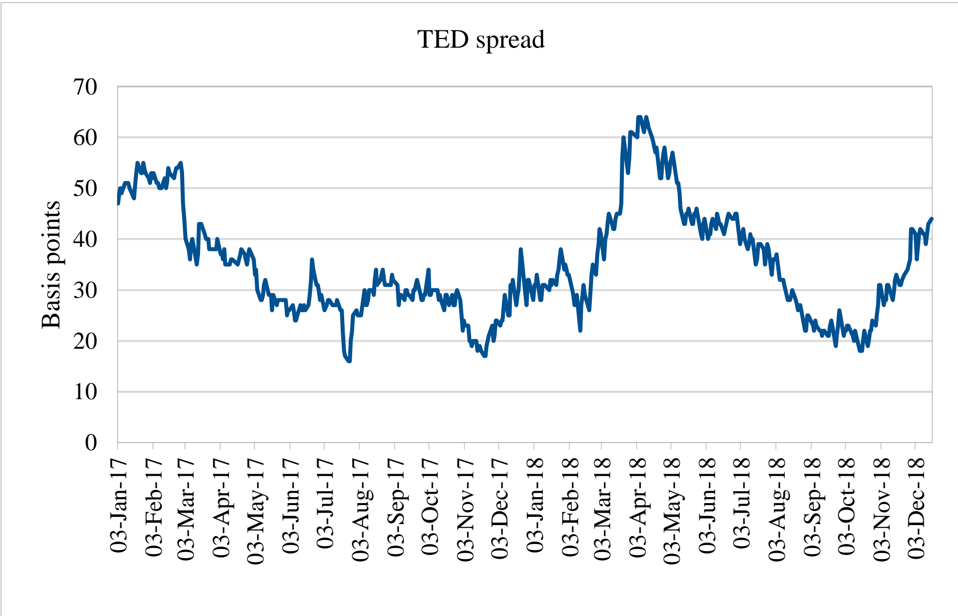
Prior to the onset of recession, as economic excesses build, firms pare-back activities reducing payrolls and slowing orders for new goods in the process. As a result, measures of these activities represent long-leading indicators providing the earliest clues of economic weakness. While any single measure may provide a misleading signal of strength or weakness at a given point in time, coherence across a broad series of data provides a reliable measure of economic risks. The charts below provide the history for the two long-leading indicators listed above. Initial unemployment claims are a measure of workforce reduction (lay-offs) and new orders reflecting business confidence in future growth. Like most long-leading indicators, these measures continue to point toward positive though slowing future growth. As noted above, this growth should support continued, though slower, earnings growth.





3. Temporary liquidity issues may be contributing to downside volatility

Regulatory reform undertaken after the financial crisis may be having an impact. Going into quarter-end and year-end, banks work to reduce their balance sheets in order to improve their leverage scores – an important component of regulatory reform. These acts of balance sheet reduction combined with the Federal Reserve's gradual reversal of quantitative easing and the Federal government's increased funding requirements have reduced the funds available for short-term funding, but not credit in general. Evidence of this can be seen in the recent increase in the 3-month TED spread, which reflects the increased cost of obtaining short-term funding relative to Treasury bill rates, shown in the chart below.



Current balance sheet pressures can be seen in the relative richness of off-balance sheet instruments such as swaps and Treasury futures – instruments that allow investors to maintain market exposure to interest rates without using their balance sheet. The effect of these balance sheet pressures is to reduce the amount of short-term funding for risk assets, putting pressure on prices. Note that similar conditions prevailed earlier this year, another period associated with a sharp sell-off in risk assets. We expect these pressures will substantially moderate as we move into the new year.

Putting this all together, markets are priced to compensate investors for a range of adverse scenarios, but portfolios need to be sufficiently diversified to weather market volatility while capturing any repricing. While there has been an abrupt change in market volatility, equity performance is still consistent with long-term capital market expectations.

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