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Reverting Toward Normalcy

One of the distinguishing features of 2017 was the extremely low volatility that accompanied above average equity returns. On a total return basis, the S&P 500 index rose every month. The same benchmark experienced no daily price changes -- up or down -- of over two percent for the entire year, whereas eight days is more typical. The standard deviation of returns throughout 2017 was the second lowest on record, and less than half the norm.

Those days are gone, courtesy of an air-pocket price reversal and volatility spike in early February of this year. The downturn produced the first 1,000-point single-day loss in the history of the Dow Jones Industrial Average, contributing to the first 10-percent decline in almost two years. The total duration of this correction -- if indeed it is over -- was just nine days. Corrections in a bull market are short and sharp, this one exceedingly so.

Dow Jones Industrial Average

What to make of it?

Evidence continues to suggest that stocks' rise in volatility, fall in price, is mostly a liquidity event; a market made vulnerable by extreme correlations across asset classes, combined with out-sized futures and options positioning, all expecting a continuation of an unsustainable trend. At some

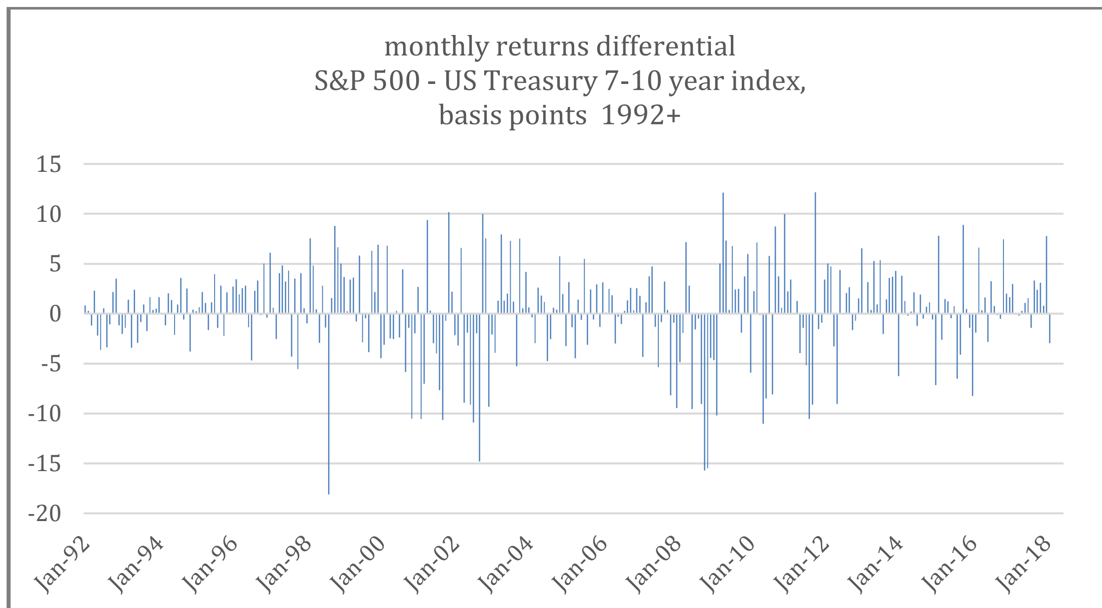
point, when everyone is in on the same trade, markets change direction. This turn just happened to be wilder than most.

Why now?

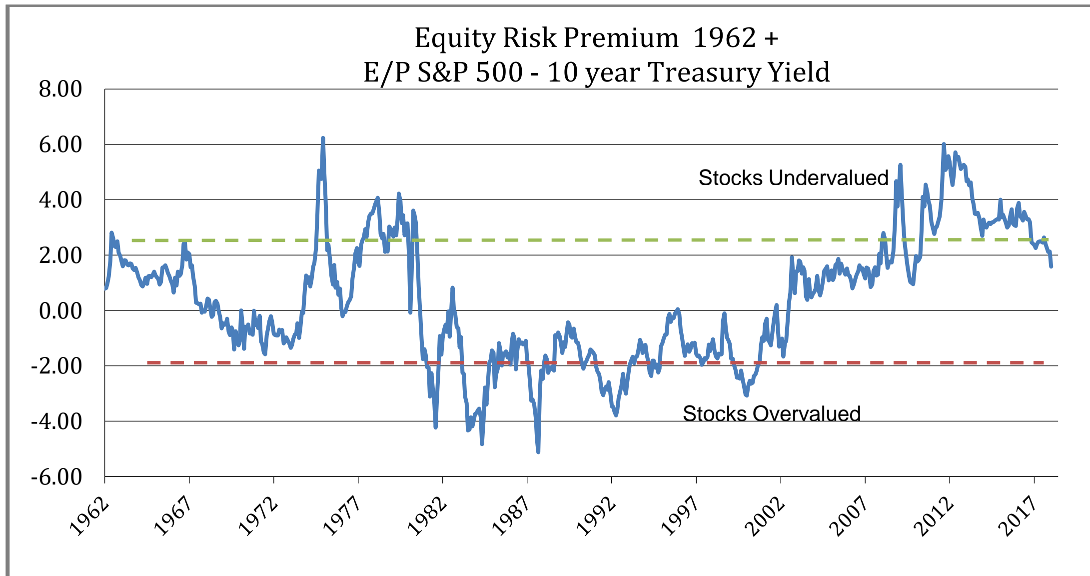
One piece of the timing puzzle is asset allocation re-balancing. While many observers tend to view stocks and bonds as two discrete markets, large investors such as pension plans typically own both asset classes, weighing the relative appeal of one versus the other, within pre-determined guidelines. As portfolios become over-weighted in stocks, these investors re-balance their accounts by selling stocks and buying bonds. This activity typically takes place in the last week of any month and the first week of the new month, and is usually so benign as to be imperceptible. But not always.

Indeed, the first sign of troubling volatility showed up in late January, accelerating into the first week of February. Not that it was predicted, but if a volatility spike was to occur, it was right on schedule.

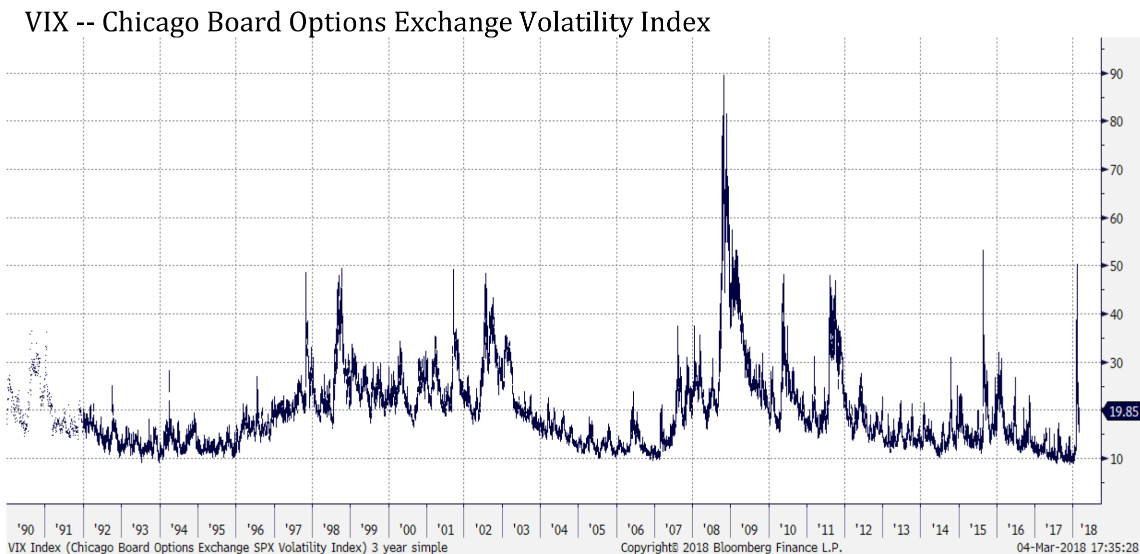
Further support of this view is provided by two additional bits of data. First, stocks outperformed bonds by 778 basis points in January. This is an out-sized gain, ranking as the 12th best month for equities versus bonds since 1992, and should certainly be cause for portfolio re-balancing -- out of stocks and into bonds.



Second, given the move in stocks and bonds, late January marked the first time since 2010 that the equity risk premium fell below 200 basis points, dropping from December's 213 basis point reading, to 159 basis points by month end. In other words, after seven years, bonds finally offer a competitive alternative to stocks.



Focusing further on volatility itself, the Chicago Board Options Exchange Volatility Index, aka the 'VIX', briefly traded above 50 in February, up from its early-January levels below 10. As shown below, the 50 threshold has only been pierced on two prior occasions -- for a single day in 2015, and for an extended period during the global financial crisis. This is not a replay of 2008.



As the VIX rarely reaches the 50 level, we can broaden our view to prior periods when this measure approached 50. These included October 1997, October 1998, September 2001, July 2002, May 2010, August 2011, October 2011.

The subsequent 12-month total returns for the S&P 500 from these dates were +18%, +41%, -11%, +18%, +25%, +28%, +33%. That's six double-digit positive returns, versus one negative return. All in all, history suggests a VIX spike is a buying opportunity.

Of additional note, credit markets -- typically an advance warning system -- are showing no sign of distress. In fact, since the intermediate low in interest rates last summer, quality credit and high yield spreads have narrowed versus the 10-year Treasury.

It is possible for stocks to rise too far, too fast; with too little volatility and too much investor complacency. At some point, corrections are inevitable, if difficult to time. They are also typically short, sharp, and healthy. We suspect that is the case this time around.

Budget Busters

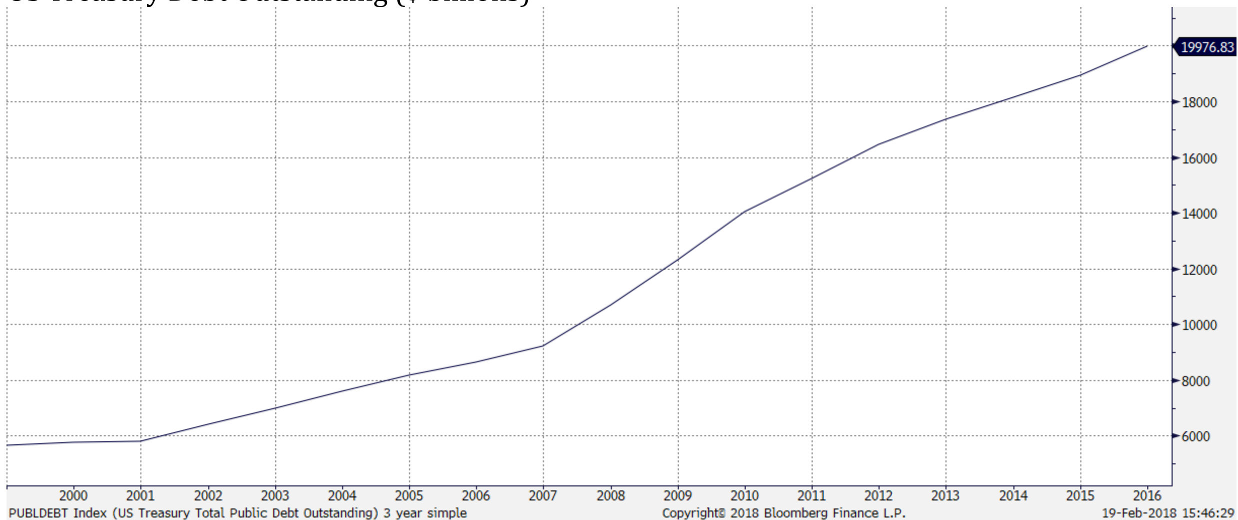
Once we step away from the usual blame game of party politics, there is a compelling argument that, when it comes to government spending, democrats and republicans are one and the same. The past 17 years have bolstered this view, and the past two months seem to have extinguished any lingering doubt.

When George W. Bush entered the White House in 2001, the federal government budget was in surplus, thanks to a combination of spending restraint, incentive-based tax rate cuts, and the tech-driven boom of the late 1990s. Total Treasury debt outstanding -- essentially all the money our government had borrowed, net of repayments, since its founding -- totaled under six trillion dollars. By the time President Bush left office, that figure had risen to over 10 trillion dollars. It's a neat trick, almost doubling our Treasury debt, while claiming to be a conservative.

Not to be outdone, under President Obama we again nearly doubled our nation's debt, this time working off a starting point almost twice as high. While deep recessions come with a cost, so do 'shovel ready', 'cash for clunkers', auto industry bail-outs, and other social-driven programs.

In round numbers, over the course of two administrations, Treasury debt rose from six trillion dollars to 20 trillion dollars. And what do we have to show for it? A global financial crisis, followed by the weakest economic recovery in modern history. Whether we blame it on the White House or on Congress, the result -- an inescapable debt burden and loss of fiscal restraint-- does not change a bit.

US Treasury Debt Outstanding ($ billions)



Still, there is a new sheriff in town, and with his business background and pledge to drain the swamp, perhaps Washington will change its profligate ways.

Fat chance.

The much-needed corporate tax reform of 2017 was accompanied by a perplexing cut in personal tax rates. While we should not complain too loudly about keeping more of our own money, the timing of this tax gift was difficult to justify. Tax cuts are meant to act as a stimulant, a boost to an economy mired in recession or, if you prefer the Jimmy Carter era, a malaise. No such condition exists today. The tally for this tax deal over the next 10 years is estimated at 1.5 trillion dollars in lower federal revenues. Let's straight-line the numbers and call it 150 billion dollars per year.

These tax cuts were followed by a recent budget compromise adding roughly 150 billion dollars per year to military and domestic spending programs, combined. Added to the tax cuts, that amounts to a 300 billion-dollar hike in budget deficits, a late-cycle fiscal stimulus leaving economists and deficit hawks scratching their heads.

As last year's budget deficit measured nearly 700 billion dollars, it doesn't take a math wizard to see that we are approaching a dubious government milestone: a trillion-dollar annual deficit, while deep into an economic expansion.

Moreover, the White House recently proposed a budget outline for 2019 and beyond. For fiscal conservatives, the bad news is that over the next decade under this plan, red ink will total seven trillion dollars, national debt will approach 30 trillion dollars, and the budget will not balance for as far as the eye can see, even with sustained economic growth. The good news is… well, there is no good news.

There is an apropos tale about the late-Senator Daniel Patrick Moynihan. The Senator was asked, when it comes to politicians spending other people's money, was there a distinction between democrats and republicans. As the story goes, after brief pause, Moynihan replied with a wry smile, "Democrats enjoy it more". Then and now, as the Senator knew, it is a distinction without a difference.

Tidbits..

International Monetary Fund raises its 2018 global growth forecast to 3.9 percent, highest rate in seven years.
US service industry surveys indicate best growth profile in 12 years.
Eurozone business activity measure approaches 12-year high.
McKinsey & Company study predicts productivity surge in US and Europe over the coming decade.

US government panel halts China's Ant Financial from acquiring US-based MoneyGram, citing national security concerns.
Proposed sale of Chicago Stock Exchange to Chinese investors is blocked by Securities and Exchange Commission.
Trump Administration threatens import tariffs on steel and aluminum.

National interests threaten to incite trade wars.

Brokerage firm Merrill Lynch prohibits clients from trading in Bitcoin and related products.

Intel reveals flaw in its chips gives computer hackers pathway to users' information.

Foreign automakers overtake Detroit, become largest car manufacturers in US.

New York City sues big oil companies, blaming them for climate change woes.
New York City announces long-term plans to divest its pensions of energy company holdings.

A novel approach from New York: suing the same companies you own.

Federal regulators scuttle White House plan to subsidize nuclear and coal-fired power plants in name of national energy security.
International Energy Agency forecasts "explosive growth" in US oil supplies, eventually surpassing Saudi Arabia and Russia as world's top crude oil producer.
US becomes net exporter of natural gas, first time in 60 years.
White House infrastructure plan calls for more than doubling of federal gasoline tax, to 43 cents per gallon.

Limited appetite in Congress for higher fuel taxes.

Amazon Go, convenience store without cashiers, opens in Seattle.

Colorado Girl Scouts ready for cookie sales outside marijuana stores.

Reaching a new high in product placement, cross selling.

California wins race to the bottom, ranks as state with highest poverty rate.

Source:
Bloomberg
McKinsey & Company
The Wall Street Journal