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THE OLD NORMAL

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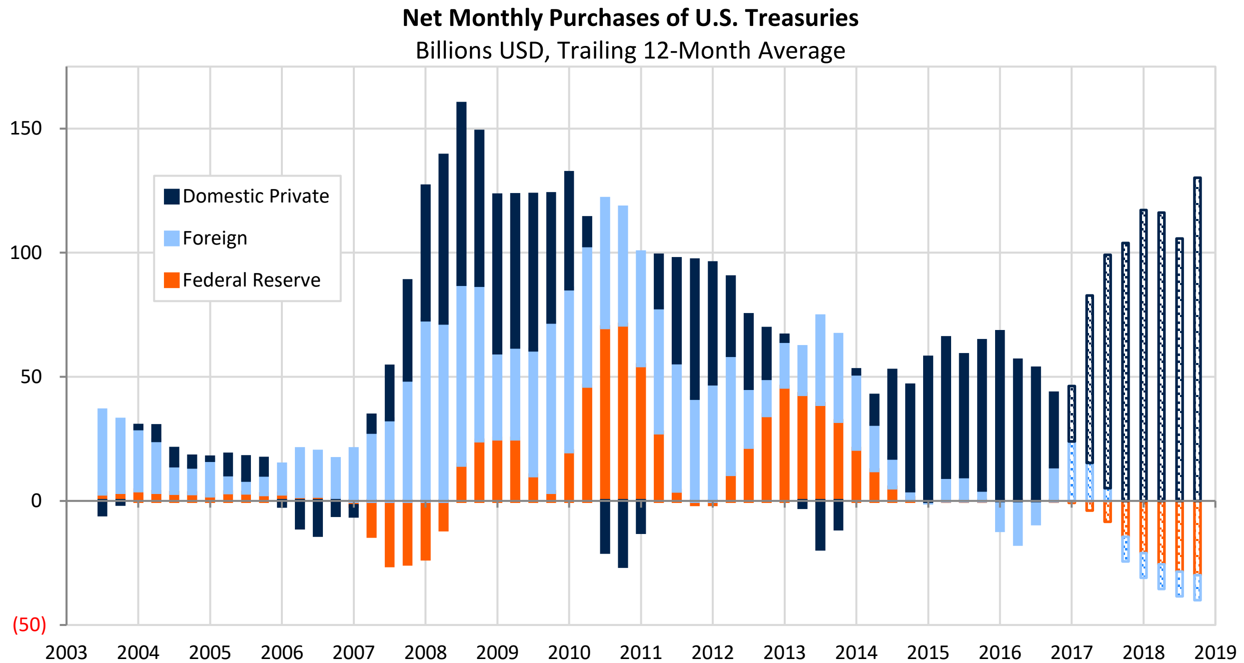
- **Market Psychology Has Reversed After a Decade Denying Rates Would Rise**
- **Fundamentals, If Anything, Have Been Improving**
- **Inflation is Not Dead, Just Slow and Late Like Everything Else**
- **Post Correction, Equity Valuations Now Reflect a 4% 10-Year Rate**

"Paradigm shifts" are too often imaginary constructs to resolve mysteries or misunderstandings, or to provide a flawed shorthand explanation for something more nuanced. The last time we heard this dangerous phrase it was being used by regulators and politicians to defend rapidly rising home prices relative to family income. A few years later this "new" paradigm ended very badly as home prices collapsed to meet seriously lagging family income. The resulting price drop was a century record.

The recent and dramatic market retraction in the face of rising interest rates is similar in nature, although unlikely to be anywhere near as dramatic. But it will persist as investors leave the comfort of abnormally supportive interest rates and finally recognize in recent data what central banks have themselves been saying for some time: Monetary ease has prevailed long enough, it has dubious ongoing purpose and has likely spawned significant market distortions (bubbles) that must now be addressed.

This market correction followed a confluence of events and data. 1) Central banks across the world have openly discussed their apprehension over quantitative easing for at least a year. 2) The Davos Economic Forum in January produced a chorus of such apprehension. 3) Treasury's January Quarterly Refunding Presentation finally recognized sharply higher estimates for the deficit and net new borrowing needs, up 11% and 10% respectively for FY 2018 and 23% and 20% for FY 2019. 4) The Bureau of Labor Statistics Friday release included a 2.9% hourly wage increase, seen as a harbinger of wider inflation.

Adding to #3 is our monthly supply/demand analysis of Treasuries at auction. We have routinely referenced this exhibit, which now incorporates these new supply estimates against the new absence of Fed and foreign demand, which together own the vast bulk of our Treasury debt. It is not a comforting picture. Domestic demand (dark blue bars) will soon have to absorb well over twice what it purchased during the 2008-9 crisis unless foreign demand somehow recovers.

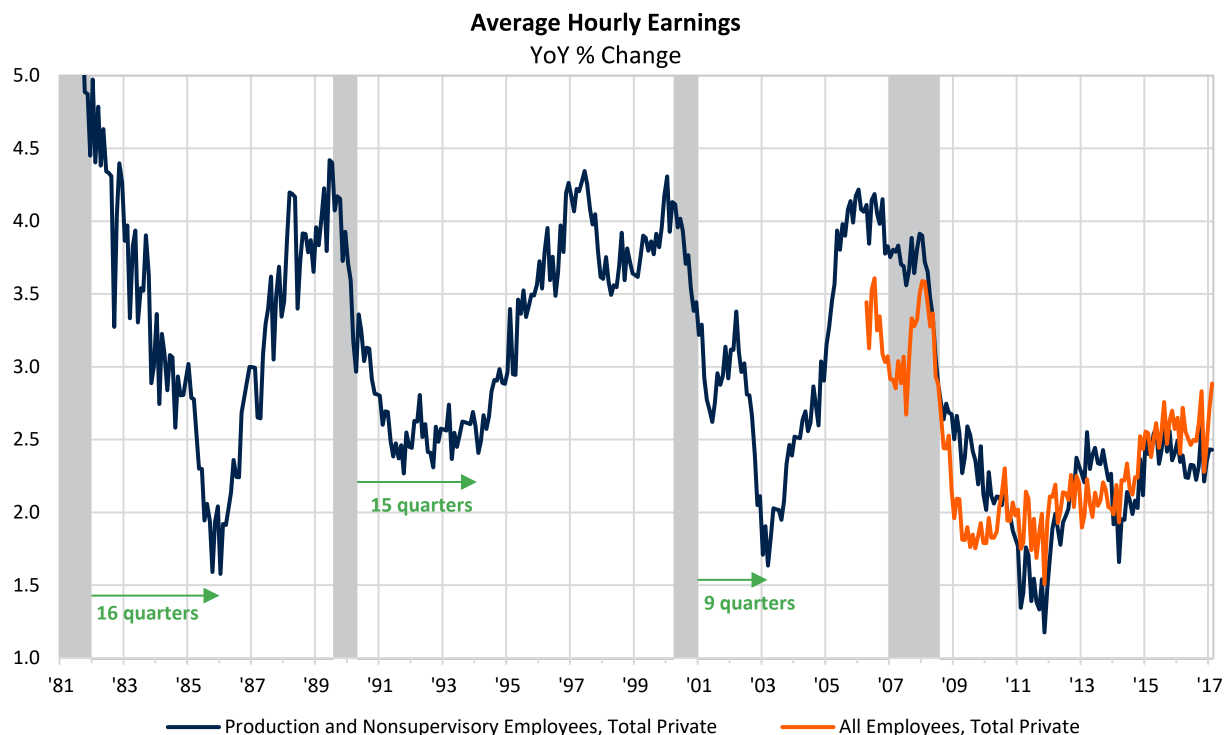


Source: US Department of the Treasury, Federal Reserve, Sandler O'Neill

The common thread in most of our strategy thinking has been to recognize the constant cyclicality of the U.S economy, attempting to isolate any variables that are or were truly "different this time." The defining variable change has simply been the timeline of the recovery, not its natural sequence of stages and events. We have noted multiple "markers" in this cycle that fit past cycles only except for their timing.

Moreover, these markers all appear to be consistently occurring between 2-1/2 to 3 times later than in the past, depicting a slow-motion cycle rooted in deteriorating demographics that had become visible by the millennial. We have included a few exhibits at the end of this report that help illustrate and support this view.

Seen through this analytical "adjustment" even the first Fed rate hike in late 2015 was actually on time and in sequence with past cycles, occurring 6-1/2 years after the recession ended instead of the two-year average of prior recessions. Inflation can now also be seen to be at least roughly in-line with this new, delayed timeline. Inflation in hourly wages clearly caught market attention last week as it reached 2.9% year-over-year.



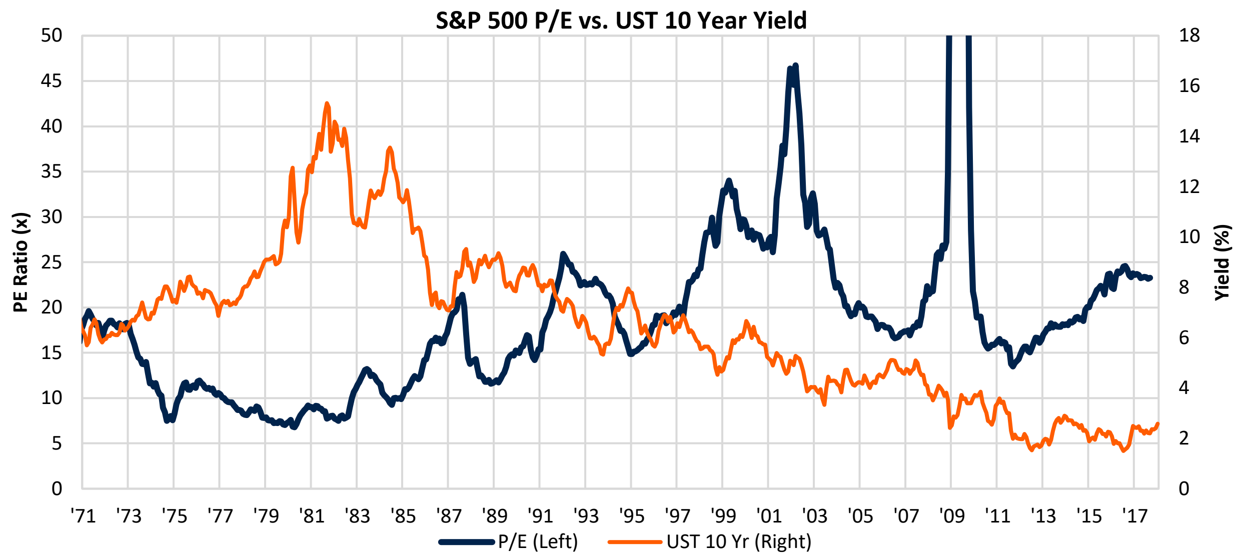
Source: US Department of Labor, Sandler O'Neill

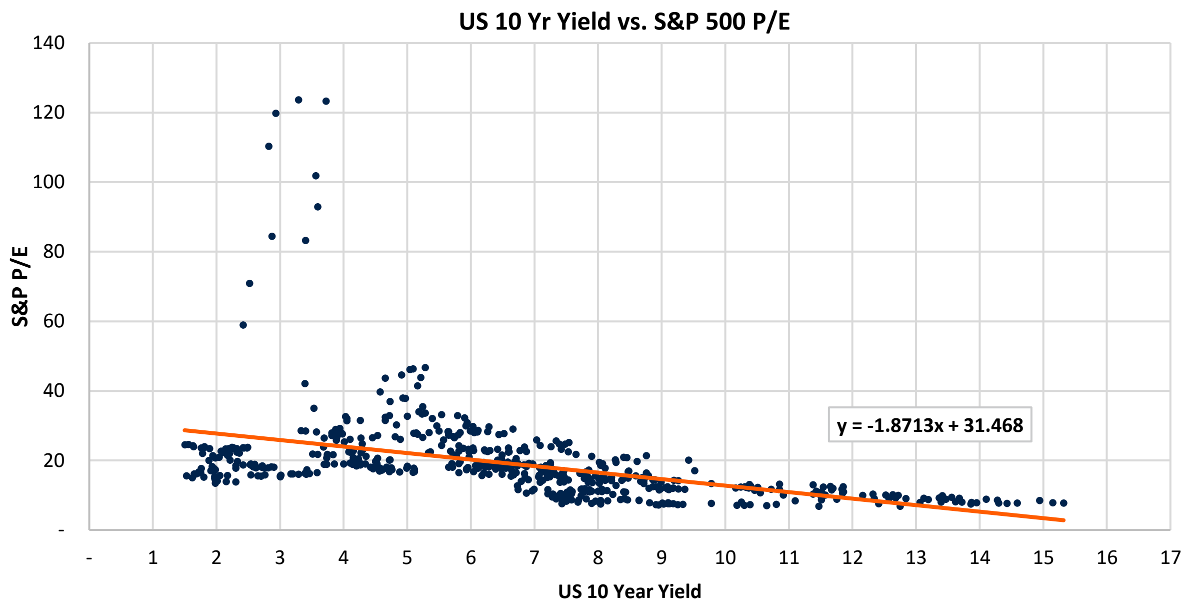
Wage growth historically reappears between two to four years after recessions end. Pinpointing the cyclical revival in wages is difficult this time as the revised series has been very gradually rising for almost three years. The unrevised, full historical series shows two clear bottoms, the last being 5-1/2 years after the recession. However the revised "All Employees" hourly wage data spiked twice to 2.8% in mid-2016 and again last August. If we consider the 2.9% advance this January as the "tipping point" then it occurred 8-1/2 years after the recession end, which puts it in a rough position within the elongated range we have seen in many other macro variable markers.

A very important, accompanying distinction should be made. An elongated cycle is also a slower cycle. It is no surprise that markets would over react as they reverse their future bias on rates for the first time in a decade. It is also unlikely that this reversal has been fully incorporated in just a few days of trading. But it does not follow that the degree of rising rates should be exceptional, unless we are grossly underestimating economic growth and its inflationary impetus.

In our last report we invoked "normalization" over "tightening" to describe the common intent for central banks. It is fair to say that the Fed not only remains data dependent but also sensitive to the yield curve as it plots future policy rate hikes. We have said many times that the 10-year rate averages slightly less than nominal GDP growth over long periods. Translating this relationship into Fed hikes, nominal growth is currently over 4% leaving at least six 25-basis point future hikes in the policy rate (assuming at least a 100 basis point Fed Funds spread beneath the 10-year.) Within reason the market is already recognizing this as a likely pace during normalization. The forward curve was wrong.

While it has never easily submitted to concise, quantitative assessment there is clearly an inverse relationship between long term interest rates and equity market valuations. A scatter diagram of the 10-year Treasury rate and the Shiller S&P price/earnings ratio provides some guidance for this relationship as seen below. A 100-basis point rise in the 10-year suggests an 8% decline in equity valuations which is a bit less than the market correction to date. By this methodology the 10-year approaching 4% has been more than reflected in the S&P 500.



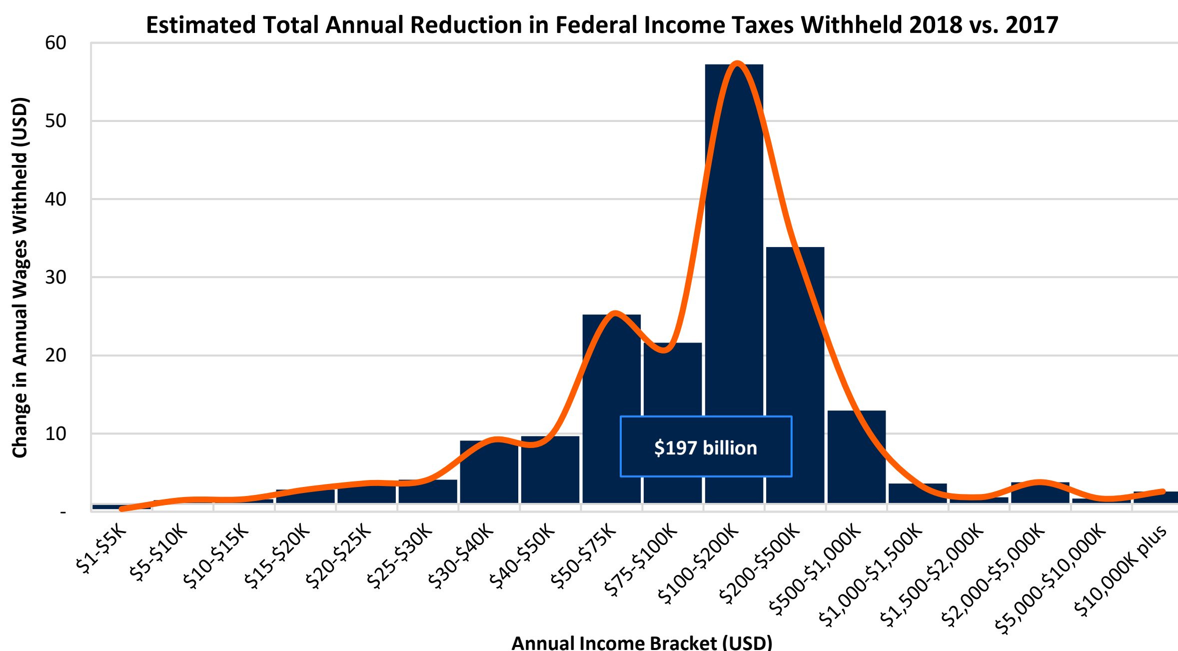


- *From 1971 through 2017, the S&P 500's P/E ratio has been mostly inversely correlated to the US 10-Year yield*
- *Correlation suggests a 100 bp increase in the 10-Year yield would result in the P/E ratio compressing by 1.9x*
- *Assuming a 10-Year rise to the ~3.85% vicinity, the above would imply ~8% downside from the current P/E of 23.3x*
- *Caveat: This correlation carries a wide variance*

Source: FactSet, Sandler O'Neill

If the U.S. economy were to break free of its current 2% trend line and the CPI expands further with the new tax regime at least temporarily propelling nominal growth closer to 5%, the neutral 10-year rate could easily reach the high 4s suggesting more like nine Fed policy rate hikes to keep pace. This would push equity valuations even lower but still by a containable amount in our view, as it would most certainly spur both top line revenue and earnings growth in most industries.

There have been many studies suggesting only an additional fraction of a percentage point in GDP growth will result from the Tax Cut and Jobs Act (TCJA) of late December. But It could well be more. Chris Donat in our Equities Research group did an interesting analysis of the changes in the withholding tax tables after the TCJA. Shown below it suggests that personal income could be as much as $200 billion higher this year which would mean a full one percentage point advance in GDP if it were fully spent, although some of it would likely be saved or used to reduce debt. Business spending, already showing recovery after six quarters of serious erosion, should also benefit from lower tax rates, offset with capital repurchases and higher salaries. The net effect from both sectors is still a complex model. We are realistically unlikely to have better visibility on how the money will flow until at least mid-year. Many offsetting variables will moderate fiscal stimulus and there will be more data for the dependent to consider as the year unfolds.



Source: Internal Revenue Service, Sandler O'Neill

One way or another, our interest rate cycle is returning to the "old" normal and therefore has implicit and ongoing shock value based on its truly abnormal and lengthy absence. For a decade the default view, or worry, has been that rates are unlikely to rise in this presumed new paradigm of sluggish economic growth. The default worry has now swung in reverse to worry first about any overheating with inflationary repercussions. This will provide pockets of stock weakness or headwinds in general this year if warranted in the macro data. But we seriously doubt the Fed will move from normalization to tightening in 2018 under any scenario.

Financials, particularly banks, should fare better relative to the markets.

1) Net interest margins continue to respond to Fed hikes in lagging fashion. Retail deposit rate sensitivities (betas) have been moderate to date while commercial deposit funding costs have not. Loan yields have lagged, on average, but after incorporating fourth quarter results loan betas are getting ahead. Median data for banks between $2 billion and $500 billion in assets, which we referred to in our last report, produce a 25% loan yield beta for the full year 2017 against a deposit beta of only 15%.

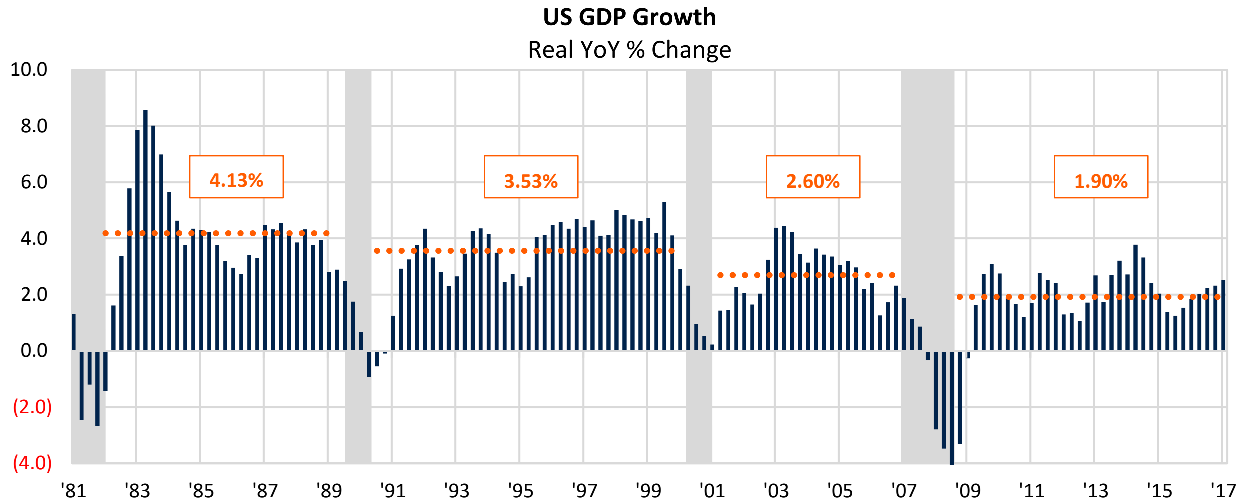
2) Loan growth is likely to accelerate in 2018 particularly from business spending which should revive the moribund commercial & industrial borrowing category. Equipment spending, over a third of all business investment, accelerated all of last year and surpassed 9% growth in the fourth quarter accompanied by a solid 7% gain in structures. The TCJA should add further momentum.

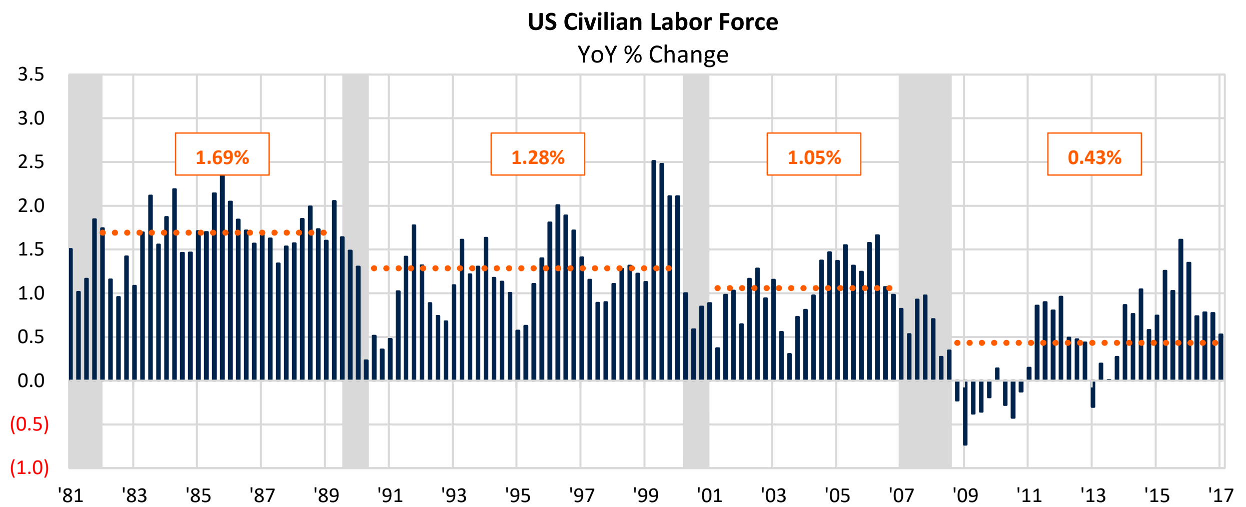
3) Expense leverage has reached a new level. A surprising number banks are projecting virtually flat to minimal expense growth in 2018 based on a sampling of earnings calls.

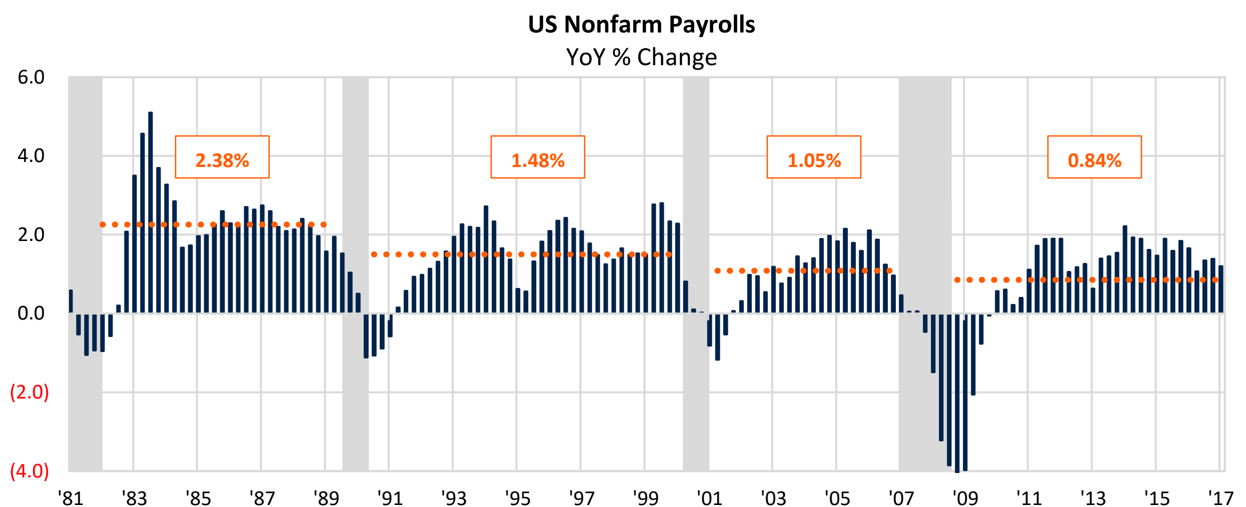
4) Banks are generally full, direct beneficiaries of lower Federal taxes, so much so that internal generation of excess capital will elevate return of capital to shareholders, with dividend hikes likely to be the predominant avenue.

In the end, 2018 earnings will be accelerating as valuations come down and we are currently comfortable that the former will overcome the latter for the banking sector. The old normal is back, other than the elongated timeline. Subsequent inflation data will define the shape and degree of interest rate normalization.

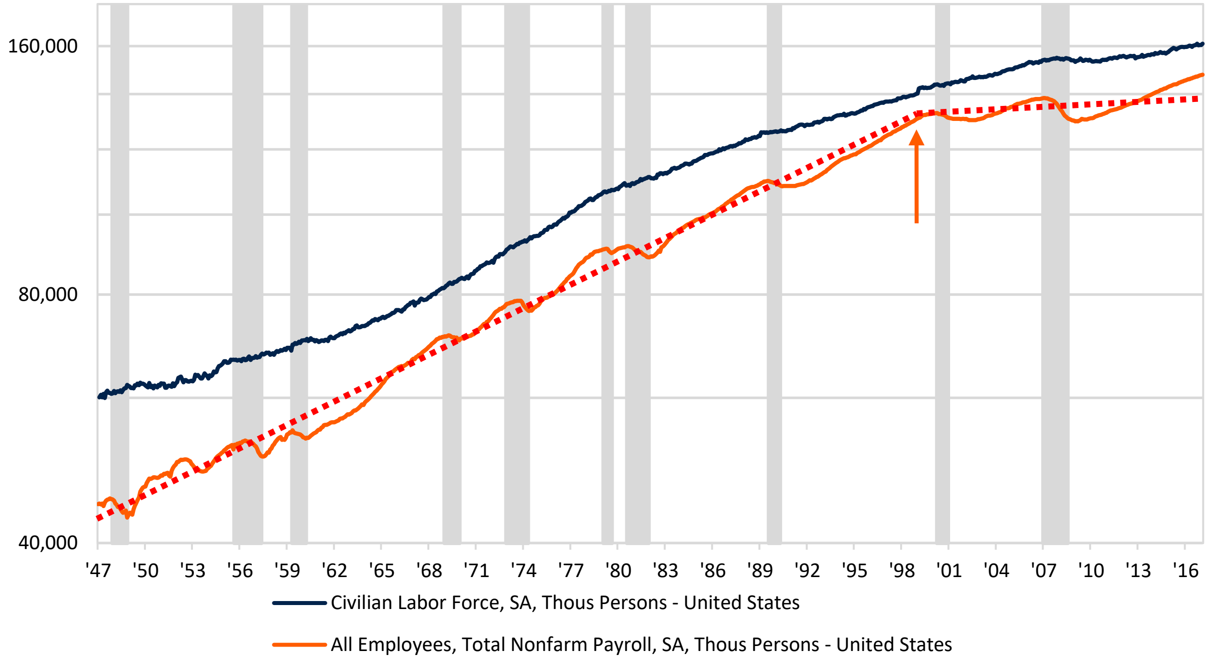
Our central concern would be that fiscal stimulus confronts a demographically capped labor force and monetary normalization could lose its "gradual" character. We do not think so but until this is clearer volatility will continue and stocks will remain vulnerable to episodic weakness, which we would see as buying opportunities.

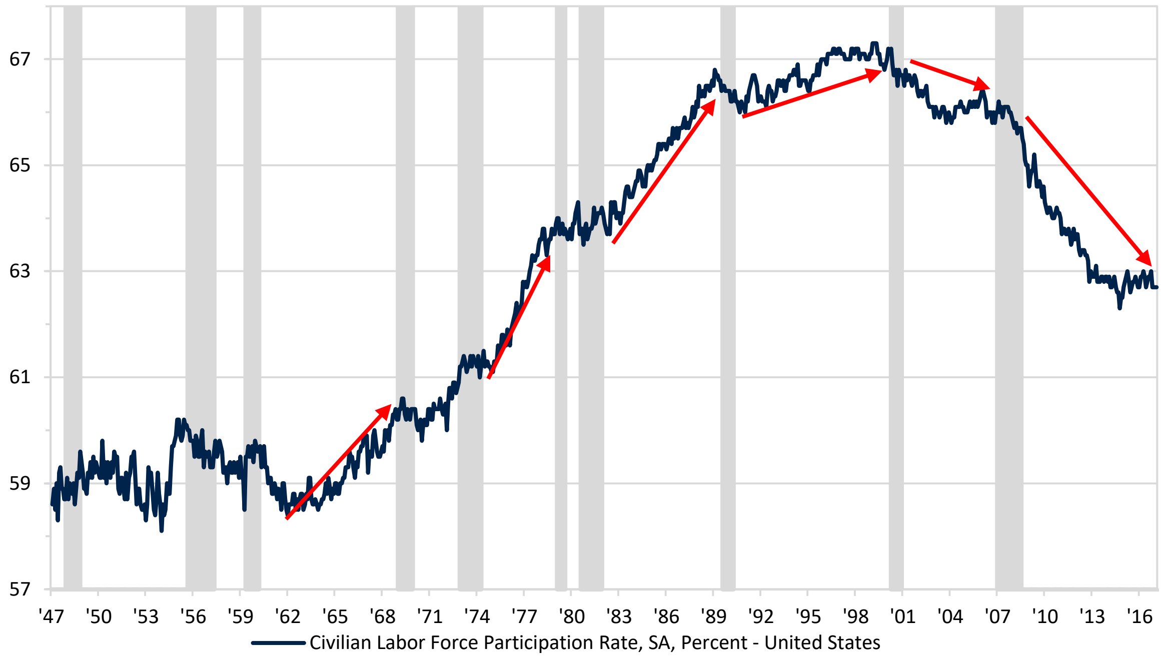






Source: Bureau of Economic Analysis, U.S. Department of Labor





Source: US Department of Labor

Normal Economic Cycle Markers … Only Stretched Over Timeline

- The post-2009 cyclical pattern is surprisingly like past recovery cycles … with one BIG exception:
  The time scale has elongated by 2.5x – 3.0x
- **Time frames to regain pre-recession levels versus average of previous 3 recessions:**

GDP (Real)	..... took 14 quarters versus 6 quarters
GDP (Nominal)	..... took 10 quarters versus 2-4 quarters
Consumer spending (PCE)	..... took 3 years versus 1 year average
Jobs	..... took 6 ½ years versus 2 ¼ years
Bank business loans (C&I)	..... took 7 quarters versus 2 quarters
Labor force to recover	..... took 4 years and never went down before!
Wage inflation	..... historically began just short of 6 years after recession onset (we are beginning 9th year without visible wage inflation)
First Fed Hike After Recession	..... took 6 ½ years versus 2 years

- Popular analysis simplistically argues past recessions have occurred about every 8 years … The above argues for much longer unless some external, non-cyclical event intervenes … Fed not trying to slow the economy with rates, for the first time just the reverse

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