In the Spotlight

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The Disillusionment Narrative

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Since the beginning of October, the S&P500 has fallen almost 20%. The fall began with the spike in 10-Year Treasury yields in early October. When 10-Year yields breached technically and psychologically important levels, investors changed the lens with which they look at factors affecting the market. Before the spike, the market was trading with an optimistic view, but since the spike, the view has switched to disillusionment.

Factor	Optimism	Disillusionment
Tax Law	Beneficial for companies	Bad for debt and deficits.
Trade Battles	Getting a better deal for U.S.	Precipitating recession
Oil Price Decline	Excess supply; stimulative	Lack of demand; recession risk
Federal Reserve	Taking a measured path to normalizing rates	Tone deaf, too aggressive, recession risk
Trump Presidency	Getting things done	Chaos

For the most part, the market's pivot from optimism to disillusionment, and the associated sharp drop in equities, is not matched by changes in the factors affecting the market.

- **Tax Law:** The new tax law is both beneficial for companies and bad for debt and deficits. This has been the case since the law was passed.

- **Trade Battles:** It's amazing what a couple months can do to perspective. Consider the following two headlines:
  - 09/19/2018: "The booming economy trumps Trump's trade battle with China" – thehill.com
  - 11/29/2018: "Trump's trade war collides with economic reality" – politico.com

  The reality is that the economy was on track to slow down next year trade battles or not. President Trump's negotiating pattern has been to take an extreme position then settle for less and claim victory. If the pattern holds, it is unlikely he will plunge the economy into a trade-war induced recession. The real problem is that he is erratic and the market does not trust his temperament. The risk that he takes the game of "chicken" too far with China is not new and it remains.

- **Oil Price Decline:** While there is a modest demand-side impact from a slowing global economy, this is primarily an excess supply problem. The long-term dynamics of oil have changed with the birth and growth of fracking in the U.S. According to a December 6th Wall Street Journal article, the U.S. is now the largest producer of oil and natural gas and is a net exporter of oil and refined fuels. The power of OPEC is diminished. Add the Iran sanctions miscue – OPEC increasing production to offset expected loss of Iranian oil only to see the Trump administration grant waivers that have resulted in only a modest reduction of Iranian oil on the market. This miscue caused excess supply and downward pressure on oil prices. The good news is that a drop in oil prices lowers inflation (less pressure for the Fed to tighten) and is similar in effect on consumer spending as a tax cut (more discretionary money to spend supporting growth).

- **The Federal Reserve:** By unanimous vote of the Federal Open Market Committee, the Federal Reserve raised the Fed Funds target rate by 0.25% to 2.50% on December 19th, just as they have been telling us they would. Wanting a delay of this increase, the market reacted like a spoiled child and sold off while talking heads labeled the Fed "tone deaf." The Fed played its part as the exasperated parents trying to undo a decade of babying by holding firm to the decision but promising less discipline later (signaling fewer rate hikes for 2019).

The reality is that the unemployment rate is just 3.7%, a level not seen since 1969-70. Core inflation is near the Fed's 2% target. From the Fed's perspective, they have achieved their dual mandate of full employment and 2% inflation and therefore rates should no longer be accommodative. A 2.5% Fed Funds rate is near the low end of the neutral rates for the Fed and is by no means restrictive. Raising the rate was the right decision given current economic conditions. It also gives the Fed more room to lower rates in the future to offset potential drags on the economy from fiscal tightening or failed trade negotiations.

- **The Trump Presidency:** This is one area where the change in perception is matched by the change in reality. Whether one agrees with his policies or not, he did get things done in the first two years of his Presidency – tax reform, deregulation, repeal of the individual mandate, judicial appointments, travel ban, and the USMCA agreement (new NAFTA) to name several.

However, President Trump was dealt a strong rebuke in the midterm elections with Democrats gaining control of the House by a wide margin. His legal woes are worsening as the Mueller probe and NY prosecutors accrue guilty pleas and cooperation agreements with formerly close allies. Last week he was forced to close his foundation under a cloud. He is having trouble attracting and retaining qualified people to serve in his administration. Nick Ayers, his first choice for his new Chief of Staff, turned the job down. Jim Mattis, Defense Secretary, and Brett McGurk, U.S. Envoy to the global anti-ISIS coalition, both resigned in protest. Of the 706 key positions requiring Senate confirmation, only 381 have been confirmed and 123 have yet to be nominated. The first requirement of leadership is to have followers. President Trump is losing followers, and the stock market is one of them.

The collapse of equity prices in December is being driven by a loss of confidence and a failure of leadership. It is not a dire economic situation like 2008 where we had major financial institutions going belly up – Bear Stearns, Lehman - and a 30% drop in housing prices. At current price levels, the market is supported by fundamental valuations. The table below shows degree of under (over) valuation depending on the valuation model used.

	Degree of Undervaluation	
Valuation Model	Using Current Earnings	Adjusted for Earnings Cycle
Historical P/E (PE)	1.9%	-11.0%
Earnings Yield vs Bond Yield (EYBY)	39.0%	21.5%
Earnings Yield vs Inflation (EYI)	16.2%	1.6%

The Earnings Yield versus Bond Yield (EYBY) model shows a large undervaluation partly because bonds remain overvalued relative to inflation on a historical basis. The Earnings Yield versus Inflation (EYI) model is probably the best model to assess valuation currently because it is not dependent on bond yields which have been supported by the Fed over the past decade. The Historical P/E (PE) model is the least robust as it compares the current P/E in the current economic environment to a history that includes P/E's from economic environments nowhere close to today (e.g. double digit inflation of the 1970's) without consideration of related economic variables (inflation or interest rates).

The loss-of-confidence driven rout in equity prices may not be over as the risk of a Trump-driven event with economic consequences remains. However, for investors with a long-term perspective, fundamental evidence suggests the chaos is presenting a buying opportunity.

Email research@wealthcarecapital.com with questions, comments or requests. Sources include the Federal Reserve, Bloomberg, The U.S. Treasury, politico.com, thehill.com, The Washington Post, Partnership for Public Service, S&P CoreLogic Case-Shiller, Wealthcare.