Deja Vu All Over Again?

"Stocks Plunge" (CNBC) on Wednesday triggered Thursday's WSJ headline:

Tech Rout Sends Stocks Tumbling

Trump blames central bank for raising interest rates, declaring 'the Fed has gone crazy'

By Corrie Driebusch

The Dow industrials extended their steepest October retreat since the financial crisis Wednesday, posting an 832-point decline that raises fresh concern about the health of the nine-year-old bull market for stocks.

The selling was led by the technology shares that have fueled much of the 2018 advance in U.S. stocks, with Netflix dropping 8.4%, Amazon declining 6.2% and Apple off 4.6%. Combined the three companies shed nearly $120 billion in market value on Wednesday.

Selling accelerated toward the end of the day and losses spread well beyond tech stocks ....

When asked about Wednesday's market decline, President Trump said "the Fed has gone crazy."

The Fed's more-restrictive stance has joined with other signals to unsettle investors even as major U.S. indexes rose to new highs. The market's worries aren't all aligned—some investors are worried a strong economy will lead the Fed to rate increases that hurt stocks, while others on Wednesday pointed to recent indicators in housing and autos that suggested the economy is losing steam. A shared concern, however, is that trade tensions between the U.S. and China appear to be worsening and that a slowdown in the Chinese economy could spill over into global markets.

Chinese authorities have stepped up their efforts to keep money flowing in the world's second-largest economy amid concerns about the ramifications of a years long increase in Chinese debt issuance.

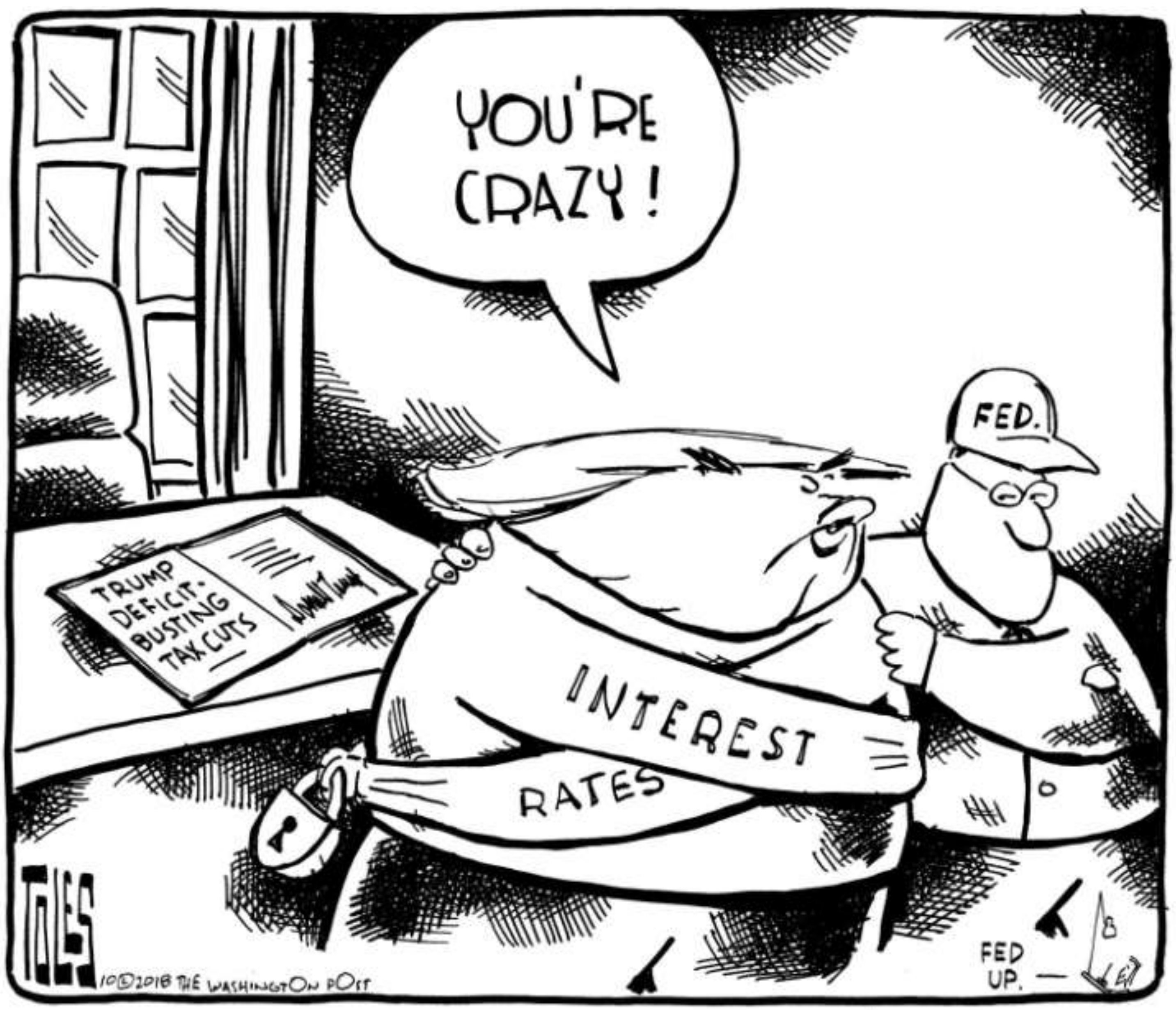
The result: A simultaneous selling of 2018's biggest stock-market winners in the U.S. ...

The shift has come as the yield on the benchmark U.S. Treasury note has risen to seven-year highs. It settled at 3.221% Wednesday ....

The S&P 500 tumbled 3.3% Wednesday, its fifth consecutive session of declines and longest losing streak in nearly two years. The Dow Jones Industrial Average dropped 3.1% to 25599, falling 4.6% from its all-time high notched Oct. 3. Both indexes registered their biggest losses on a percentage basis since Feb. 8.

All sectors in the S&P 500 slumped Wednesday, with technology stocks down nearly 5%. Other growth sectors including consumer-discretionary and communications shares posted big declines as well. The tech-heavy Nasdaq Composite dropped 4.1% (its worst percentage decline since the Brexit vote in June 2016), extending its declines for the month to 7.8%. The index is suffering its worst start to a fourth quarter since 2008, when it fell 21%. ...

The risks have borne out in the past when other popular trades have unraveled. Bets against volatility fed the stock market's tumble in February after the implosion of a number of exchange-traded products that had risen in value when gauges of volatility declined. (The CBOE VIX Index, Wall Street's "fear gauge," jumped 44 percent, its largest jump since February. However, it closed at 22.96, well short of its February peak of 37.32.) Similarly, bitcoin investments tumbled at the beginning of the year on doubts about the practical utility of cryptocurrencies. ...



The selloff continued on Thursday, resulting in Friday's WSJ headline:

Jittery Investors Deepen Stock Fall

Dow is down 5.2% after second day of rout; anxiety rises as tech shares fall

By *Corrie Driebusch*, *Akane Otani* and Jessica Menton

A gloomy October on Wall Street turned darker Thursday, as heavy selling overseas and failed intraday rallies in the U.S. sent major stock indexes to another stinging retreat.

The Dow Jones Industrial Average tumbled 546 points, leaving the blue-chip index down 5.2% after two days of volatile trading that has been marked by sharp declines in the last hours of the day. The cost of hedging against stock-price declines soared Thursday in a sign of rising anxiety, with the Cboe Volatility Index, or VIX, soaring to its highest level since the February rout that set the Dow's intraday point-decline record. ...

Rising U.S. interest rates, stretched share valuations and concerns about U.S. trade relations with China and other major nations have weighed on trading throughout 2018 ....

The selloff took with it some of the best-performing stocks in the S&P 500 this year, sending Netflix down 9.7% over two days, Amazon.com off 8.1% and Apple 5.5% lower.

Investors had been fixated for most of the past week on a steep rise in government bond yields—something that had challenged a longstanding dynamic of low yields making relatively risky stocks attractive in comparison. But even as bond prices rallied Thursday, sending yields lower, the stock selloff continued. ...

The S&P 500 tumbled 2.1%, and the technology-heavy Nasdaq Composite lost 1.3%, closing down nearly 10% from its Aug. 29 record close of 8109.69. Those indexes are on track for their worst week since March ....

Stocks overseas also fell, with the Stoxx Europe 600 posting its biggest one-day slide since June and Hong Kong's Hang Seng suffering its biggest one-day loss since February.

Traders braced for further volatility. The Cboe Volatility Index, which measures investors' expectations for stock swings, jumped 8.8% to 24.98—extending a recent climb that has brought it to its highest level since February. ...

With Friday's volatility came this weekend's WSJ headline:

Investor Shift Triggers Stock Market's Wild Ride

Share prices rebound but end the week lower as a long-awaited rise in rates spurs a revaluation

By Corrie Driebusch and Sam Goldfarb

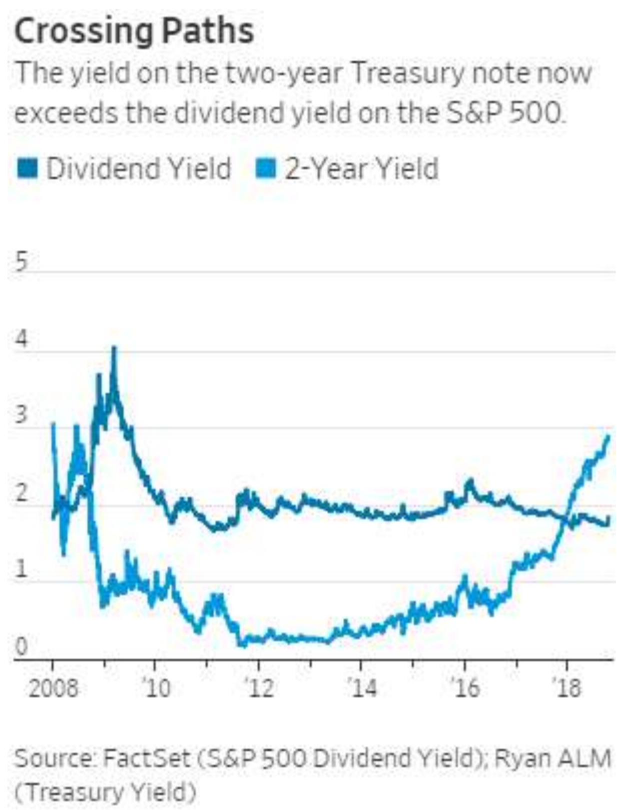
A Friday bounceback couldn't save U.S. stocks from their worst week since March, as investors reassessed the value of American companies in the face of a long-awaited rise in interest rates.

Broad-based selling on Wednesday and Thursday sent the Dow Jones Industrial Average down more than 1,300 points in two sessions, shattering months of steady rises in major indexes. On Friday, the Dow recovered some territory, rising 287.16 points, or 1.1%, to 25339.99.

Helping to fuel the week's drop was a swift rise in U.S. government bond yields. Those reached seven-year highs in the days before the stock swoon ....

The action upended a market dynamic in place since the financial crisis. Hundreds of billions of dollars have flowed into U.S. stocks as interest rates plumbed all-time lows. ...

The reversal has been long in the making, but it hit stocks with force this past week. As a campaign of Federal Reserve interest-rate increases and signs of inflation pressure sent long-term interest rates past 3% ....



Short-term Treasury yields have been rising steadily since late 2015, when the Fed raised interest rates for the first time after the financial crisis.

In late 2017, the yield on the two-year Treasury note edged higher than the S&P 500 dividend yield for the first time in nearly a decade ....

Over the past couple of weeks, investors have confronted the possibility that Treasury yields may again march a sustained, upward path after trading within a narrow range for most of the year.

Before this month, yields ... had climbed from record lows reached in the summer of 2016 mostly in two short bursts—once at the end of 2016 and again a year later, when Republicans passed tax cuts that promised both to expand the supply of government debt and stimulate the economy.

From Bespoke:

A Sell-Off of Global Proportions

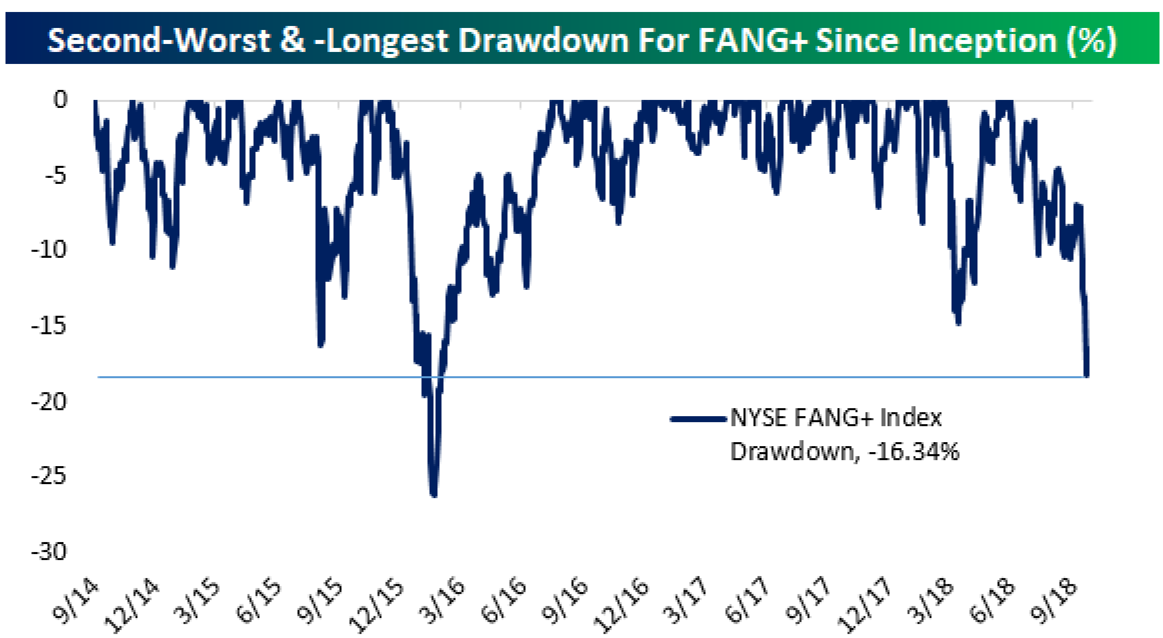
Oct 12, 2018

Wow! That was pretty extreme. After the most severe sell program in the market since the 'flash crash' of 2010 sent US equities plunging for a second straight day, the S&P 500 finished at what can only be considered a ridiculously oversold level on Thursday at more than 3.7 standard deviations below its 50-day moving average. For reference, we consider 1-standard deviation below the 50-DMA to be oversold, and two standard deviations to be an 'extreme' oversold reading. We'll let you use your own adjectives to describe a level nearly twice that. To put some perspective on that oversold reading, the last time the S&P 500 was more oversold was August 2015.

FAANG+ Flush

Oct 12, 2018

This week has been a pretty brutal one for growth stocks. One of the best ways to see this is the performance of the NYSE FAANG+ Index, which has flat-out collapsed. The index is slightly broader than the traditional FAANG (Facebook, Amazon, Netflix, and Alphabet, formerly Google) index, and it currently includes Apple (AAPL), Nvidia (NVDA), Twitter (TWTR), Alphabet (GOOGL), Facebook (FB), Amazon (AMZN), Netflix (NFLX), Tesla (TSLA), Baidu (BIDU), and Alibaba (BABA). As shown in the chart below, yesterday's close brought the group's decline to more than 18%, its second-worst drawdown since inception back in 2014. The length of the drawdown is also notable at 78 trading days, also the second-longest in the history of the index.



Our thoughts

From our Website:

"Here is what Warren Buffett wrote about fixed-income investing in his 2012 annual letter to Berkshire Hathaway, Inc., shareholders: 'They are among the most dangerous of assets. Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal… Right now, bonds should come with a warning label.'"

While there may come a time in the future when long-term Bonds once again make sense as a part of a diversified portfolio, currently it is an asset class best avoided."

Besides repeatedly warning about Bonds, we have avoided all of the FAANG+ stocks for our clients investing in individual stocks. To repeat a quote we shared in June: **"Being a value investor in the F.A.N.G. era is no fun at all. - Patrick O'Shaugnessy** Perhaps this past week will be remembered as the beginning of the end for that particular lament. It can get expensive when you are on the wrong side of a fad at the end.

As for where we go from here, we provide 2 analyses, one from Friday's Global Investment Strategy titled **Bond Bears Maul Goldilocks**, and the other from SentimenTrader in a separate Sharing that will not be posted to our website.

Bond Yields: Up, Up, And Away

... The MSCI All-Country World stock market index has now fallen by 6.3% in dollar terms since last Wednesday. Even the mighty S&P 500 has finally buckled under the pressure.

The vulnerability of U.S. stocks had been accumulating beneath the surface for some time, as evidenced by the fact that the advance-decline line has been deteriorating since the late summer. The small cap Russell 2000 is down 11.3% from its August 31st highs (Chart ... 1B).

Bond yields usually fall when equities swoon. This time around, it is the increase in bond yields itself that has undermined stocks. In the U.S., yields have risen in response to better than-expected growth, a wider budget deficit, rising oil prices, and an increasingly hawkish Fed. In Italy, worries about debt sustainability have been the primary driver of rising yields.

Neither factor spells doom for global risk assets. However, a period of indigestion is likely over the coming weeks, which could see global equities go down before they go up again.

The U.S. Economy: Too Much Winning?

We have argued for much of this year that investors were under appreciating the extent to which the Federal Reserve can raise rates without choking off growth. The past few weeks have seen a growing recognition among investors that the Fed may be behind the curve in normalizing monetary policy. This has led to a steepening in the expected path of U.S. short term rates, which, together with an increase in the term premium, have pushed up yields at the longer-dated maturities.

Both better economic data and Fedspeak contributed to the bond sell-off. On the data front ... the unemployment rate fell to a 48-year low of 3.68% in September. While average hourly earnings ticked down to 2.75% on a year-over-year basis, this was entirely due to base effects. On a month-over-month basis, average hourly earnings have risen by 0.3% for three straight months. If this trend continues, the year-over-year rate will rise to 3.2% by the end of this year.

Tellingly, recent wage growth has been concentrated among workers at the bottom of the income distribution. This is important because not only do the wages of low-income workers correlate better with labor market slack than those of high-income workers, but low-income workers are also more likely to spend the bulk of their paychecks.

Higher wage growth will boost consumer spending. Indeed, it is probable that consumption will rise more than income, given that the personal savings rate has plenty of scope to fall from the current elevated level of 6.6%. Rising wages will incentivize companies to invest more in labor-saving technologies, translating into an increase in capital spending. Add in ongoing fiscal stimulus, and we have a recipe for an overheated economy.

Starstruck No More

As of today, the market has priced in one Fed rate hike in December but only two rate hikes in 2019. Investors expect no rate hikes in 2020 and beyond. That still seems implausible to us, which suggests that the bond sell-off has further to go. ...

Trump And Bonds

President Trump was quick to blame the Fed for this week's stock market sell-off. Within the span of 24 hours, he used the words "crazy," "loco," "ridiculous," "too cute," "too aggressive," and "big mistake" to describe recent Fed policy.

We doubt Trump's rhetoric will have any immediate effect on Fed decision-making. But even if it did sway the Fed to slow the pace of rate hikes, the result will be higher bond yields, not lower yields. This is simply because any further delays in raising rates will lead to even more overheating, and ultimately, higher inflation and the need for higher rates down the road.

Bond Sell-Off Will Produce A Correction In Stocks, Not A Bear Market

At the height of this week's bond sell-off, the 10-year Treasury yield breached its 200-month moving average for the first time since … October 1987 (Chart 4). While that sounds pretty ominous, keep in mind that the 10-year yield had reached almost 10% on the eve of the 1987 stock market crash, or about 6% in real terms.

As my colleague, Doug Peta, discussed two weeks ago, it is the level of interest rates that tends to matter more for stocks rather than the change in rates. Specifically, equity returns tend to be lowest at times when monetary policy is already in restrictive territory (Chart 5 and Tables 1 and 2). That was the case in 1987. It is not the case today.

CHART 4
Two Lines Meet After Three Decades

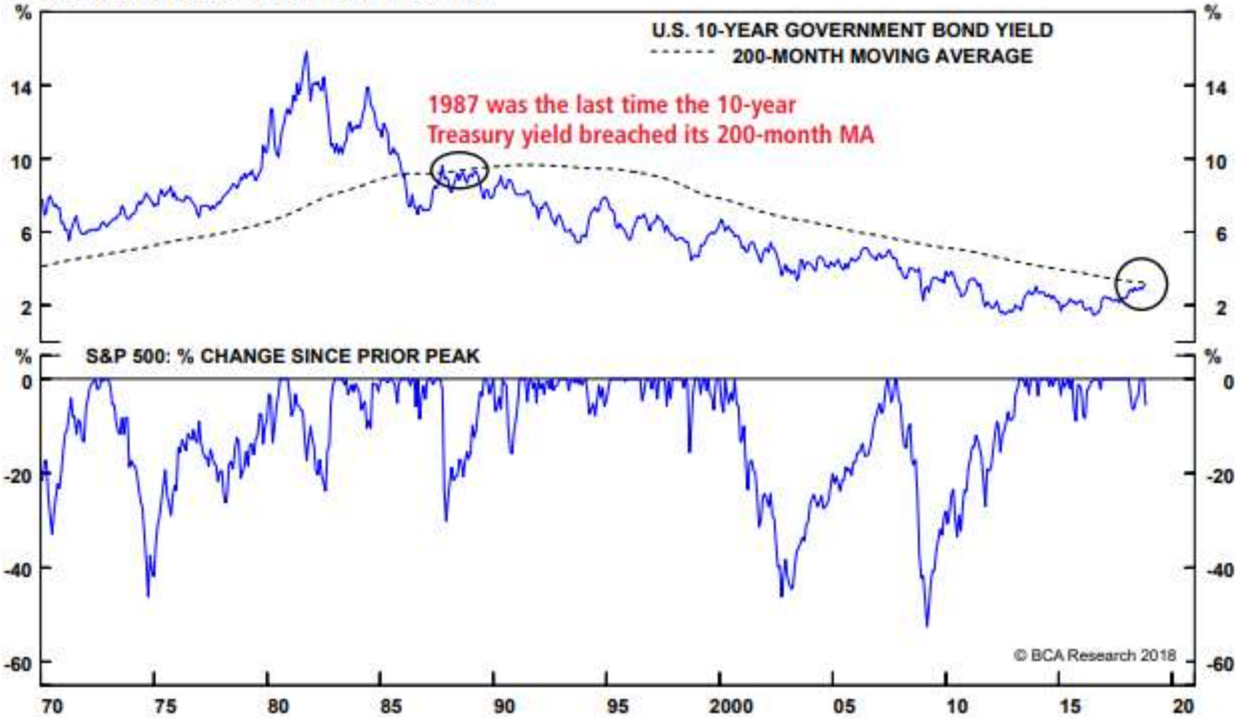


CHART 5
The Fed Funds Rate Cycle

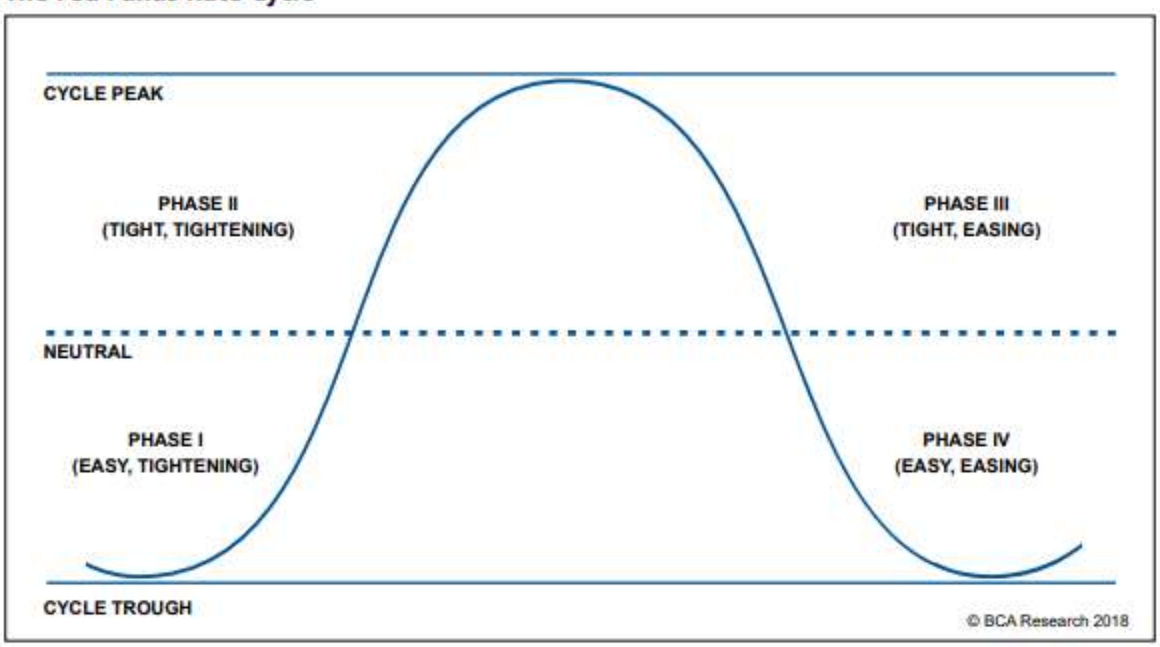


TABLE 1

Tight Policy Is Hazardous To Stocks' Health…

S&P 500 ANNUALIZED RETURNS BY FED FUNDS CYCLE PHASE, AUGUST 1961-SEPTEMBER 2018	CAGR	# OF MONTHS
PHASE I (EASY, HIKING)	7.7%	226
PHASE II (TIGHT, HIKING)	0.8%	125
PHASE III (TIGHT, EASING)	0.9%	101
PHASE IV (EASY, EASING)	12.0%	234
EASY (PHASES I & IV)	9.9%	460
TIGHT (PHASES II & III)	0.9%	226
ALL PHASES	6.8%	686

TABLE 2

…Especially In Real Terms

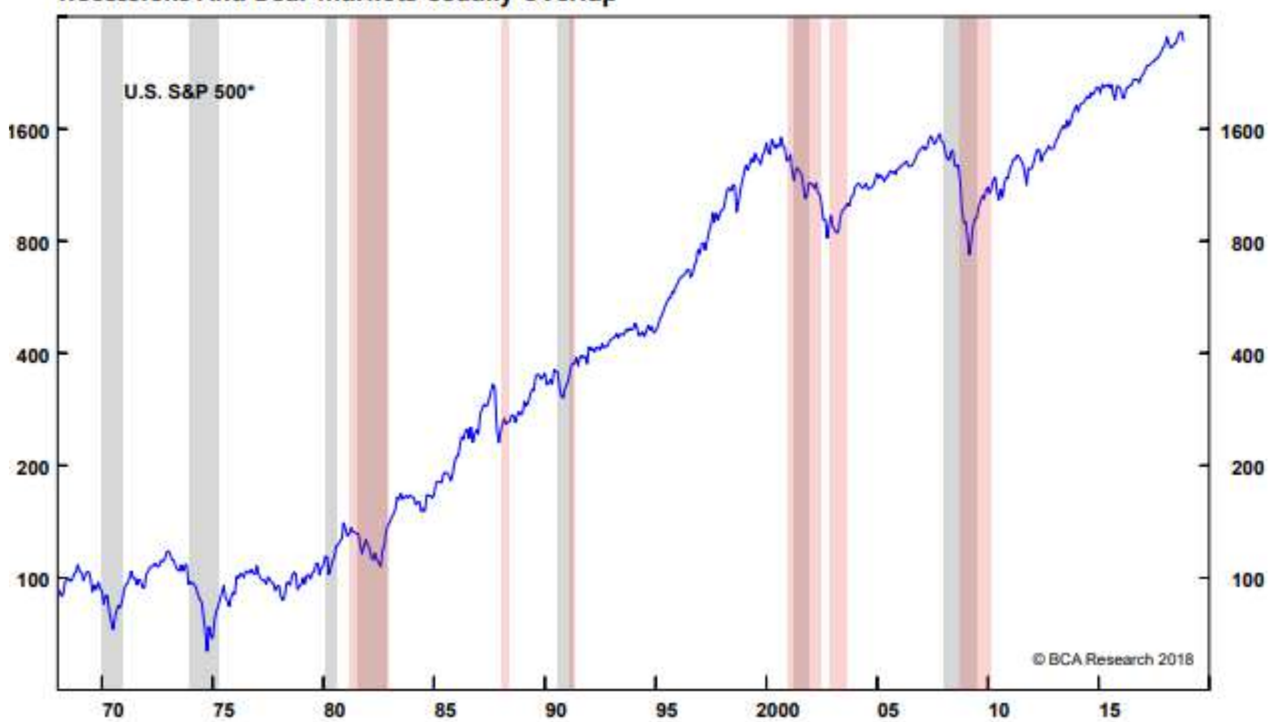
S&P 500 ANNUALIZED REAL* RETURNS BY FED FUNDS CYCLE PHASE, AUGUST 1961-SEPTEMBER 2018	CAGR	# OF MONTHS
PHASE I (EASY, HIKING)	3.6%	226
PHASE II (TIGHT, HIKING)	-3.8%	125
PHASE III (TIGHT, EASING)	-4.2%	101
PHASE IV (EASY, EASING)	9.4%	234
EASY (PHASES I & IV)	6.5%	460
TIGHT (PHASES II & III)	-3.9%	226
ALL PHASES	2.9%	686

* NOMINAL RETURNS DEFLATED BY HEADLINE CPI.

The fact that stocks do worse in environments where monetary policy is tight makes perfect sense. A restrictive monetary policy is usually a prelude to a recession. As Chart 6 illustrates, bear markets and recessions almost always coincide, with the latter usually leading the former by about six-to-twelve months. None of our favorite leading recession indicators are flashing red now (Chart 7). Even the yield curve has steepened in recent weeks.

CHART 6

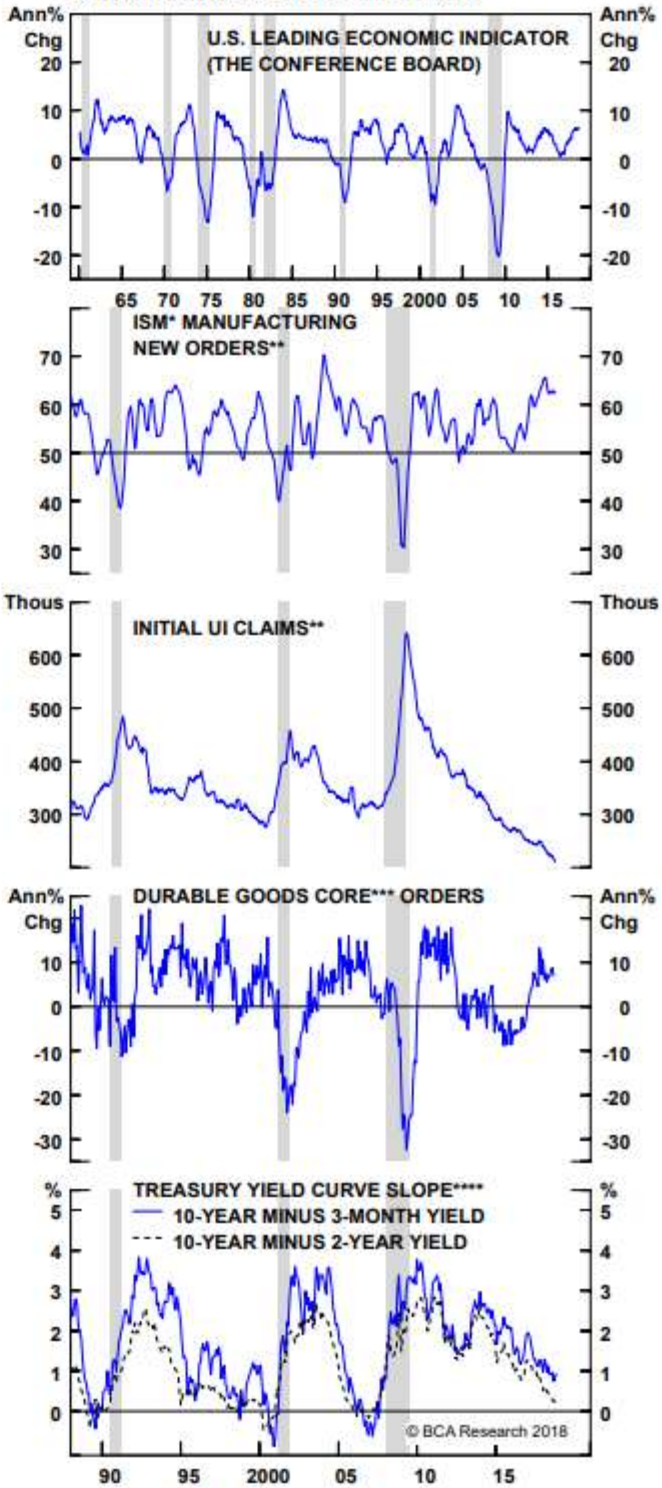
Recessions And Bear Markets Usually Overlap



* SHOWN IN LOG SCALE.
NOTE: LIGHT RED SHADING INDICATES BEAR MARKETS; GREY SHADING INDICATES NBER-DESIGNATED RECESSIONS.

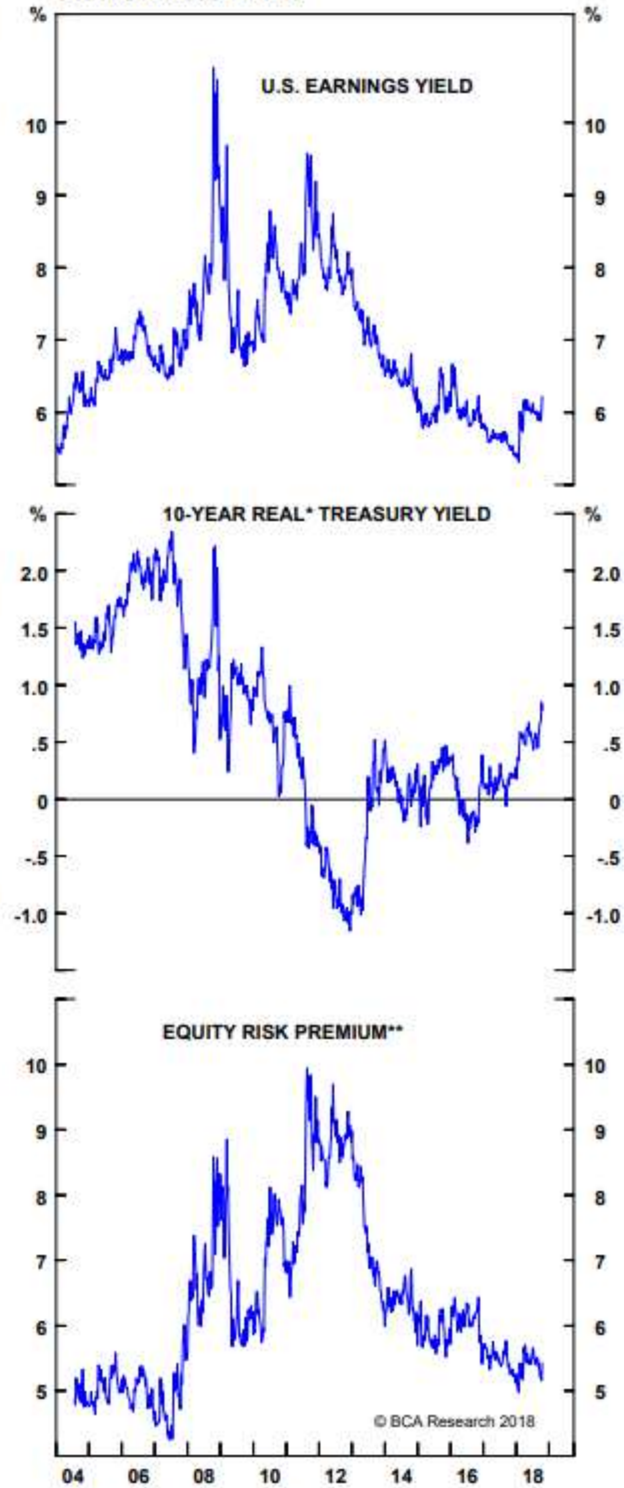
Still, higher long-term bond yields do reduce the long-term attractiveness of stocks compared with bonds. The S&P 500 earnings yield has risen modestly since 2016 due to the fact that earnings have grown somewhat more quickly than equity prices. However, the U.S. real 10-year yield has surged by almost 120 basis points over this period. On balance, this has caused the equity risk premium to decline (Chart 8). In order to bring the equity risk premium back down to mid-2016 levels, the S&P 500 would need to fall by about 15% from today's levels. We do not expect stocks to fall by that much, partly because the economic environment is more robust than back then, but a further drop of 5%-to-10% from current levels is certainly plausible.

CHART 7
A U.S. Recession Is Not Imminent



* INSTITUTE FOR SUPPLY MANAGEMENT.
** SHOWN AS A 3-MONTH MOVING AVERAGE.
*** MANUFACTURING NONDEFENSE CAPITAL GOODS EXCLUDING AIRCRAFT.
**** BASED ON MONTHLY DATA.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED PERIODS OF RECESSIONS.

CHART 8
Stocks Versus Bonds

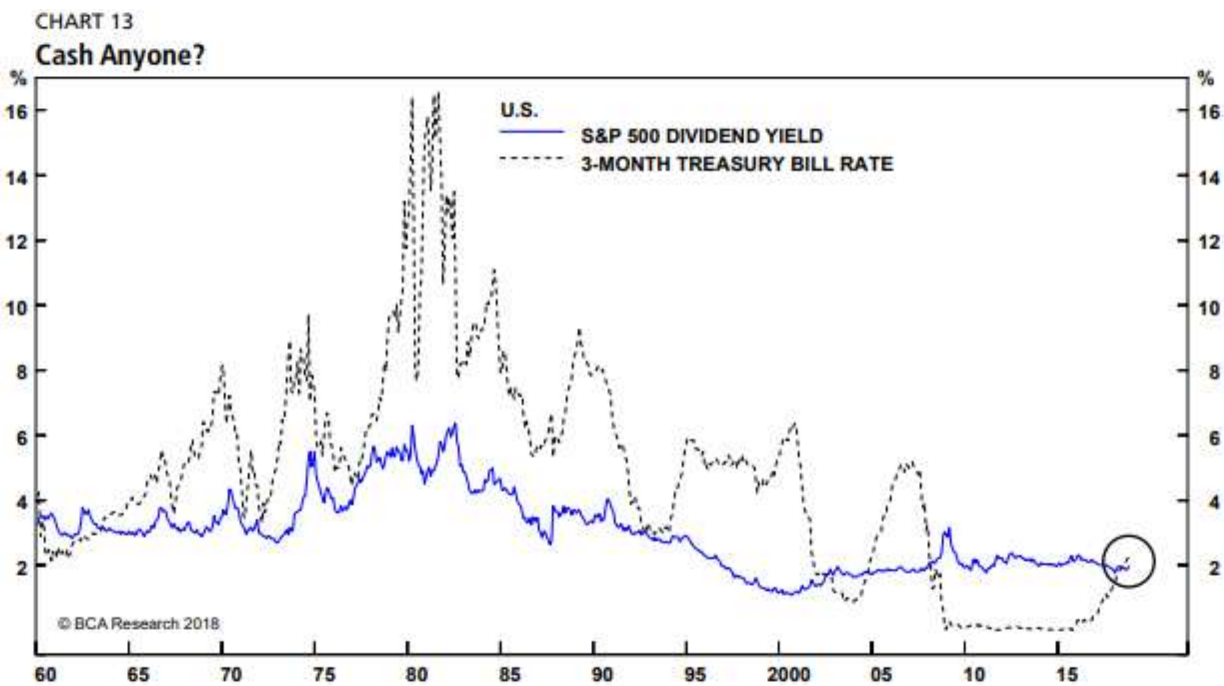


* DEFLATED BY CPI SWAP RATE.
** DIFFERENCE BETWEEN S&P 500 EARNINGS YIELD (INVERSE OF THE FORWARD P/E RATIO) AND THE REAL 10-YEAR BOND YIELD (DEFLATED BY CPI SWAPS).
NOTE: EARNINGS YIELD BASED ON IBES DATA.

Investment Conclusions

Goldilocks will survive, but the next couple of months will be challenging. ... Bond sentiment is quite bearish at the moment, which makes a brief countertrend bond rally quite likely. However, the cyclical trend in yields remains to the upside. We stated last week that investors should consider scaling back risk if they are currently overweight risk assets.

We continue to favor this more cautious stance. For the first time in over a decade, short-term U.S. rates are above the dividend yield on the S&P 500 (Chart 13). Holding a bit more cash is finally an attractive option, at least for U.S.-based investors. (With the CPI's most recent core rate of inflation over the past 12 months at 2.2%, "attractive" is not the adjective we would use.)



If the sell-off in global equities continues (see our separate Sentiment analysis), it will present a buying opportunity, given that the next major global economic downturn is probably at least another two years away. Barring any major new developments, we would turn bullish on stocks again if the MSCI All-Country World Index were to fall by 12% 10% 8% from current levels. ...

Our thoughts continued

If you go back to Chart 5, you will see a horizontal dashed line labeled "Neutral". What is that rate? Unfortunately BCA's Chief Global Strategist Peter Berezin doesn't provide an estimate in his Weekly Report. The well written Doug Peta report he references estimates the "Neutral" rate at "3.75 - 4% 10-year Treasury yield." Bank of America's strategists won't worry until the 10- year yield hits 5%. From CNBC on 10/9/18:

Bank of America: Don't worry about stocks until the 10-year yield rises to 5%

- If the 10-year Treasury yield reaches 5 percent, investors would see value in bonds over stocks, according to Bank of America Merrill Lynch stock strategists.
- "If the 10yr Treasury, the so-called 'risk-free' rate (The "risk-free" rate actually refers to 3-month Treasury Bills, not 10-year Treasury Bonds.), climbs to the level of expected equity returns, the decision between stocks and bonds would be clear cut," they write.

- The strategists say it is not yet time to bail out of stocks, but they do point to some "pot holes" in the market to be avoided as rates rise, including bond proxies and credit-sensitive growth stocks with no earnings.

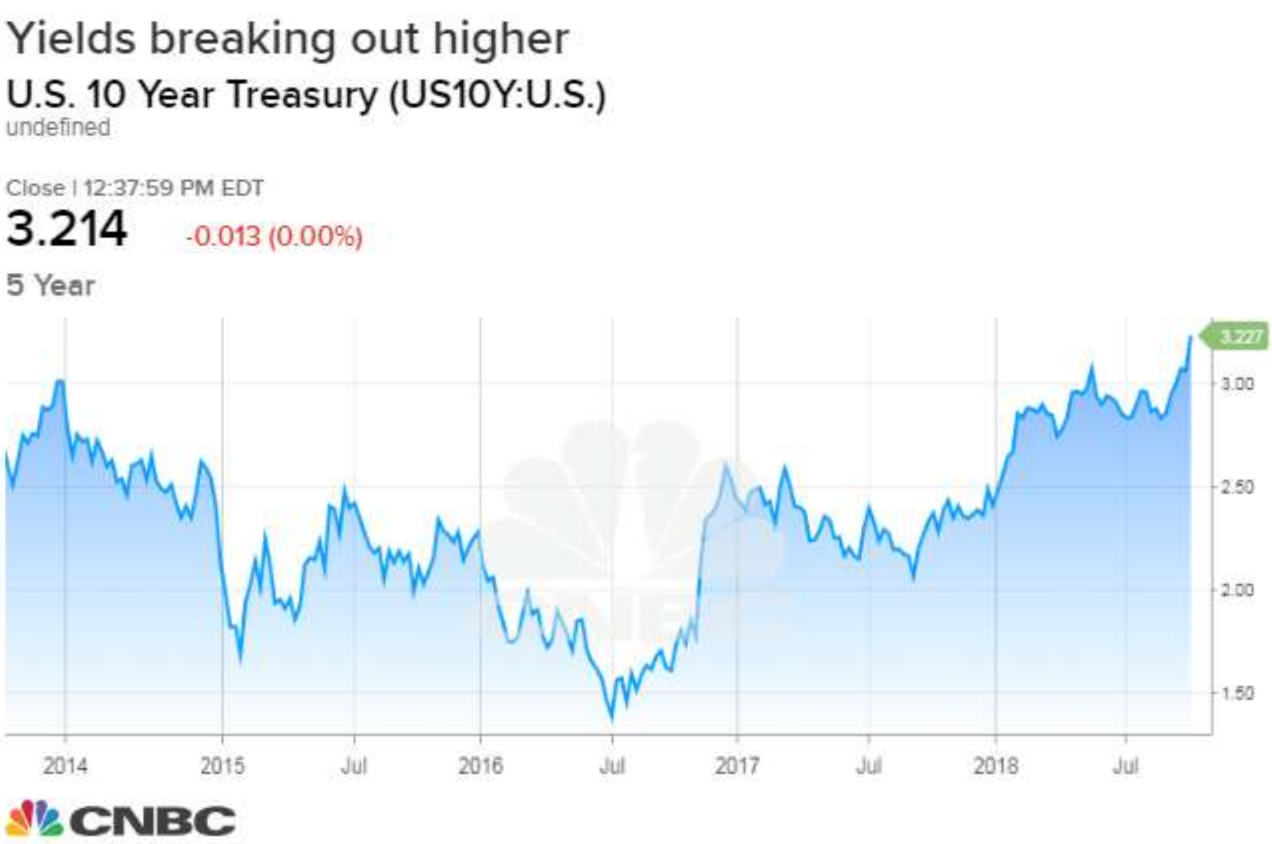
Patti Domm

Bonds will become more attractive than stocks only when the 10-year Treasury note yield reaches 5 percent, according to Bank of America Merrill Lynch equity strategists.

With interest rates rising, Wall Street has been handicapping how high yields can go before the stock market begins to really suffer, and some analysts say the market could start to get nervous as soon as the 10-year touches 3.5 percent. The 10-year reached 3.26 percent early Tuesday before retreating.

But the BofAML strategists say it's 5 percent, where the return on equity investments is challenged by the ability to earn yield in the bond market.

"Asset allocation is a dynamic process, and we would hate to oversimplify. But we tested a few frameworks to determine the 10-yr yield breakpoint at which bonds look more attractive than stocks, and they all spit out the same number: 5%," the BofAML strategists wrote.



The analysts said they ran tests to see where Wall Street allocations to stocks peaked.

Five percent "is the level of the 10-yr at which our market derived equity risk premium framework indicates that stocks trade at fair value to bonds, all else equal," they wrote. "5% is the expected return of the S&P

500 over the next decade, based on our valuation framework… And 5% on the 10-yr is the level at which the reward to risk ratio for stocks vs. bonds skews more favorably toward bonds." ...

Sell bonds on rising rates

Stocks have been selling off in recent sessions, as the 10-year yield broke out to new 7-year highs after Fed Chairman Jerome Powell said the Fed is nowhere near neutral with its rate hiking. Neutral is a level at which interest rates neither stimulate nor stall the economy.

Despite the runup in rates, BofAML analysts said it is not time to sell equities.

"We think stocks ... are attractive amid rising rates based on historical analysis and the output of our other models. Rising rates are a more definitive reason to sell bonds, in our view," they said.

However, there are stocks that could have problems, or hit "pot holes," as interest rates go higher, the analysts said. Those stocks include high-dividend-paying "bond proxies"; growth stocks that are credit sensitive with no current earnings, and companies that have not used low rates to lock in lower debt payments. ...

So if 5% were to become the consensus view, is it conceivable that some investors might start worrying at 4.9%? Keynes described the action of rational agents in a market by using an analogy of a beauty contest, in which to win you must pick what the average opinion of the judges will be: **"It is not a case of choosing those that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees." (Keynes, General Theory of Employment Interest and Money, 1936).**