February 2018

Shortly after my last piece making the bullish cash for stock prices, my skills as a prognosticator were severely tested. From their peak in late January, stock markets fell 10% over 9 trading sessions. This proves the old adage that markets can do three things: go up, go down, or stay the same. Over the past month, the stock markets have done all three.

The cause for this decline has generally been reported as the January jobs report, indicating a sharp rise in wage inflation and igniting concerns of rapidly rising inflation and a forecast that the Fed would raise interest rates faster and more than anticipated. This may have been a part of the market action but bigger role might be assigned to quantitative investment funds whose trading is significantly driven by market activity. Analysts' reports have indicated a significant increase in selling by these funds. Some experienced significant reversals this year and their trend following nature of many of these funds may have resulted in significant selling.

The movement in the markets was primarily limited to stock markets, as painful as this might have been. There were not indicators of a systemic flight from other markets. U.S. investment grade credit spreads were virtually unchanged, currency markets remained calm, foreign sovereign bond markets held steady, and gold prices actually declined. These are hardly the signs of a market driven by fear, such as that experienced a decade ago. Although wage increases are one data point of potential inflation, which bear watching, the fixed income markets reacted with a reduced implied inflation rate since earlier this month.

Historically, wage inflation has had to approach 4% before any statistical linkage to overall inflation can be found. Recent consumer price indices showed a jump in CPI for January, but on a year over year basis, inflation, at the consumer level, is little changed. The Federal Reserve Open Market Committee has communicated their expectation of 3 interest rate increases yet this year. Some market commentators have predicted 2, others 4, but all parties are expecting interest rate increases this year. This may help abate any rapid increase in inflation. Remember that global central banks have been attempting to increase inflation, with the Fed's target set at 2%. Current conditions would indicate we have not yet met these targets.

It would appear that more has changed in the stock market than in the real economy. There is little doubt that volatility has increased, along with prescriptions to treat blood pressure. Since the financial crisis of 2008, central banks have resorted to a number of unconventional measures that were intended to boost asset prices, encourage risk taking and tamp down volatility. In the years since, rising prices and low volatility began to feel normal. As central bankers begin to remove the "punchbowl" markets will revert to long term trends. Although the decline earlier this month may have come as a shock, it is not historically unusual. What was unusual was the lack of a significant decline during 2017, and several prior years of relative calm.

Fundamentally, little has changed, other than a reduction of price multiples from 19 times 2018 earnings to 17.5 times. Corporate earnings are generally showing growth of 12% to 15% and current

quarter revenue growth up 7% to 9%. Growth could be further boosted by the recent corporate tax cut and increased government spending. Some of this may be offset by rising interest rates and recent tightening of financial conditions, but these are doing the work of the Fed, keeping a rein on inflation.

We will hear more of the causes and repercussions of the recent sell off in the weeks ahead. Does this signal that constant price appreciation of financial assets will continue, unabated, in the future? No. If nothing else, the selloff was a reminder: markets can do three things.