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"I want to believe"

Market briefing

- The US stock market is hitting all-time highs without any strong macroeconomic data support.
- Investors seem to be giuded by a kind of wishful thinking process feeded by Trump's promises.
- The OCDE is warning of a detachment between the indexes' evolution and the real economy.

Despite the common sense call for looking into grounded explanations, agent Mulder (*The X Files* TV series) had on his office wall a poster which became famous. Under a poor-quality image of an UFO the statement, in bold letters, "I want to believe" summarized the FBI agent's approach to his job of investigating cases with no other plausible explanation than the paranormal one or the existence of extra-terrestrial life. Something similar seems to be happening nowadays with investors in the US stock markets. Despite the absence of strong evidence pointing to a general economic improvement in growth expectations, since the current president of the United States won the election back in November the stock market has soared. This market behavior is worrying the authorities who are warning of the dangers of a market bubble. How coherent is the sentiment of the investors?

When markets rise it is easy to call in the explanation of market irrationality

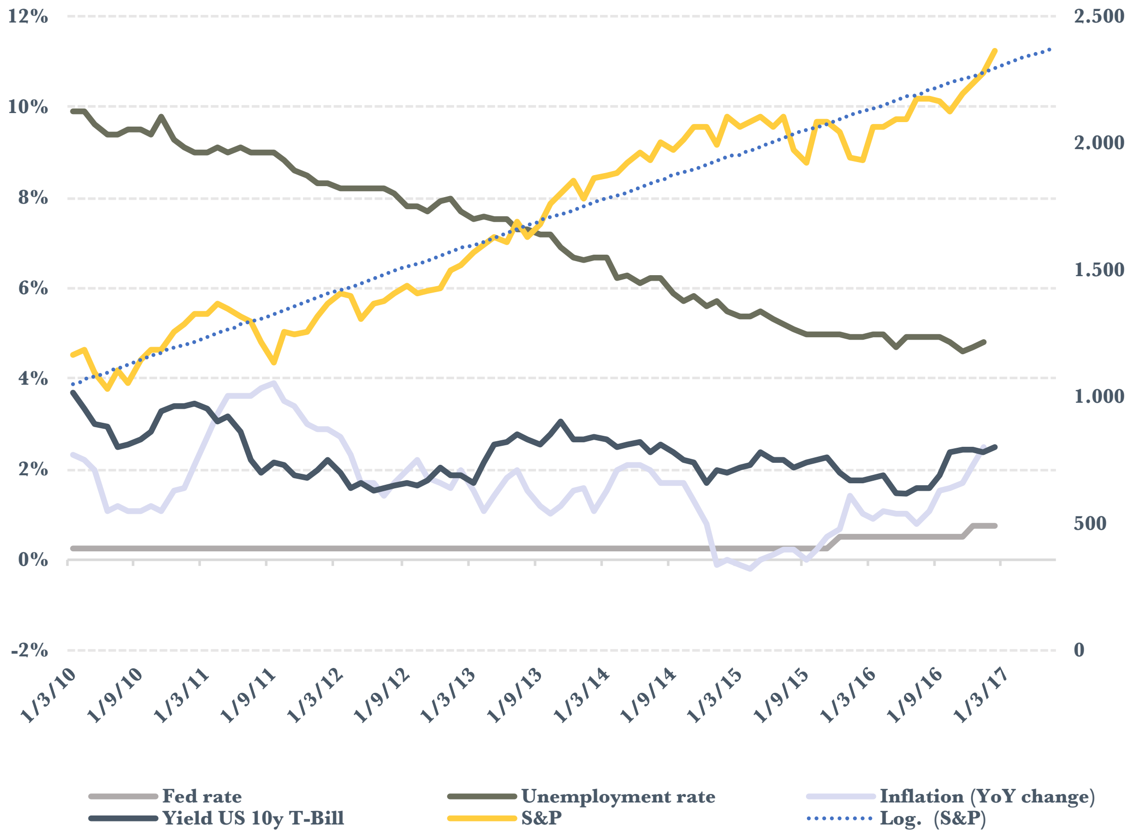
2008 was the year of the crisis. In March 2009 the S&P 500 reached the bottom closing at 682 points, but since then the index has had a constant positive trend. Well, as constant as a stock index can be, but you get the point. By March 2010 it almost doubled and one year later it kept growing although at a much slower pace. Identical situation was the one of March 2012 when the index was up several points from one year before. Nothing different happened in the months between March 2013 to March 2017. What was the GDP evolution during the same period? In 2008 the change rate on the US GDP was -0,3%. Even worse was 2009 with a -2,8%. In 2010 the GDP grew at a 2,5% which left the total GDP in a lower absolute level than 2007. In 2011 the growth rate was a modest 1,6% followed by a 2,3% in 2012. Things didn't change significantly in 2013 with a 2,2% YoY change in the GDP. Comparing the evolution of the stock market and the economy during that period is easy to deduct that what we are living today isn't something strange. GDP growth forecasts range between 1,8% and 2,5% for this year. What is the concern then? Well, one may look at the interest rate market were a rise in the short term is expected. However, if this interest rate hike can curb the enthusiasm of investors is something we need to see.

Will a hike in interest rates bring down the belief in a better future?

As this market briefing is being written, chances that the FED will raise interest rates in the near future are very high. It is almost certain. But again, let's look into the recent past. Investors can't invest at the FED rate but instead they can go for the US T-Bills. Now the yield on the 10y T-Bill is just above 2,5%, 30 basic points up from when the last market rally started. Back in 2014 the same yield reached 3% while the stock market kept rising. Back in 2014 unemployment in the US was above 6% for most of the year while in January this year it marked 4,8% having been under 5% since January 2016. And what about Capacity Utilization? Well, after a peak in November 2014 when the "Total Industry Capacity Utilization" index reached 78,9 it went downward during 2015 and since 2016 it has been between 75 and 76. Hence, no extra pressure here either.

The US economy combines low unemployment with appropriate spare capacity

In the graph below we compare the evolution of the S&P Index (right axis) with broad economy statistics (left axis). In the first half of the period selected the stock market went up with strength in the midst of high unemployment (for US standards), inflationary pressure and a relatively high yield on the US sovereign bonds. During all that period, the FED rate was 0,25%. In mid 2013 statistics started to show some improvement, with unemployment falling below 8% (still high although), inflation around a more suitable 2% and a stronger 10y T-Bill. The rise in the FED rate, late 2015, occurred when unemployment breached down the 5% threshold and inflation pressures started to mount. If we compare the situation today with the recent past only one variable may suggest some overheating in the economy: Unemployment.



Source: Bloomberg, Federal Reserve St. Louis, Bureau of Labor and Statisctics

But as it happens with almost all statistics, unemployment rate must be analysed within a context. We just mentioned that Capacity Utilisation is not in the red zone which suggests companies do have spare capacity to put to work. Also important, non-farm productivity in the US has went up less than 4% since March 2010.

Even assuming that the stock market entered into an "overoptimistic" spiral following Trump's conquest of the White House, deviation from the trend is not greater than 5% (see dotted line). Beliefs tend to be, by definition, irrational given the acceptance of some truth without proof. That may be the case nowadays in the stock market: A group of believers is pushing prices up. But beware of believers because they tend not to change positions quickly. Also, beware of believers because when they do change that move is done impetuously.

If we look into Fundamental Analysis then things are more worrying. Based on the Schiller PE Ratio the market is at a 29,11 level which is historically high. The last higher value has been calculated for 2002 with a level of 30,28. Based on the "normal" PE measure (26,52) we are also at the highest level since 2009 (70,91).

Predicting market behavior is tricky. Even if you are right you can be dead by the time the market proves your statement. But based on hard data we can expect a correction, although not a big one, in the US stock market within the next six months and the higher the level of the indexes the sharper the correction will be. That is what happens when you depend on believers. On the other hand, if the market remains more or less at its current level for a while, and macroeconomic statistics, specially productivity, continue to improve then we can see a "hidden correction", one that leaves the market at a lower level than believers expect today but without the overshooting component. A rising FED rate is not the major threat. The biggest concern we must have is for believers to discover to soon that the truth is not out there and start to trust no one.

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