Comments on financial market turbulence

Woody Brock | SED | 22 February 2018

Was the recent market volatility predictable? Was the volatility exogenous or endogenous in nature? What lies ahead as regards inflation and interest rates?

Predictability

The exact timing of an outburst of market volatility can never be forecast in advance. However, the time was right for precisely the adjustment we have seen. Long-simmering expectations about rising inflation and interest rates were finally fulfilled.

Additionally, the combination of global economic strength along with incipient inflation has convinced market participants that the longstanding era of stagnant inflation and interest rates is over. "The end of the era of easy money is at hand." Given this shift in the wind, and given how high the market has risen, a temporary 10% correction in stocks was perfectly reasonable. This correction has already fallen in half. So there was momentary overshoot of a kind that is typical of many corrections.

Overshoot and endogenous risk

But why did the market correct by only 10%, rather than drop by another 10%? A 20% drop would have been out of proportion to the somewhat moderate "news" about fundamentals. That is, such volatility would have been endogenous as opposed to exogenous. [Recall that the Efficient Market Theory predicted that prices always move in strict proportion to the news. Any greater change in price is deemed endogenous risk.] But why are we claiming that the news driving the market was moderate?

First, good news about healthy earnings growth and revenue growth and share repurchases simultaneously helped to offset the bad news about inflation. Second, recall from our previous research that one of the fundamental causes of market overshoot is the degree to which investors' expectations are correlated.

When the US housing price bubble burst in 2007, some 90% of homeowners did not expect that their house prices would ever drop. As we recall, on 1 January 2007, some 60% of homeowners expected prices to rise moderately over the next year, whereas 30% expected prices to remain unchanged. Thus, when house prices actually fell by 25% to 55% (depending on location), the vast majority of homeowners and investors shifted their views from neutral or optimistic to pessimistic.

When adverse shocks upset highly correlated expectations, and when there are high levels of leverage to make matters worse, prices plunge and a Perfect Storm results, as I explained in Chapter 5 of my book American Gridlock.

Happily, during the past two weeks, there was little *ex ante* correlation of beliefs. There existed a happy mix of bears and bulls. This encouraged bulls to "buy on the dip" which in turn helps stabilise price corrections when news breaks. Additionally, leverage in the stock market was nothing like what it was in the housing market.

Future inflation and interest rates

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Turning to what lies ahead, recall that it is changes in inflation expectations that is by far the most significant driver of both short- and long-term interest rates. Thus, what will now happen to inflation and inflationary expectations will be the most important driver of interest rates, and in turn of the stock market (although earnings will also matter in the case of the market). What lies ahead?

In our essay "The Truth about the Phillips Curve" published last year, we explained why the market (along with central bankers everywhere) has persistently been wrong about inflation during the past eight years. Most market commentators did and still do use the Phillips Curve relationship to forecast when inflation will rise or fall. This relationship postulates that, as the economy expands and the unemployment rate falls, inflation will rise – driven up by rising wages.

But as we explained, the Phillips Curve is merely a half-truth, for it assumes that the prices of the non-wage components of inflation are constant. But in the environment of the last 25 years, the technology revolutions we have discussed at length in prior pieces have mercilessly driven down many non-wage prices. Thus, depending on the magnitude of wage versus non-wage changes in costs, there need be no increase in inflation as unemployment falls – at least until the unemployment rate falls below 4.1%, which MIT's Olivier Blanchard and other economists have shown is the level at which wages begin to rise. But wages only rise modestly until the unemployment rate is below 3.8%, when wages rise notably.

We thus concluded that, because unemployment had fallen to about 4.1%, wage increases would put very modest pressure on inflation. We also pointed out that, because of the ongoing behavior of non-wage costs, the overall inflation rate would rise much more modestly than in past recoveries. And this is what has been happening. An additional reason for a slow resurgence in both wages and inflation is the pool of unofficially unemployed males that are now choosing to return to work. The re-entrance of these workers creates yet another buffer against rising inflation.

The market as a whole does not appreciate the logic we have just introduced, and thus may believe that inflation and interest rates will rise faster than we expect. But as has been the case during the recent decade of disinflation, the bond market's pessimism will probably be reduced if and when the official statistics prove our own view to be correct. Thus, we can see 10-year T-note rates rising to 3.1% or even 3.3% over the next few months, but then falling back to 3%.

New drivers of volatility

Many claims are being made that recent volatility has been heightened by new forms of leveraged VIX contracts, as well as by the increase in ETF funds. The arguments for higher volatility that are cited often cut in both ways, and we are frankly confused as to what is true.

Implications for Main Street

Most investors overestimate the impact of higher interest rates on economic activity. A principal reason for this overemphasis on rates is the failure of many observers to appreciate the stabilising role of the interest-rate-insensitive services sector, which now generates some 80% of private sector income in the US. In this regard, recall our essay "A Random Walk Down Main Street" where we documented that, over the last eight decades, decade-by-decade volatility on Main Street has steadily dropped 85% from what it used to be. The lack of correlation within the service sectors, along with their lack of inventory cycles and intrinsic stability, was partly responsible for this decline in macroeconomic risk.

Another mistake is to think that the impact on the economy of, say, a 2% rise in rates will be the same whether current rates are 2% or 6%. This is wrong. tThe starting point does matter, and the evidence is that the impact of higher rates on Main Street is less in the former case than in the

latter. This situation is analogous to the way in which a large fall in unemployment from 10% to 4% drives wages up very little compared to a small fall from 4% to 3.6%.

Given these observations, and given the boost to the US economy from the Trump tax plan and from highly stimulative fiscal policy, we do not believe that today's modest increases in interest rates will impact Main Street at all. If we are right, this is good news for the stock market because it does not presage a drop in earnings.

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