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OVERNIGHT 3/5/18

(Bloomberg) --

U.S. stocks fell to their lowest in a week and the dollar jumped as investors assessed the Federal Reserve's signal that it's in no rush to raise rates even as inflation rises to its target.

The S&P 500 ended near session lows after briefly pushing higher following the central bank's decision to hold rates steady. Equities tumbled in the final hour of trading as concern mounted that the Fed may let inflation run hot as it gradually tightens. Treasury yields resumed a march to 3 percent and the dollar strengthened versus major peers, adding to equity headwinds.

Central bank officials may have signalled their willingness to allow inflation to exceed their 2 percent goal somewhat by adding a reference to the "symmetric" nature of their target.

"This week's government data showed inflation moving closer to its 2 percent target. This adjustment is simply an acknowledgment by the Fed that its inflation forecast is, in fact, playing out as predicted," Robin Anderson, a senior economist at Principal Global Investors, said in an email. "Since inflation was running below 2 percent, this language indicates that the Fed might be willing to let it run a little above 2 percent for a little while."

The British pound and the euro traded lower. Emerging-market equities and currencies mostly dropped. Gold and oil gained after the Fed announcement.

Earlier, miners, automakers and technology shares led the Stoxx Europe 600 Index toward its best gain this week, shrugging off declines in most Asian markets.

As U.S. trade officials prepare to visit China for talks Thursday and Friday, the People's Bank of China weakened its daily currency fixing by more than traders and analysts had expected. The move raises questions about whether it may devalue further to counter American import tariffs.

A senior government official said China won't succumb to "threats" from the U.S. just as trade talks are set to begin in Beijing. China won't accept any U.S. preconditions for negotiations, such as abandoning its long-term advanced manufacturing ambitions or narrowing the trade gap by $100 billion, said the official, who asked not to be named, citing protocol. Meanwhile, there may be signs that the Trump effect is starting to weigh on Chinese exports. Wednesday's PMI report showed declines in the sub-indexes that track new export orders.

These are some key events to watch this week:

- Eurozone producer prices are scheduled for tomorrow.
- The European Commission will present its spring economic forecasts, including growth, inflation, debt and deficit projections.

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- Payroll gains in the U.S. probably picked up in April, with the unemployment rate forecast to drop to 4 percent, according to surveys of economists before the data reports due Friday.
- Earnings season continues with Tesla Inc. on Wednesday and HSBC Holdings Plc Friday.

Stocks

- The S&P 500 Index declined 0.7 percent as of 4:01 p.m. New York time.
- The Stoxx Europe 600 Index advanced 0.6 percent.
- The U.K.'s FTSE 100 Index gained 0.3 percent, its fifth consecutive advance.
- Germany's DAX Index surged 1.5 percent to the highest in almost three months.
- The MSCI Emerging Market Index fell 1 percent, the biggest drop in a week.

Currencies

- The Bloomberg Dollar Spot Index gained 0.3 percent.
- The euro fell 0.4 percent to $1.1941.
- The British pound fell 0.4 percent to $1.3563.
- The Japanese yen declined 0.1 percent to 109.92 per dollar.

Bonds

- The yield on 10-year Treasuries gained one basis point to 2.97 percent.
- Germany's 10-year yield climbed two basis points to 0.58 percent, the largest surge in more than a week.
- Britain's 10-year yield climbed five basis points to 1.457 percent, the first advance in a week.

Commodities

- West Texas Intermediate crude gained 0.7 percent to $67.73 a barrel, the biggest gain in two weeks.
- Gold increased 0.1 percent to $1,304.55 an ounce.
- LME copper rose 1.1 percent to $6,820 a metric ton.

THE FED

Fed officials may have signalled their willingness to **allow inflation to exceed their 2 percent** goal somewhat by adding a reference to the "symmetric" nature of their target. The Federal Open Markets Committee also noted the weakness in growth in the first quarter, removing a reference in the March statement that the economic outlook had "strengthened in recent months." They balanced that out by noting strong growth in business investment.

EARNINGS ARE G-R-R-R-R-R-EAT, BUT THE REACTION TO THEM ISN'T

Patrick O'Hare ,*Originally posted at Briefing.com*

When we published our first quarter earnings preview on April 6, the projected earnings growth rate for the first quarter was 17.3%. Today, it sits at 23.2%, according to FactSet, which would be the highest earnings growth since the third quarter of 2010.

What hasn't been so great is the stock market's reaction to it. Since JPMorgan Chase reported its results before the open on April 13, the S&P 500 has increased a measly six points.

With rounding, we'll call it unchanged, which seems completely out of line with the strongest earnings growth seen in nearly eight years.

What's the problem?

The market's behavior suggests this good earnings news was already priced in; moreover, there is a nettlesome sense that this earnings growth cycle is at, or near, a peak.

A Metamorphosis

Coming away from this week, just about every pundit will call attention to the guidance from **Caterpillar** (CAT) as the moment that crystallized concerns about being at, or near, peak earnings.

Briefly, after reporting some terrific first quarter sales and earnings, Caterpillar said it thinks its first-quarter adjusted profit per share will be its high-water mark for the year.

In effect, Caterpillar's revelation induced a metamorphosis in the stock market, which suffered a sharp reversal on the heels of that remark.

The truth of the matter is that there were latent concerns already about earnings growth nearing a peak. All Caterpillar did was bring those concerns to the surface.

To wit, there was ample talk throughout the first quarter about how good the earnings growth should be for the first quarter and all of 2018. Despite that talk, the S&P 500 on April 12 (the day before JPMorgan Chase reported) stood at nearly the same level it closed at on December 29, 2017 (2673.61).

A lot transpired between December 29 and April 12, including a big jump in earnings growth estimates on the heels of the tax reform plan, yet the earnings growth story didn't lead the market; it only supported it.

Is the Fix Due to Break?

The problem for the market now is that it seems to be at a loss for determining what will drive the market higher in 2018 if the strong earnings growth hasn't been able to do the trick.

One can argue, incidentally, that the projections for strong earnings growth this year pulled 2018 returns forward into 2017 and helped catalyze the January rally as a fear of missing out on further gains led to some speculative buying interest.

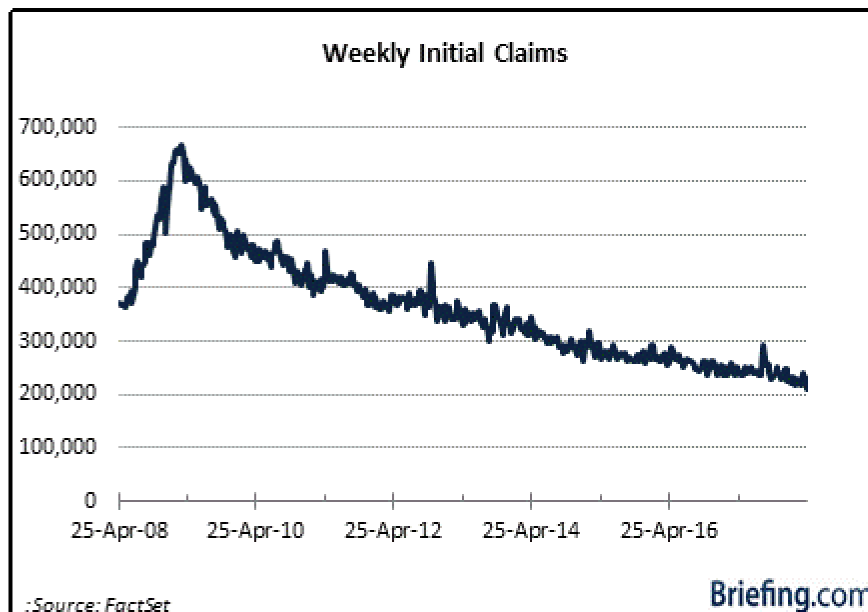
The fear now, then, is that the earnings fix is in and that rising input and labor costs are going to break things.

Several industrial companies have made note of rising input costs and so, too, have several consumer staples companies. **Chipotle** (CMG), meanwhile, has raised its menu prices to help offset higher food and labor costs.

On a related note, the first quarter Employment Cost Index revealed compensation costs for civilian workers increased 2.7% for the 12-month period ending in March 2018 compared to a 2.4% increase for the 12-month period ending in March 2017. Wages and salaries were up 2.7% versus 2.5% for the 12 months ending March 2017.

The latest initial claims report also created some anecdotal angst about the potential for wage-based inflation pressures to pick up.

There were 209,000 initial claims for the week ending April 21, which was the lowest level of weekly initial claims since December 6, 1969, and a sign of a tightening labor supply that typically precedes wage increases.



What It All Means

Companies confronted with rising costs have a choice. They can protect profit margins by passing those costs to their customers or they can eat those costs at the expense of higher levels of profitability, assuming they can't cut costs elsewhere and/or increase productivity.

If companies choose to pass the higher costs to their customers, that will likely spur increased inflation pressure as those customers pass the higher costs to their customers and so on. And, if inflation pressures go up, so will the Federal Reserve's proclivity to raise interest rates.

Conversely, if companies eat the higher costs, their profit growth won't be as strong and that will make investors more cautious about paying up for that earnings growth, which is to say valuation concerns will hold back their stock price.

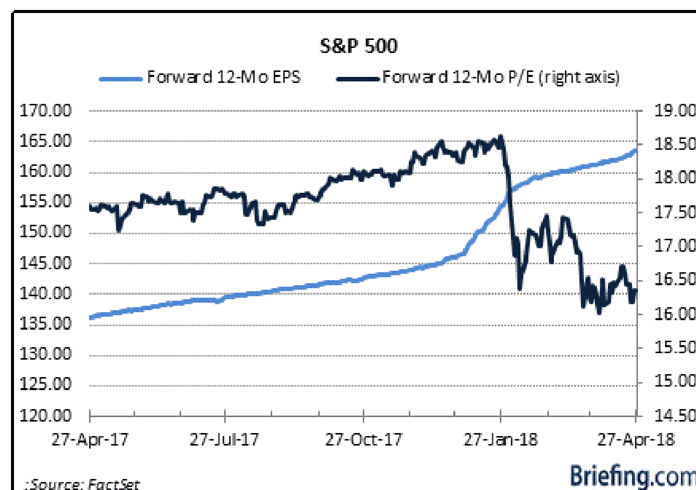
It's a dilemma for the companies and a conundrum for the market.

What will it be?

Neither choice is a great option for the stock market to ponder, which is part of the reason this bull market has stalled in the face of really strong earnings growth.

Inflation could be going up and/or earnings growth could be slowing in the months ahead.

That understanding is the basis for the multiple compression seen this year, as investors recognize it's not a G-r-r-r-r-eat backdrop to pay a premium for future earnings growth that might not be all that it is expected to be.



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GLOBAL EQUITIES ARE POISED FOR A "BLOW-OFF" RALLY OVER THE NEXT 12-TO-18 MONTHS

BCA

Global equities are poised for a "blow-off" rally over the next 12-to-18 months.

Long term return prospects, however, are poor.

The final innings of the 1991-2001 economic expansion saw a violent rotation in favour of value stocks and euro area equities. We expect history to repeat itself.

After sagging by as much as 7% in the second half of 1998 and going nowhere in 1999, the dollar rose by 13% between January 2000 and February 2002. The greenback today is similarly ripe for a second wind.

The correlation between the dollar and oil prices was fairly weak in the late 1990s. The correlation is likely to weaken again now that U.S. crude imports have fallen by about 70% from their 2006 highs thanks to the shale boom.

The U.S. 10-year Treasury yield peaked at 6.79% in January 2000. Thus far, there is scant evidence that the recent increase in bond yields is having a major effect on either U.S. capital spending or housing demand.

This suggests yields can go higher before they enter restrictive territory.

INFLATION IS COMING

On the inflation side, the 3-month annualized change in U.S. core CPI and core PCE has reached 2.9% and 2.8%, respectively.

The prices paid component of the ISM manufacturing index hit a seven-year high in March.

The New York Fed's Underlying Inflation Gauge has zoomed to 3.1%.

The market has been slow to price in the prospect of higher U.S. inflation .

The TIPS 10-year breakeven rate is still roughly 20 bps below where it traded in the pre-recession period, even though the unemployment rate is lower now than at any point during that cycle.

As long-term inflation expectations reset higher, bond yields will rise.

Higher inflation expectations will also push up the term premium, which remains in negative territory.

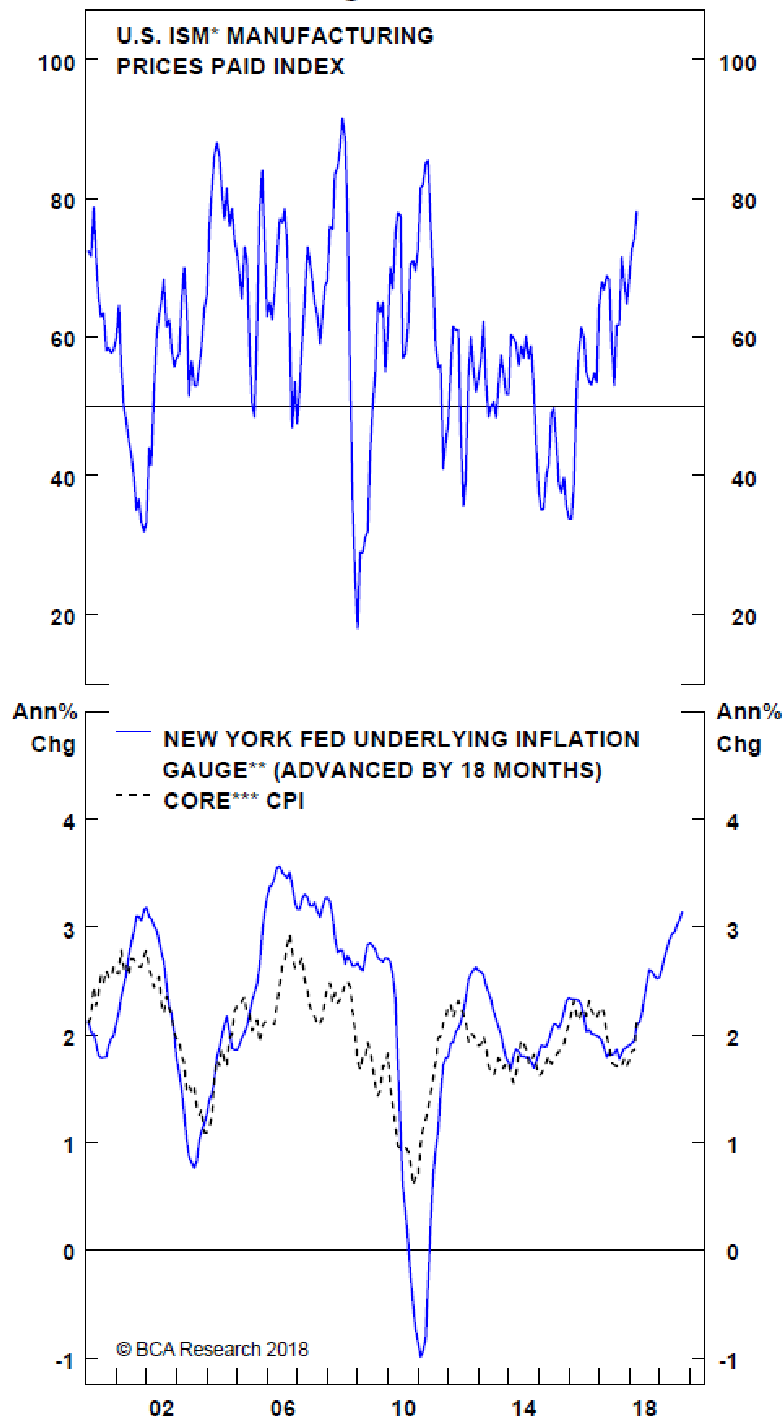
CHART 5
Inflation Is Coming...
U.S. ISM* MANUFACTURING
PRICES PAID INDEX
100
80
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Ann% Chg
NEW YORK FED UNDERLYING INFLATION
GAUGE** (ADVANCED BY 18 MONTHS)
CORE*** CPI
4
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02
06
10
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18
* INSTITUTE FOR SUPPLY MANAGEMENT.
** TREND INFLATION MEASURE BASED ON BROAD PRICE VARIABLES, MACROECONOMIC VARIABLES, AND FINANCIAL VARIABLES.
SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
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The U.S. Economy Is Not Yet Succumbing To Higher Rates

For now, there is little evidence that higher rates are having a major negative effect on the economy. Business capital spending has decelerated recently, but that appears to be a global phenomenon.

Capex has weakened even more in Japan, where yields have barely moved. In any case, the slowdown in U.S. investment spending has been fairly modest.

Core capital goods orders disappointed in March, but are still up 7% year-over-year.

Likewise, while our capex intention survey indicator has ticked lower, it remains well above its historic average. And despite elevated corporate debt levels, high-yield credit spreads are subdued and banks continue to ease lending standards for commercial and industrial loans .

In the household realm, delinquency rates are rising and lending standards are tightening for auto and credit card loans. However, this has more to do with excessively strong lending growth over the preceding few years than with higher interest rates. Particularly in the case of credit card lending, even large movements in the fed funds rate tend to translate into only modest percent changes in debt service payments because of the large spreads that lenders charge on unsecured loans.

The financial obligation ratio – a measure of the debt service burden for the average household is rising but is still close to the lowest levels in three decades.

Mortgage debt, which accounts for about two-thirds of all household credit, is near a 16-year low as a share of disposable income . As Ed Leamer perceptively argued in his 2007 Jackson Hole address entitled “Housing Is The Business Cycle,” housing is the main avenue by which monetary policy affects the real economy.

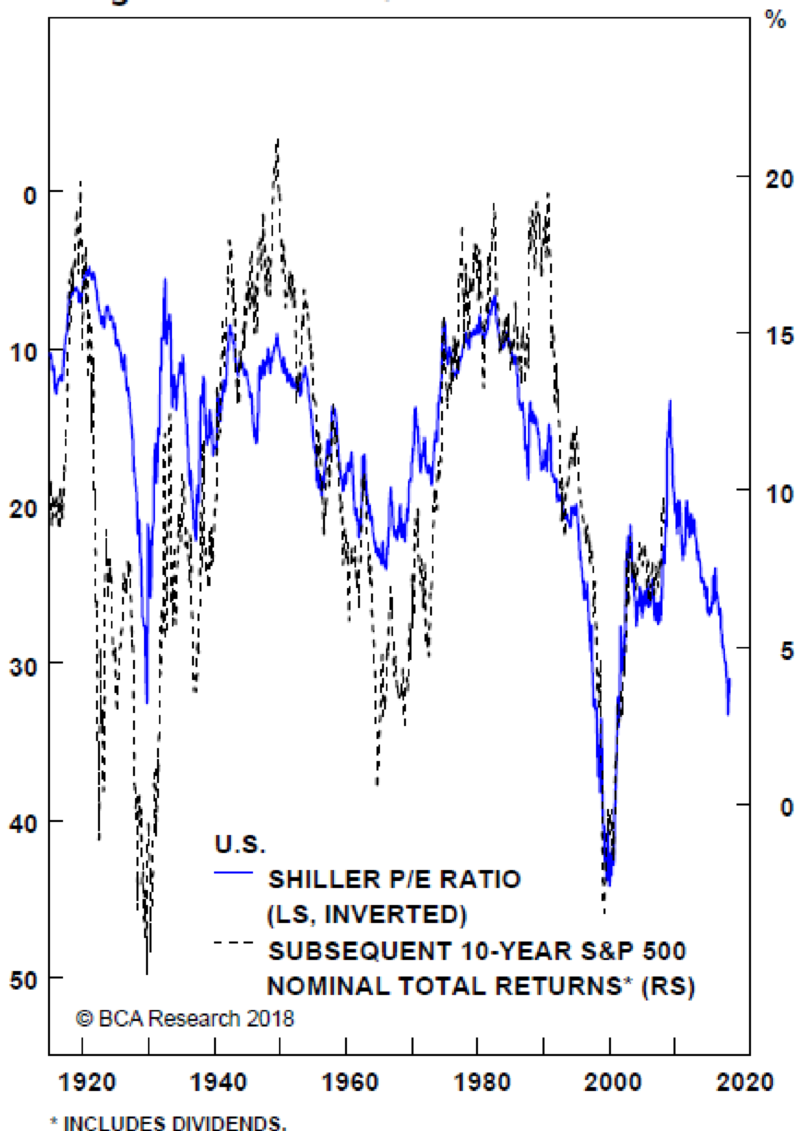
Similar to business capital spending, while the housing data has leveled off to some extent, it still looks pretty good: Building permits and housing starts continue to rise. New and existing home sales rebounded in March. Home prices have accelerated. The S&P/Case Shiller Home Price Index saw its strongest month-over-month gain in February since 2005.

The MBA Mortgage Applications Purchase Index is up 11% year over-year. The percentage of households looking to buy a home in the next six months is at a cycle high. Homebuilder sentiment has dipped slightly, but it remains at rock-solid levels.

The Outlook For Equities

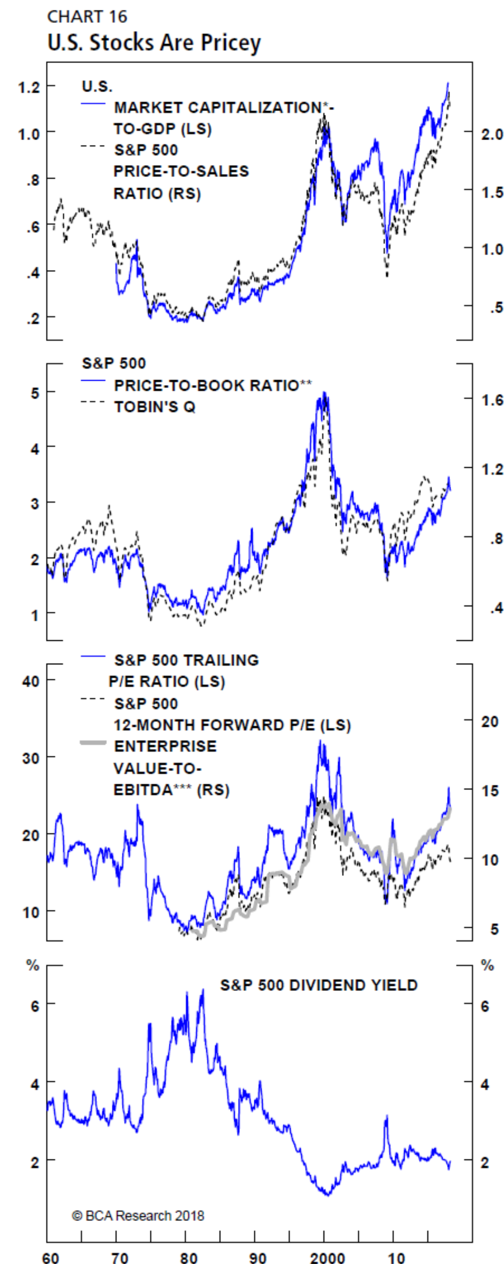
Following the script of the late 1990s, stock market volatility has risen this year, as investors have begun to fret about the durability of the nine year-old equity bull market.

Valuations are not as extreme as they were in 2000, but they are far from cheap. The Shiller P/E for U.S. stocks stands at 31, consistent with total nominal returns of only 4% over the next decade.



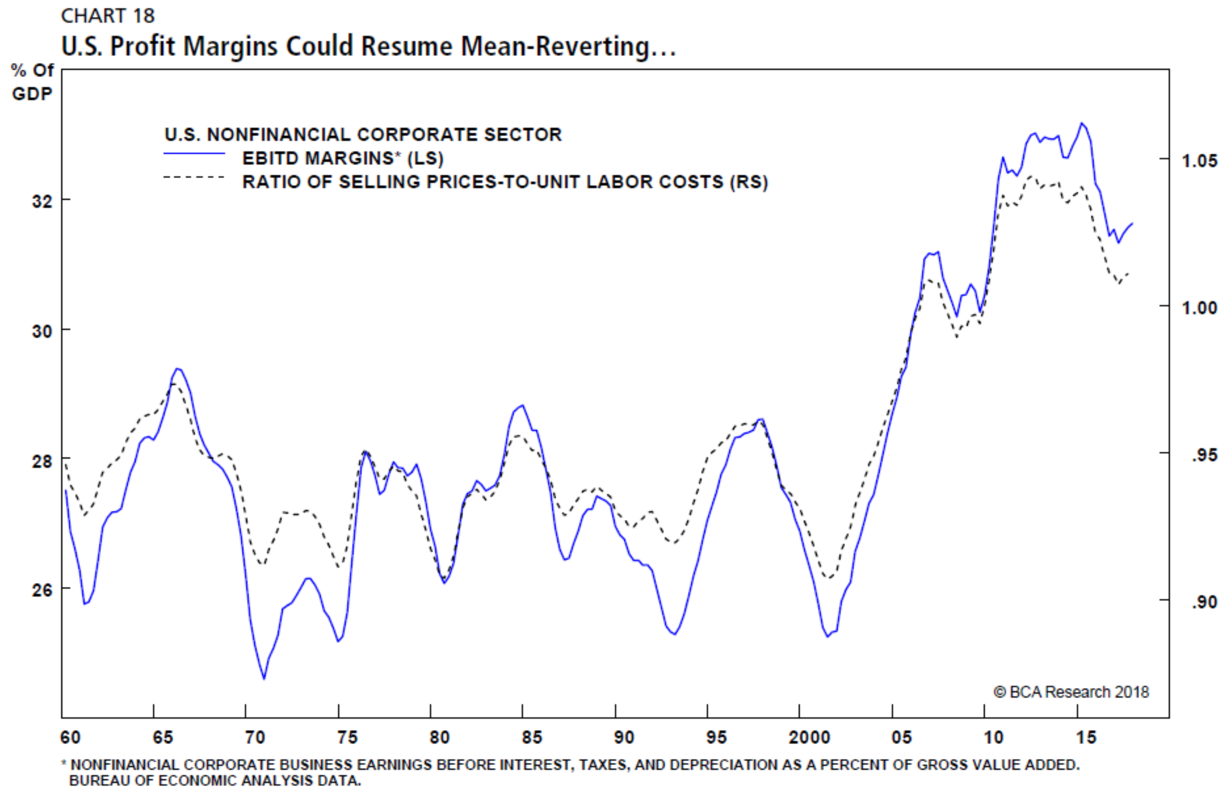
On a price-to-sales basis, U.S. stocks have surpassed their 2000 peak .

Such a rich multiple to sales can be justified if profit margins stay elevated, but that is far from a sure thing. Yes, the composition of the stock market has shifted towards sectors such as technology, which have traditionally enjoyed high margins. The explosion of winner-take-all markets has also allowed the most successful companies to dominate the stock market indices, while second-tier companies get pushed to the sidelines.



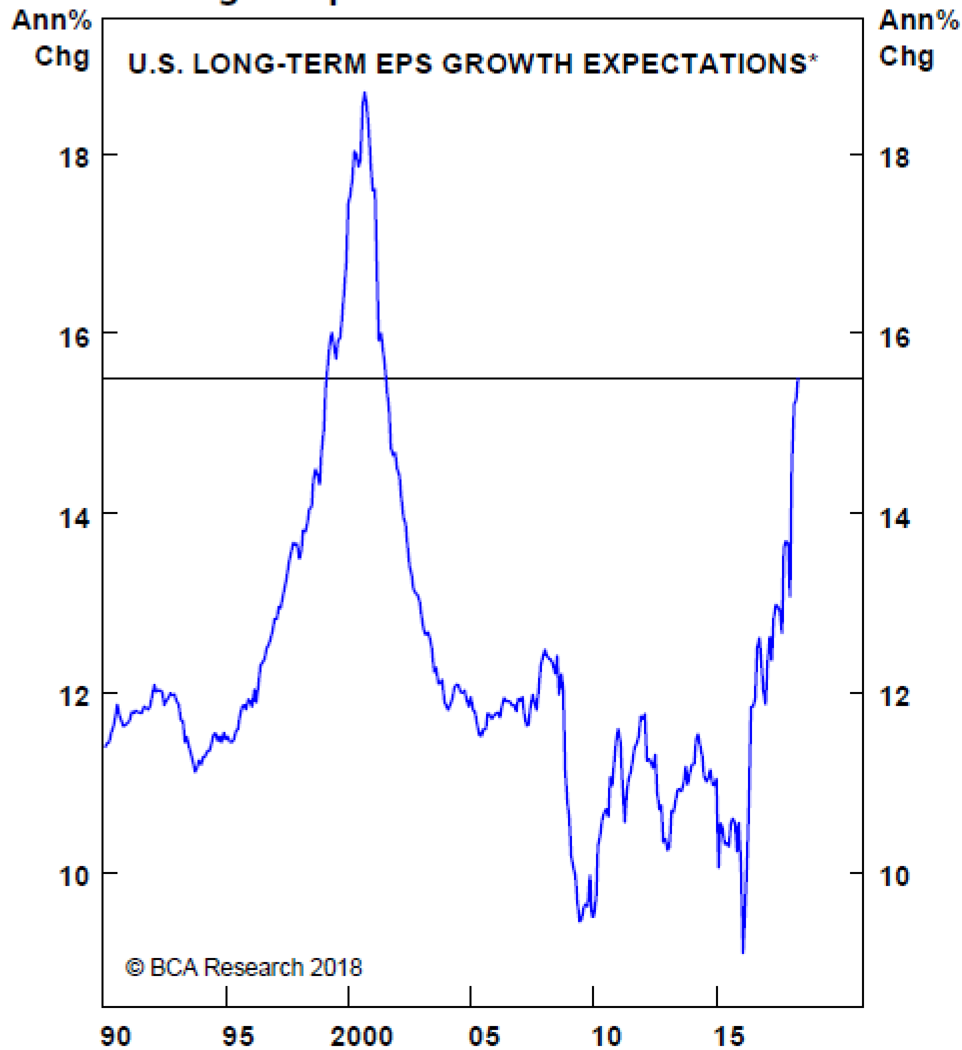
Nevertheless, there continues to be a strong relationship between economy-wide profits and the ratio of selling prices-to-unit labour costs . The latest data suggest that U.S. wage growth has picked up in the first quarter . Low-skilled workers, whose wages tend to be better correlated with economic slack than those of high-skilled workers, are finally seeing sizable gains.

Even if productivity growth accelerates, unit labour costs are likely to rise faster than prices, pushing profit margins for many companies lower.



Bottom-up analysts expect annual EPS growth to average more than 15% over the next five years, a level of optimism not seen since 1998 .

The bar for positive surprises on the earnings front is getting increasingly high.



Go For Value

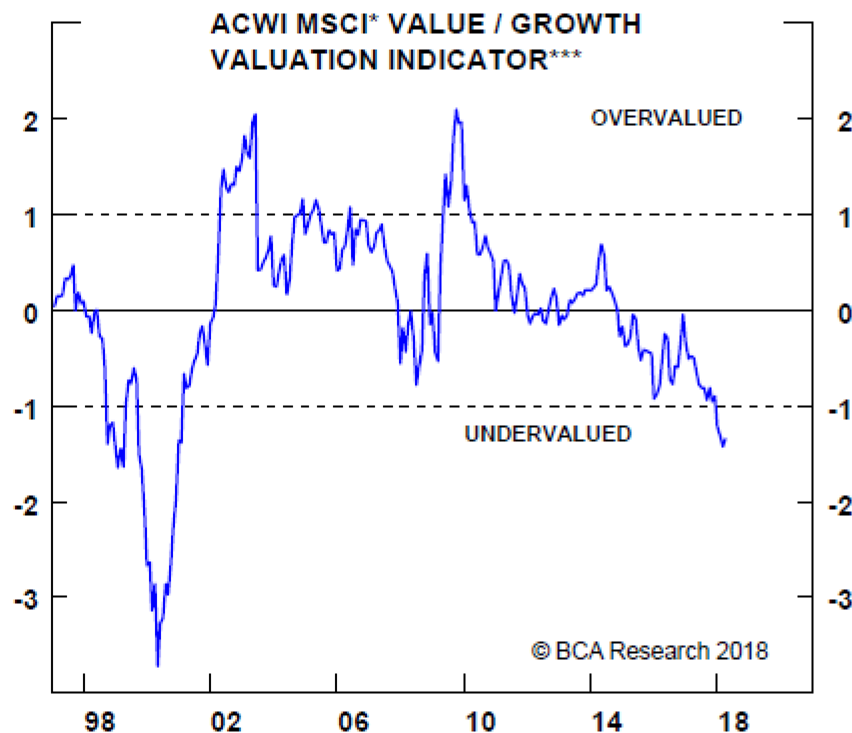
Historically, stocks tend not to peak until about six months before the start of a recession. Given our expectation that the next recession will occur in 2020, global equities could still enjoy a blow-off rally after the current shakeout exhausts itself.

But when the music stops, the stock market is heading for a mighty fall.

Given today's lofty valuations and the uncertainty about the precise timing of the next recession, we would certainly not fault long term investors for taking some money off the table. For those who feel compelled to stay fully invested, our advice is to shift allocations towards cheaper alternatives.

Value stocks have massively underperformed growth stocks for the past 11 years .

Today, value trades at a greater-than-normal discount to growth. Earnings revisions are moving in favour of value names. Just like at the turn of the millennium, it may be value's turn to shine .



Timeline Of A Crisis

By Blonde Money

Batten down the hatches. Can you feel the storm coming? Did you hear the warning from the Cap'n? Andrew Bailey, Chief Executive of the Financial Conduct Authority couldn't be clearer in his speech last week:

'our job is to be watchful to the build-up of risks and vulnerabilities in the system… The secondary market liquidity of ETF shares is dependent on market makers and authorised participants… We know relatively little… about the capacity and willingness of APs to execute their function in stressed conditions where they may be under pressure to tighten their own risk limits. The result could be unexpectedly large discounts for ETF investors selling their holdings relative to the estimated value of the underlying assets, and possibly a need to suspend fund dealings… this could have the potential to amplify shocks to market conditions which are already under stress. We have no easy way of sizing this risk, but we cannot ignore its potential given the rapid growth of ETFs.…the global financial system is more resilient than it was… [the issue] lies in what level of continuous market liquidity conditions investors expect, and thus the liquidity transformation they accept.'

Aye there's the rub. **Liquidity.**

This isn't just a warning for a few years from now. It's already happening. Prices are moving around more than we might expect under "normal" conditions.

Look at Facebook.

The weekly fall in its share price in March ranked as the third biggest weekly loss **ever**. It floated in May 2012, and suffered some big weekly moves around that time. But since then, fairly calm. Until this year.

You might argue that Facebook was overdue a correction; that tech companies are wildly overvalued; that the Cambridge Analytica issue was a canary in the coalmine for a company – nay, industry – now facing much greater regulation.

True. But are those arguments enough to warrant a weekly decline in the share price that sits in the top 3? The volumes traded that week weren't even in the top 10. And what's that coming in at no.11 in our list? The week including the VIX blow up. Is that a fundamental reason to sell Facebook?

Facebook constitutes a large part of many passive investments. According to ETFdb.com, Facebook is one of the Top 15 holdings of **106 different ETFs**.

Added up, their exposure to Facebook constitutes approx. $1 trn**. Its current total market cap is only** half that**.**

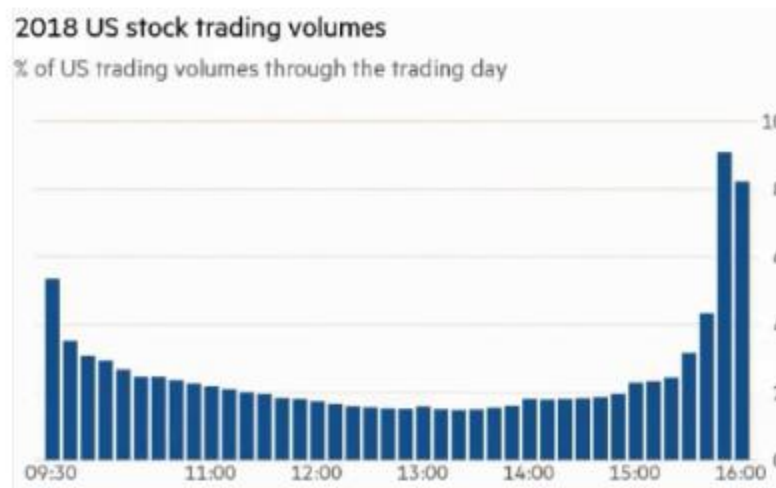
ED: I don't understand that last sentence,as I thought ETFs matched the performance of the underlying Index so how come ETFs own a supposed 1 Tril worth of FB,when its market cap is 500bn?
Especially as there many Long only investors owning FB too.
If anyone can enlighten MM, he would be most grateful.(apart from saying its all down to Delta hedgers)

Now, the holders of these ETFs might not move their positions all that much. But the market makers have to adjust their positions as the price moves. They are committed to tracking the underlying index. It's like a shadow of the $ 1trn is just sitting there, having to trade each time Facebook's share price moves.

If someone sells an ETF in the secondary market to one of the market-makers, then they have to lay off the risk as cheaply as possible. A computer is usually involved. It's a simple algorithm. If Facebook is the biggest weight in the index, then cover that risk first.

The tracking mechanism of the ETF therefore creates a multiplicative effect. That's why prices are moving more than we might otherwise expect, under "normal" circumstances. The amount of daily volume linked to passive investments is rising.

As Credit Suisse noted, 40% of all trading volume now takes place in the first and last 30 minutes of the trading day, compared to 31.5% a decade ago.



With prices moving around more, liquidity is at a premium. That's why we can get the 3rd worst weekly loss for Facebook taking place ***without*** the 3rd biggest weekly volume.

It's only going to get worse. With fundamental investors confused, they sit on the sidelines. Delta hedgers are the only people who have to trade every day. With volatility levels rising, they trade in larger size on larger moves, in order to protect their position. Liquidity suffers further. It won't take long before:

- This impairs the ability for market makers to make money
- They stop making prices
- They're kicked off the exchange
- Liquidity in the ETF suffers
- APs step in to create/redeem shares in the ETF itself, looking for an arbitrage profit
- They ram all the orders into the close but liquidity is so bad from everyone trying to do the same trade at the same time that it's executed at distressed pricing.
- The arbitrage can't be done. They step back from the market.
- The ETF no longer functions as it should.
- Investors are left holding an instrument that is entirely divorced from reality.

This process is now underway:

Step 1: With more delta hedging taking place in larger size on larger moves, we will have prices move further than you might think for a number of days, then reverse track [Rusal dropped 50% the morning after sanctions were announced; rallied back 30% when they were thought to be eased two weeks later]
Step 2: ETF issuers have to retire any products which struggle to track the underlying. [Barclays retired $1.2bn of ETNs on 12th April as they were no longer profitable, and reissued some with a new embedded call option]
Step 3: Exchanges tighten up the rules on market-makers. [NYSE Arca issued new listing standards for ETPS in January]
Step 4: Big winners will turn into the biggest losers as momentum reverses. Watch out for those much-mocked 200 day moving averages and other technical indicators that a market divorced from fundamentals relies upon
Step 5: A squeeze on markets where the liquidity transformation is most out of whack. Credit markets, particularly high yield, should suffer.
Step 6: Banks and brokers who can least manage the market-making and AP process to suffer losses.
Step 7: ETF issuers to lose assets.

For now, in Step 1, fade the big moves. When we get to Step 4, the bigger breakouts will begin, and momentum will have turned.

At each stage, expect the narrative to change, isolating the issue. Credit ETFs were always a risk, they'll say. Momentum stocks were overvalued, they'll say. It's Trump. Trade. Russia. Brexit. The Fed.

Yes, the fundamentals might understandably cause a re-pricing. But the mechanics of this market have created the perfect set up for it to turn into a crash.