Herd Movements

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"They're moving in herds. They do move in herds." Dr. Alan Grant, paleontologist, Jurassic Park. Alan Grant was speaking of herbivorous dinosaurs in a movie, but he could have been speaking of equity investors last month. It doesn't take much to set off a stampede in the equity market and any excuse (or no excuse) will do. But is it justifiable? In our judgment, both trade war fears and the comment by Fed Chair Powell that policy was still accommodative and it was likely to become slightly restrictive triggered the overreaction and provided an excellent opportunity to use available cash to add to positions, since the investment environment remains attractive.

The underlying health of the market was made evident on Friday with the addition of 250,000 more workers to payrolls. With job openings exceeding 7 million and unemployed under 6.1 million, hiring will remain robust. So labor is scarce and that is finally being reflected in higher average earnings, which rose 3.1% year over year. Strong hiring should continue, the unemployment rate will fall, and labor costs will continue to accelerate. And that does present a significant risk.

Labor scarcity drives up labor expenses and firms must ultimately pass that cost into prices, producing rising inflation. In the short-run, firms could absorb the higher labor cost by allowing profit margins to be squeezed. But that's a temporary response. Over time, they will hike prices. Inflation is currently running very close to the Fed's 2% target, but the Fed (and most investors) appreciate that rising labor costs will drive up inflation. That's precisely why the Fed continues to slowly, methodically, transparently, and, it hopes, benignly raise overnight interest rates. It knows it must get policy to neutral as quickly as it can without undermining the expansion. Only a small minority thinks it would be good policy to wait for the inflation genie to get out of the bottle before the Fed responds, as Neel Kashkari, President of the Minneapolis Fed suggested in an editorial in the WSJ on October 26. Fortunately, most Fed officials don't agree. So there's every reason to expect the same measured 25 basis points per quarter pace, which means the next one is due in December. But that schedule may have to accelerate, since arguments like Kashkari's remain semi-plausible only as long as inflation rises slowly. Any sizable rise in inflation would make it obvious that policy is behind the curve.

The threat of tariffs is unsettling investors as companies begin to report material impacts on costs. Tariffs are highly likely to undermine the pace of growth, reduce corporate profits, and worsen inflation. But the effects are likely to be fairly concentrated and, ultimately, short-lived as political dynamics push for a resolution. A negotiated settlement with China or other parties may not come this month or even this year, but should eventually. Growth may be reduced a few tenths of one percent and profits by a few percent, but only for a relatively short time and only for a relatively small group of companies, so the broad market decline of roughly 10% looks like a severe overreaction.

The other critical question revolves around whether the equity market can handle these interest rate increases. So it is enormously helpful that stocks are cheap, investors are fearful of holding stocks, and that investors have long considered prevailing interest rates as unsustainably low. The threat of higher rates is already embedded in stock prices, so there need not be a wholesale repricing as interest rates move higher. In fact, the S&P 500's price-earnings multiple has fallen to 15.2 times 2019 expected earnings, and is close to 13 times, excluding the FANG stocks. Those multiples are well below long-term historical averages, commonly seen in recessions, and traditionally mark an attractive opportunity to put new money to work. In our judgment, stocks remain quite attractive relative to bonds. Nonetheless, it is highly likely that the typical investor will react to the Fed's interest rate hikes and may even overreact from time to time. Simply put, stock valuations are volatile and highly sensitive to slight changes in market sentiment. Indeed, herds tend to be nervous and will stampede in response to any perceived threats. Maybe investors and dinosaur herds aren't so different after all.

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