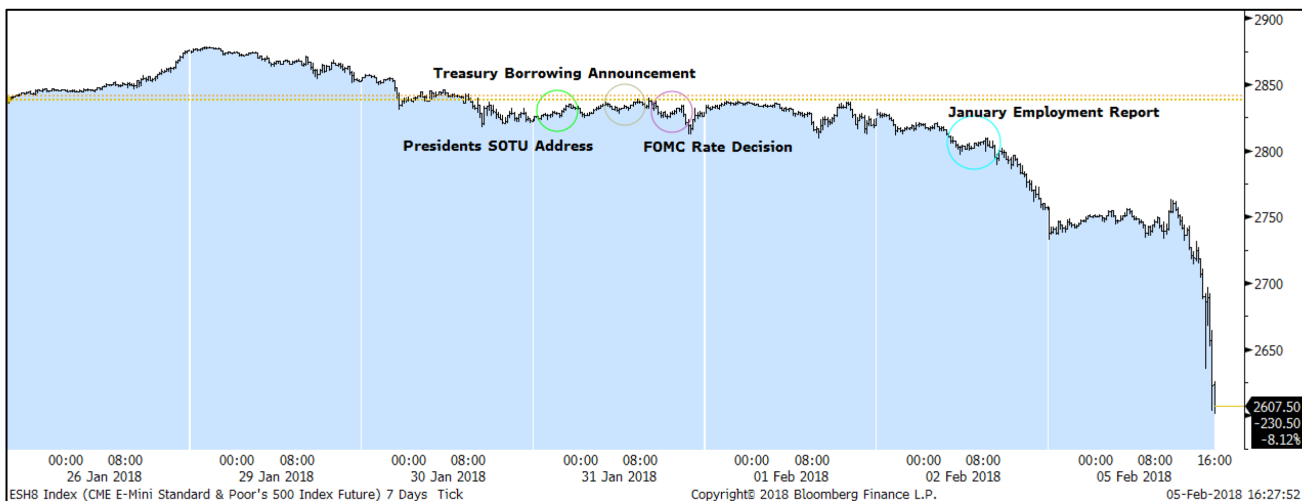
Market Update

Volatility returned to the financial markets in full force, bringing down global equities and bond prices with it. Commodities and currencies reacted with plenty of volatility of their own, but with less obvious direction. Is this just a normal bull market correction as pundits on CNBC, Bloomberg, and other financial media so confidently claim? Or, is this the beginning of something bigger?

We have remained cautious on equities for some time now—especially U.S. equities—and believe that significant downside risks are evident. So, do we believe the reaction of the markets over the last several trading days are the start of the major adjustment we have been anticipating? We can confidently say… "perhaps."

As has been a long held tradition, market participants' perennial search for answers reaches the depth of curiosity during market declines, and this time is proving no different. As of this writing, the U.S. market as measured by the S&P 500 peaked on Friday, January 26th (see Chart 1). Declines over the following Monday were rather modest (by historical standards), but the drop accelerated into Tuesday prior to the President's State of the Union Address, saw some volatility around the Federal Reserve Open Market Committee (FOMC) decision on interest rates on Wednesday (which were a non-event), and remained relatively stable on Thursday. However, last Friday morning started a relatively sharp down-draft just prior to the release of the January Employment Report, and this trend accelerated throughout the day. Some pundits even credited the release of a controversial memo from the House Intelligence Committee as partly responsible for the decline. By the time Friday was over, the U.S. equity markets had dropped by over 2% on the day.

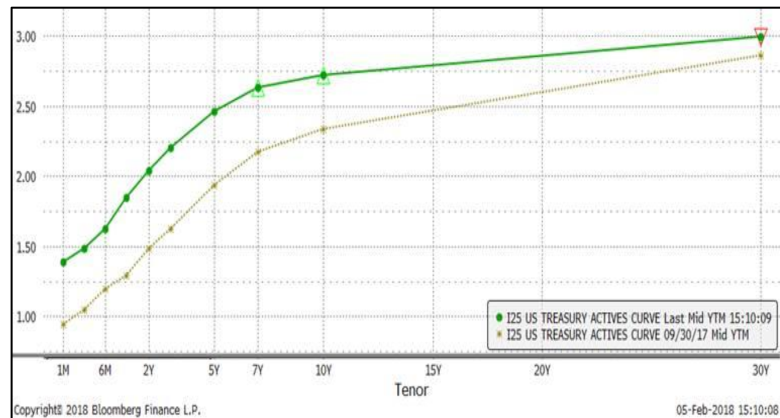
Chart 1 – S&P 500



Strong comments from the FOMC regarding the economy, followed by a relatively healthy January jobs report, were credited with the continued drop in bond prices and higher interest rates during the week. In fact, the yield on the 10-year Treasury Note reached surpassed 2.8%, with the yield curve steepening slightly by the end of the week. Many analysts credited this rise in interest rates as a catalyst for the sudden drop in equity prices. However, rates have been climbing steadily since late September (see Chart 2), and we doubt that moves above technical levels such as 2.75% were on the minds of equity investors as they contemplated holding on to positions or not.

In our opinion, the drop in markets have been due in part to an announcement from the Treasury Department shortly before the FOMC rate decision was announced on Wednesday. For the first time since the financial crisis in 2009, the U.S. Treasury announced an increase in the size of its borrowings due primarily to the rising deficit resulting directly from the Tax Cuts and Jobs Act of 2017. While the announcement was expected by the bond markets (though the degree of borrowing remained a subject of debate), the equity markets had been brushing it aside and instead concentrating on the positive effect the legislation would have on corporate earnings (forgetting that the tax cuts had to be financed somehow).

Chart 2 – Change in Treasury Yield Curve



The Treasury announced increases across the board in bills, notes, and bonds for 2018. As seen in Table 1, we expect this increase in borrowing to be the first of many future announcements. Combining the increase in deficits with the Federal Reserves decision to allow its Treasury holding to mature without reinvestment (SOMA redemptions), we expect an additional $2.24 Trillion in borrowings over the next five years. We remain mindful of the fact that this forecast is based on our recession neutral forecast. Taking into account a likely recession over the coming 24 months, the deficit projections could be considerably higher.

Table 1

	Budget Deficit			Addtl. Deficit	Fed. Res.	**Addtl. Deficit**
	Pre TCJA	Post TCJA		ACIMA minus	SOMA	**plus**
	CBO	JCT	ACIMA	Pre TCJA CBO	Redempt.	**SOMA**
2018	$563	$667	$750	$187	$229	**$416**
2019	$689	$935	$940	$251	$271	**$522**
2020	$775	$997	$1,075	$300	$176	**$476**
2021	$897	$1,079	$1,150	$253	$173	**$426**
2022	$1,027	$1,168	$1,275	$248	$152	**$400**
			Totals:	$1,239	$1,001	**$2,240**

TCJA – Tax Cuts & Jobs Act
CBO – Congressional Budget Office
JCT – Joint Committee on Taxation (US Congress)
SOMA – System Open Market Account (Fed Treasury Portfolio)

The tax cuts and the associated increase in corporate cash flows were not going to come without a cost. We all knew that. Are the markets finally signaling a recognition as such?

Stay tuned.

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