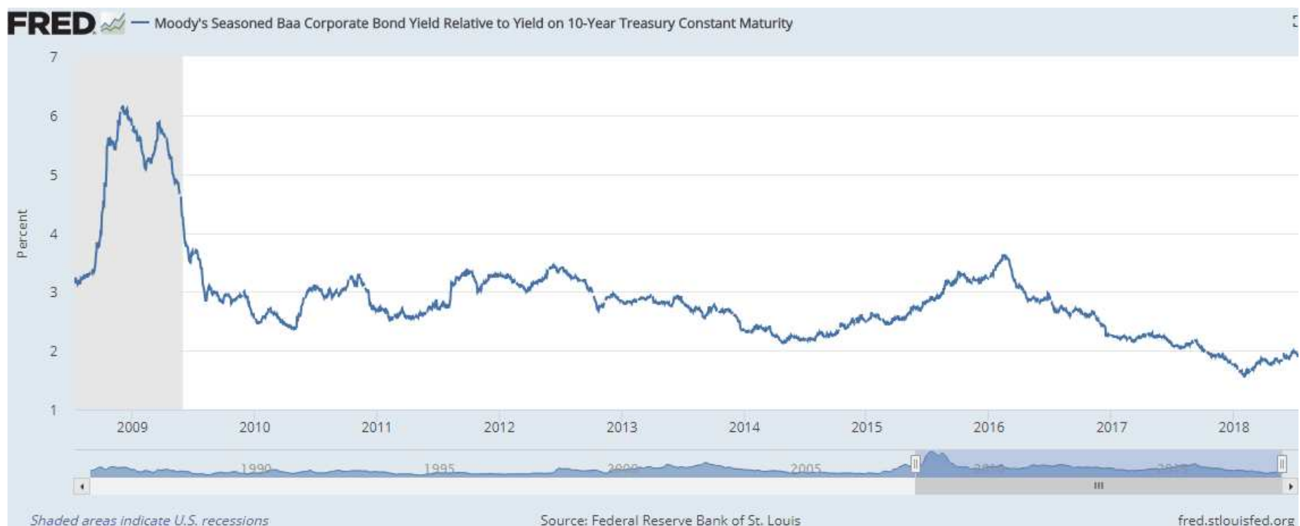
Wasatch Capital Management Commentary
Wash, Rinse, Repeat
7/13/2018

By virtue of exchange, one man's prosperity is beneficial to all others. **Frederic Bastiat**

After penning last month's commentary, I was reasonably confident July would have more pressing economic tidbits to discuss than trade. Unfortunately, I'm experiencing an overwhelming sense of déjà vu, and trade remains center stage. Protectionism continues to cast a shadow over an otherwise bright economic backdrop; the Conference Board's Leading Economic Index currently sits at 109.5, up 9 ½% from 2016. Unemployment, real wages, business & consumer confidence, capital investment, productivity, and corporate earnings are giving investors reasons to cheer. However, in Marty Feldman-like fashion, markets have one eye on rosy fundamentals and the other eye on global trade.

Despite heightened fears of an all-out trade war, global markets have held up surprisingly well, the US market in particular. As of this writing the S&P 500 Index is up 5.75% for the year, whereas bonds have lost 1.35%. But not all indicators are green. One data point, the yield curve, is flattening. The difference between the 2-year and 10-year Treasury note is the most commonly cited metric, and the 2/10 spread is currently .25%. We like to see this number above 1%, since inverted yield curves are highly correlated with recessions.

In addition to the yield curve the bond market has a second important "tell," which is the credit spread, or difference in yield between corporate and Treasury securities. Since Treasuries are considered "risk free," the difference in yield indicates the amount of risk premium investors demand for assuming credit/default risk. When spreads are wide, the bond market is sounding the alarm to run for the hills. Conversely, when spreads are narrow the bond market is sanguine. The chart below provides a graphic representation of the bond market's view of credit risk. You'll notice it peaked in early 2009, at the height of the financial crisis, then proceeded to drop like a stone as it priced-in the likelihood of economic recovery. The long-term average spread between Baa securities and Treasuries is a little north of 2%, whereas today it's 1.90%. While the yield curve warrants a Spock-like raised eyebrow, credit spreads are basically saying "Nothing to see here folks. Move along."



While we think the flattening curve is of concern and warrants keen observation, we believe the curve will normalize or, at the very least, longer term yields will continue to climb more or less in tandem with future Federal Reserve rate hikes. The market is pricing in a 97.9% probability of a Fed rate hike at the end of this month and an 87.3% chance of a second hike before the end of the year. While forecasting long-term interest rates is akin to astrology in terms of accuracy, we believe the US 10-year Treasury finishes the year in the 3.25 – 3.35% range. However, for the 10-year yield to move higher trade concerns need to subside the markets can focus on fundamentals rather than fear.

Basically, the stock market is giving investors a thumb's up, whereas the bond market is waving the caution flag. So, what is the rational investor to think? While not perfect, markets tend to be pretty good forecasters of future economic environments – markets tend to rally before the economy grows, and they tend to sell off in advance of recessions. To this

point, the stock market appears to be reasonably confident tomorrow will be a better day. In fact, we believe *if* trade was settled and no longer a concern, the US stock market would be significantly higher almost overnight. Why? According to Yardeni Research, forward earnings for the S&P 500 are $169.43/share. The S&P 500 is currently trading at 16.52 x forward earnings. With 20%+ earnings growth and a 10-year Treasury yield that is sub-3%, the S&P should be trading at least 17 ½ x earnings and maybe higher. At 17 ½ the S&P Index would be 2965 as opposed to 2798, or a 6% increase. An 18 ½ multiple of earnings, which is reasonable, would push the S&P to 3134 for a 12% increase.

In the face of conflicting signals, the stock market has been a better, more accurate barometer of future economic activity than has the bond market, at least throughout this economic cycle. On more than one occasion the bond market sounded the alarm with widening credit spreads while the stock market marched higher. At the end of the day, the bond market walked itself back, hat in hand, and the stock market was proven correct. In this case, we believe the stock market is reading the tea leaves correctly.

Item	Data point
Year-to-date S&P 500 Return[1]	5.75%
Year-to-date Bond Index Return[2]	-1.35%
Current unemployment rate[3]	4.00%
Average Hourly Earnings (YOY) [4]	2.70%
Capital Spending Growth Rate[5]	39%
Expected inflation[6]	2.10%
2018 GDP (projected)[7]	2.90%

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***Source**: [1]Bloomberg, 7/13/18, [2]Bloomberg, 7/13/18, [3]Bureau of Labor Statistics, 7/6/18, [4]Bureau of Labor Statistics, 7/6/18, [5]Bloomberg, 4/26/18, [6]Federal Reserve FRED, 7/13/18, [7]Wall Street Journal, 7/13/18*

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