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The Stock Market Charges Ahead, Despite the World's Storms

New York Times **By Conrad de Aenlle** **Oct. 13, 2017**

Hurricanes in North America, earthquakes in Latin America, tensions on the Korean Peninsula and political turbulence in the United States, Germany and Spain have produced little but shrugs on Wall Street.

The stock market's rise — not just in the third quarter of 2017 but for eight years — suggests that traders are convinced the Federal Reserve will meet any meaningful decline with fresh steps to prop stocks up. In the bond market, by contrast, rising yields betray a growing sense that monetary policy will become a headwind.

If that belief spreads to the stock market, fund managers and investment strategists warn, it could disrupt a long bull run that has left stocks expensive by historical yardsticks and more susceptible to a decline.

"Everybody wants to interpret the Fed as having orchestrated a reasonable economic environment on the upside, and that it's going to be equally successful in not getting us into too much trouble on the downside," said Kimberly Scott, a manager of the Ivy Mid Cap Growth fund. "It's silly to make that comfortable assumption. We have to make sure something doesn't sneak up on us."

That something, Ms. Scott said, could be an economy that is "somewhat more strong than people appreciate," leading to a faster pace of rate hikes. That would be especially hard on stocks in high-growth sectors like technology that have been strong performers lately.

She acknowledged that the fund owns "a lot of expensive growth stocks" and said that she was taking some profits and putting the money into areas such as health care and business services.

Tad Rivelle, chief investment officer for fixed income at TCW, expressed the opposite economic concern. After the Fed's September meeting, short-term interest rates rose as long-term bond yields fell, closing the gap between them. In bond market parlance, the yield curve flattened.

If the yield curve goes beyond flattening, into outright inversion, with short rates above long rates, it might be a sign of a recession, so even a flattening yield curve is worrisome.

"It has been often said that the smartest guy in the room is the yield curve," Mr. Rivelle said. The flattening could be "signaling that prospects for growth and inflation are more muted."

Stocks nonetheless reached new highs in the third quarter, unmoved by warnings from Fede officials that monetary policy would be tightening. The benchmark Standard & Poor's 500-stock index rose 4 percent for the quarter.

The Fed's signals seemed to be taken more seriously in the bond market. Treasury issues rallied initially, then sold off, leaving the 10-year note yielding 2.33 percent at the end of the quarter, compared with 2.3 percent three months earlier and well above its 2.06 percent yield in early September.

Mr. Rivelle advised investors to emphasize shorter-term "securities that focus on more dull parts of the bond market," such as high-quality municipal issues, AAA-rated mortgages and government-guaranteed student loans. He said he was "more skeptical of high-yield and emerging markets."

"If you wanted to take a walk on the wild side," he said, "you should have been doing that in 2010."

Bond funds provided a walk on the mild side in the third quarter, gaining 1.2 percent on average, according to Morningstar. Portfolios focused on emerging-market, local-currency debt performed especially well, rising 3.6 percent. High-yield funds were up 1.8 percent.

The average domestic stock fund returned 4.2 percent, led by a 5.5 percent gain for specialists in larger growth stocks. Technology was the big winner among sector funds, rising 9 percent.

Optimists contend that the Fed's monetary policy has been close to ideal, and that the stock and bond markets are reacting appropriately.

"We have good and solid real economic growth with dissipating inflation," said Ronald Sanchez, chief investment officer of Fiduciary Trust Company International. "Noninflationary growth is positive for both markets. Both are telling you that inflation is modest and, if anything, has started to decline."

Mr. Sanchez said he anticipated a gradual rise in interest rates for the rest of the year and a "shallow rise" in 2018. And while he finds the economic backdrop benign for bonds, he acknowledged that they are "priced for optimal inflation," leaving them at risk if his appraisal is off.

Richard Turnill, global chief investment strategist at BlackRock, thinks that investors are underestimating the economy's staying power and the Fed's commitment to tightening monetary policy.

"Right now we see no signals that tell us the cycle is about to end," he said. "The upshot is we're going to get a steeper yield curve and see bond yields gradually moving higher." As for stocks, he added, "the bottom line is this is still a constructive environment."

Judging by how far the market has risen, Mr. Turnill is not alone in that assessment. But it can hardly be disputed that stocks are expensive. It is not impossible to make a case that valuations are reasonable, but it is difficult. Just how difficult is revealed in recent research by GMO and Deutsche Bank.

A GMO report highlighted the four components of stock returns: earnings growth, dividends, price-earnings ratios and profit margins. It notes that price-earnings ratios and profit margins tend to return to average levels after they deviate appreciably, while earnings growth and dividends tend to track economic growth and account for nearly all long-term returns.

Expanded margins and price-earnings multiples are responsible for more than half of the advance of the present bull run, the report shows. They are all but certain to snap back, probably before long, it warns.

That leads GMO to forecast a decline of 3.9 percent a year for the next seven years for stocks of large American companies, with smaller companies and developed foreign markets doing better, but still losing ground. The only stock markets that GMO expects to produce gains, of 2.9 percent a year, are in emerging economies. Most bonds are expected to lose money, too, with emerging markets again doing best.

Jim Reid, a strategist at Deutsche Bank, echoed the belief that investors had few places to hide. He examined valuations of 15 stock markets and 15 bond markets since 1800 and concluded that "at an aggregate level, an equally weighted bond/equity portfolio has never been more expensive." Bonds alone have never had such rich valuations, meaning low yields, since 1800, he said, and stocks have been more expensive just over 10 percent of the time.

Mr. Reid said the high valuations come at a particularly fraught time, because of "the incredibly unique size of central bank balance sheets, debt levels, multi-century all-time lows in interest rates and even the level of potentially game-changing populist political support around the globe."

Rich valuations were among the factors that prompted warnings in the third quarter of an imminent correction in stocks. In September, Citi Research put the odds that one would begin in the succeeding three months at 45 percent. Citi cited the flattening yield curve and soft growth in earnings, along with the high valuations, in explaining its estimate.

Other firms used snippets of data to argue that a decline was anything but imminent.

Leuthold Group noted that on the 15 previous occasions since 1928 when the S.&P. 500 closed at a 12-month high on any day in September — the worst month for stocks historically — and the advance-decline line, a measure of market breadth, also reached a 12-month high, the S.&P. rose 5.9 percent on average during the fourth quarter.

The stock market seldom falls just because it is overvalued; there usually is another catalyst. A more aggressive Fed is one obvious candidate, but not the only one.

Wall Street has been largely unperturbed by North Korea's missile tests, but that would almost certainly change if a war ensues. Efforts to change the federal health care and tax laws remain works in progress — without much progress — potentially testing investors' patience. Ramifications of a stronger than expected showing by the far right in Germany's elections and a violent crackdown by the authorities in Spain as Catalonians voted overwhelmingly for independence in a referendum could unnerve the markets, too.

If overvaluation does not cause declines, it exacerbates them once they start. Some investment advisers are gravitating toward foreign markets because they are cheaper and, especially in Europe and Japan, have central banks that continue to flood the economies with cash.

A submarine missile in North Korean in April 2017. Wall Street has been largely unperturbed by the country's missile tests. Credit: Wong Maye-E/Associated Press

"I think it's very early in their cycle," Mr. Sanchez of Fiduciary Trust said of those markets. "There was a rolling debt crisis in Europe for six or seven years. After having a subdued growth profile, there's some pent-up demand there, especially vis-à-vis the U.S."

The average international stock fund rose a healthy 5.4 percent in the third quarter, led by gains of 7.9 percent in emerging markets, 10.9 percent in China and 18 percent in Latin America.

Mr. Turnill of BlackRock said that investors were "paid to take risk in emerging markets in particular." As for international markets in general, he cited their lower valuations and "higher operational leverage to economic expansion," meaning that earnings of companies there were more sensitive to a pickup in activity than those of American companies.

Both strategists also like American stocks. Mr. Turnill is partial to the technology and financial sectors, while Mr. Sanchez favors larger companies over smaller ones, although he noted that an overhaul of the tax code would benefit smaller companies.

Mr. Sanchez, emphasizing his enthusiasm for stocks, said: "We have good macro, good micro, and financial conditions are as optimal as they possibly can get."

Doesn't that mean things can only get worse? Even if the Fed is steering the economy well enough and North Korea is steering its missiles into open water instead of at people, other adverse developments can pop up and hurt markets that are expensive and therefore vulnerable.

Mr. Sanchez acknowledged that no matter how good the times are, it is still wise to moderate expectations.

"I think market returns will become more modest and more subject to volatility," he said. "I expect more of the same from an economic standpoint, but I think it's very unlikely to expect the risk/return profile we've had to date."

A version of this article appeared in print on October 15, 2017, on Page BU11/BU17 of the New York edition of the New York Times with the headline: "Charging Past Chaos." Both the print edition and the online edition of the article include useful displays not included here.