Opinion **Authers' Note**

Authers' Note: Thinking out loud

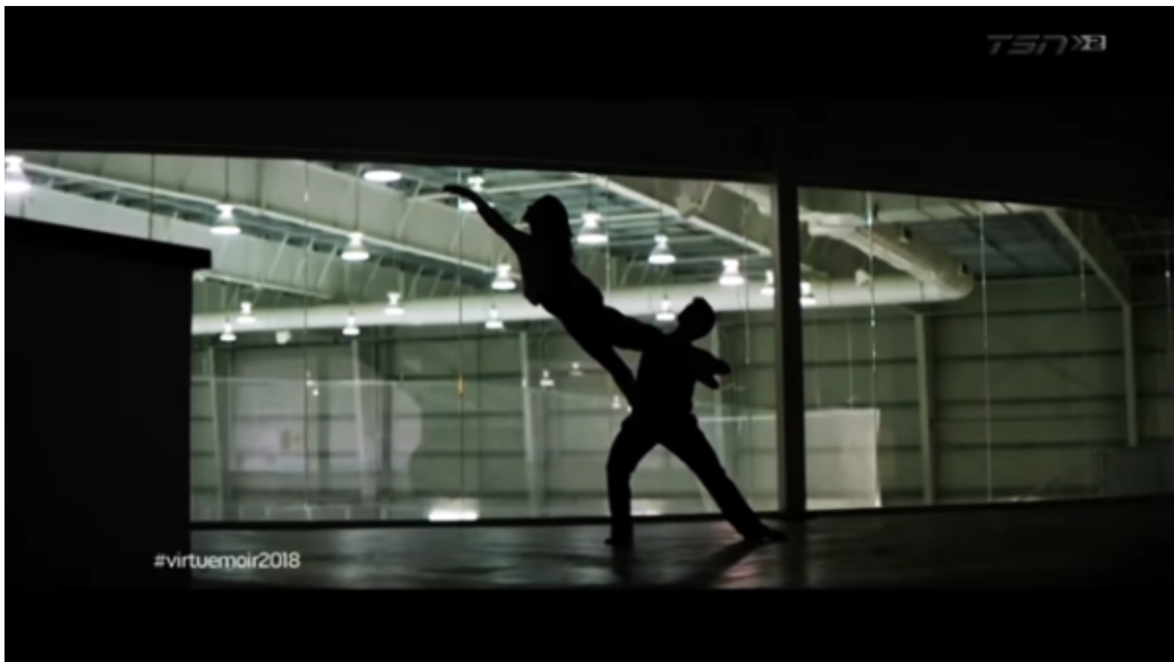
FT's daily newsletter on the world of investment

JOHN AUTHERS

John Authers 5 HOURS AGO

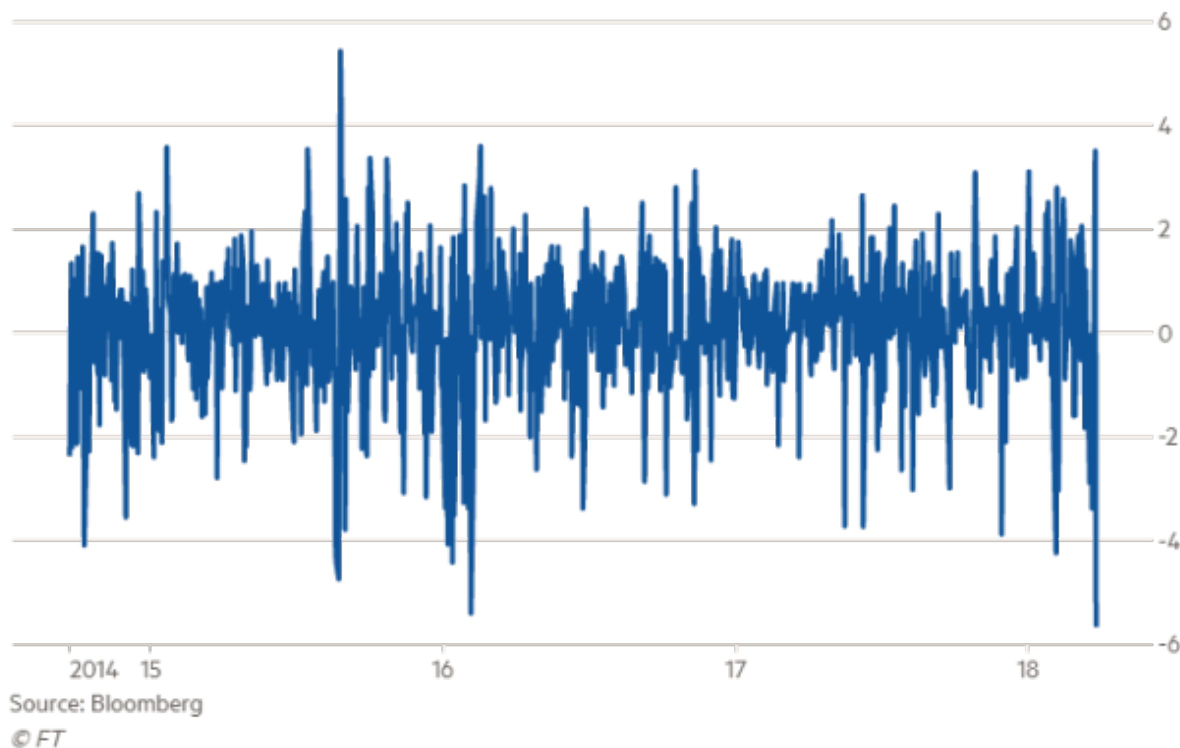
Welcome to Authers' Note, in which I will attempt to provide some context and analysis on the world of investment each day, and provide you with a handy guide to the best coverage on offer, both here in the FT and elsewhere. All feedback is welcome, particularly of the constructive variety, as we try to get this right. (Email to authersnote@ft.com).

It is time to think out loud again. Which brings to mind both a recent hit song, and the Winter Olympics.

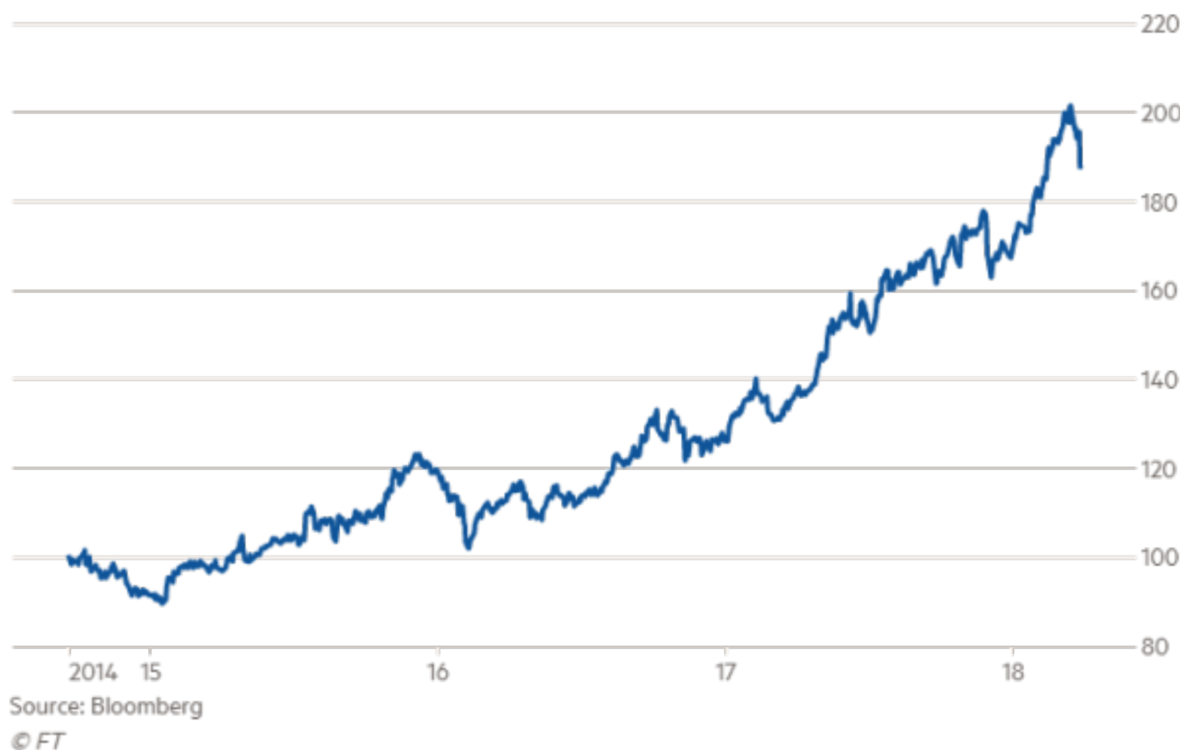


So, having observed that it's amazing what people put on YouTube, and that linking to these videos should have curried favour with my daughters, let me try to make sense of yet another day in the markets that at first sight appeared to make little or no sense at all.

I'll start with the notable landmarks. First of all, the NYSE Fang+ index had the worst day in its brief history:



This was important, because the Fang stocks (originally an acronym for Facebook, Amazon, Netflix and Google and now including some other dominant internet names), have led the market in an astonishing way. Before its recent brutal reversal, NYSE's Fang index had outperformed the S&P 500 by more than 100 per cent since inception:

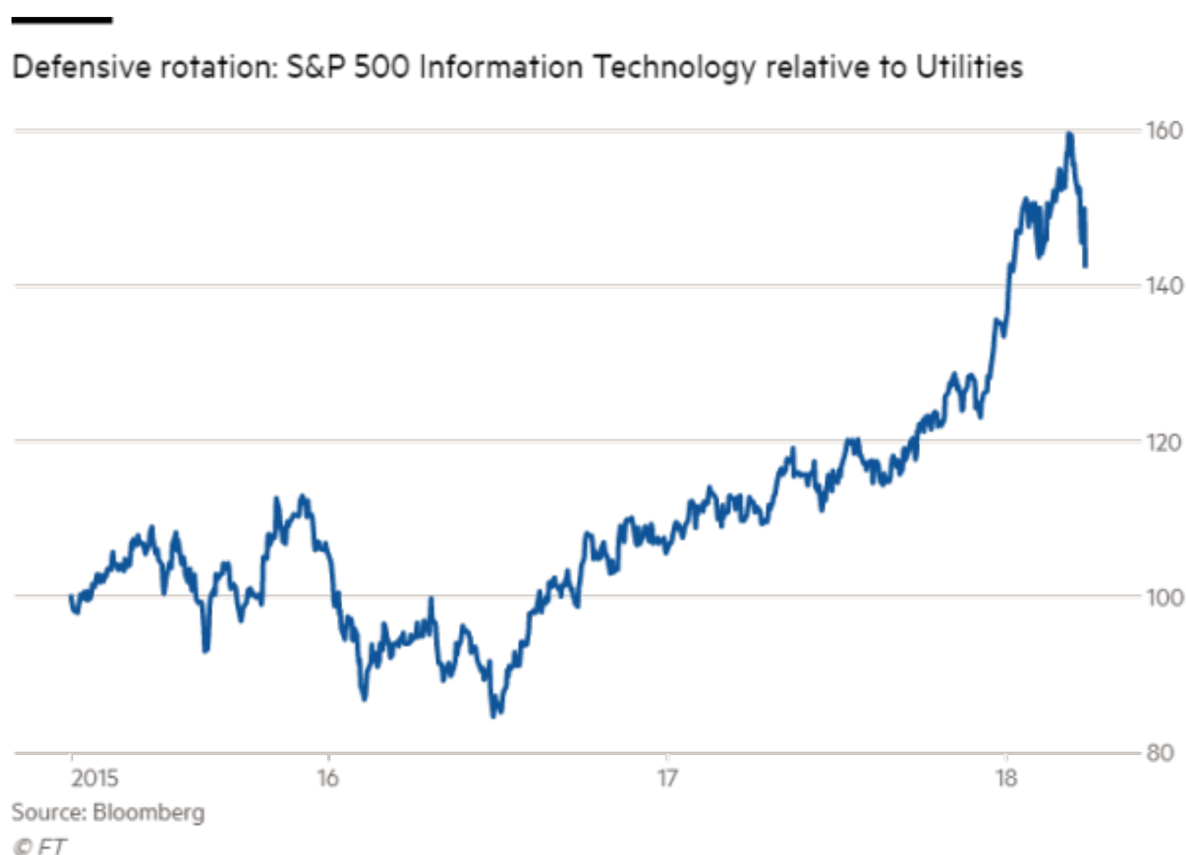


There were plenty of explanations available for this. Facebook is in horrible trouble and is making a dreadful job of dealing with its first serious scandal. The morning brought very optimistic sounding prognostications that it was now a buying opportunity. Then came a report from CNN that CEO Mark Zuckerberg would testify before Congress, and the selling resumed.

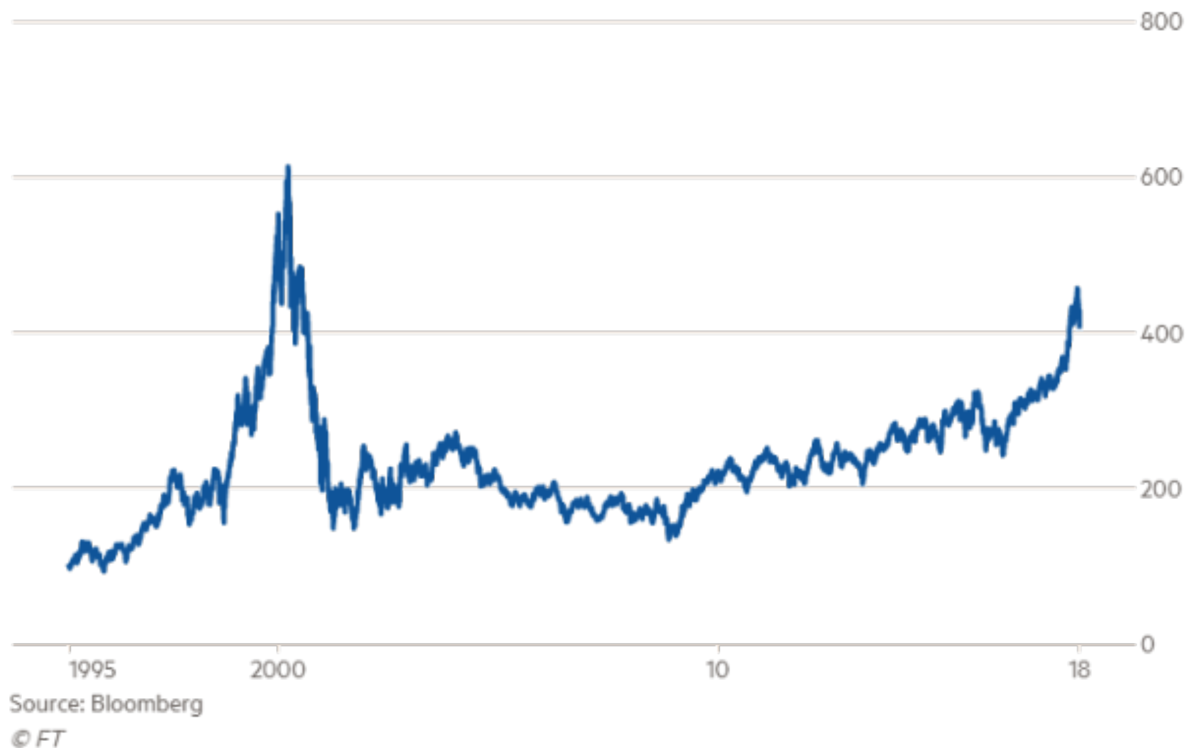
Nvidia, the chip maker and another Fang name, sold off sharply after it announced that it was suspending tests on self-driving cars using its technology. Note that if people were factoring a successful roll-out of driverless cars into their projections for Nvidia, it might have been a little optimistically priced.

Twitter, a much smaller and weaker company than Facebook, fell the most of the Fang+ stocks, presumably because it has even more to lose from the extra regulation that is being mooted for social media.

But this was not just a story of social media. The information technology sector as a whole sold off sharply, while utilities rose quite strongly. This is an unusual combination, suggesting extreme defensiveness:



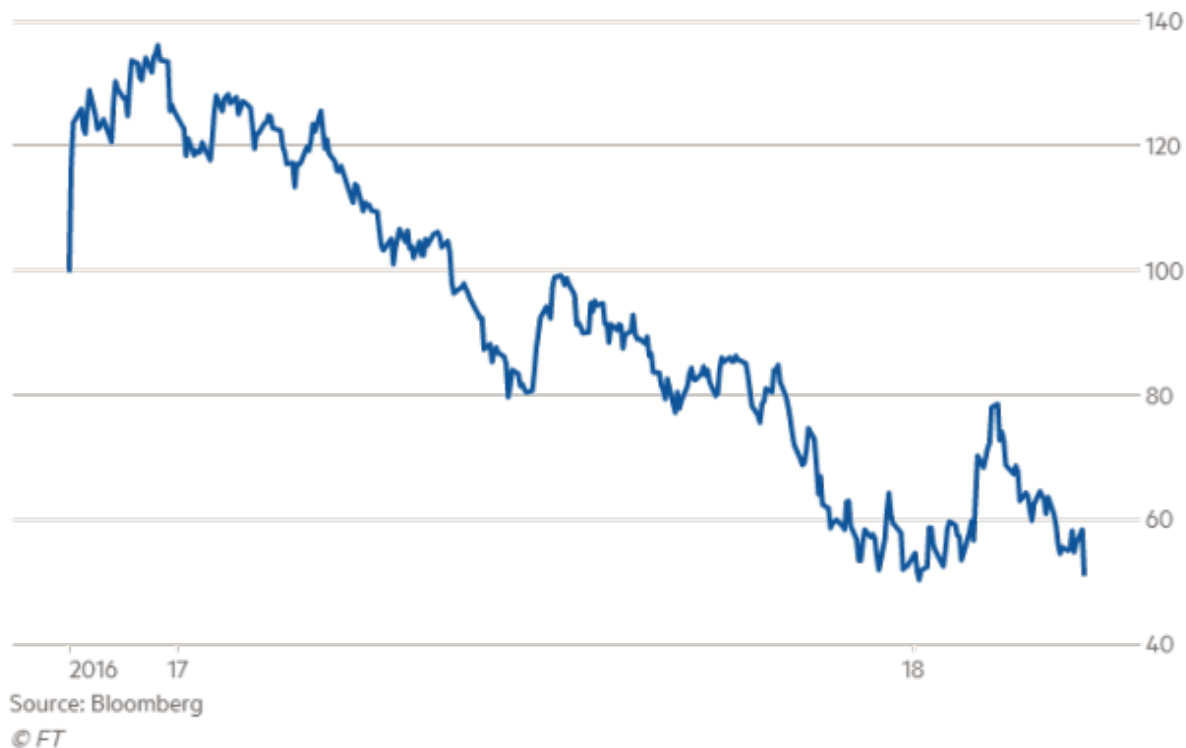
However, to be clear, it followed an extraordinary burst of overconfidence in the tech sector. Without wanting to sound alarmist, it resembled the 1999-2000 tech bubble, albeit on a much smaller scale:



To some extent this is positive. It looks more and more as though the "melt-up" phase after the long rally was mercifully brief, certainly compared with the prolonged melt-up that gave us the dotcom bubble. Then again, the precedent implies that tech stocks, and the broader stock market, have further to fall from here.

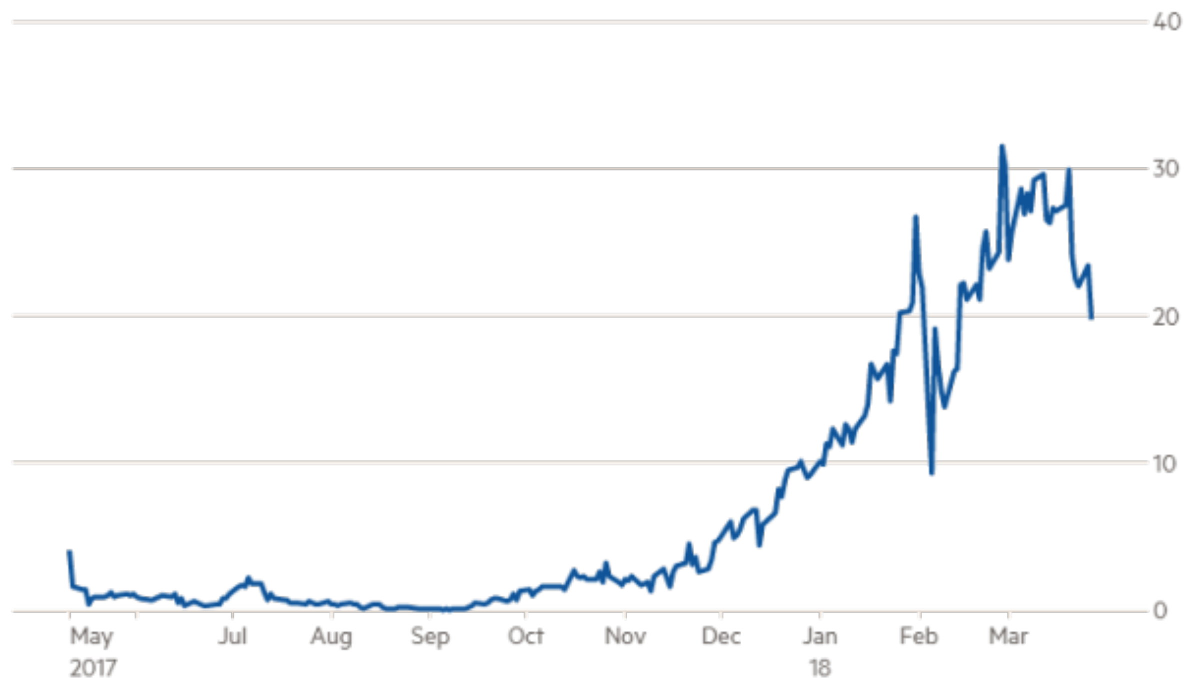
Now let us look at bond land. The 10-year Treasury yield has dropped back below 2.8 per cent, which was not supposed to happen.

Meanwhile, the yield curve flattened dramatically, helped by a large supply of new 2-year bonds which pushed upwards on their yields, while 10-year Treasury yields declined. The yield curve is now as flat as it has been since the first week of January, and again testing important levels:



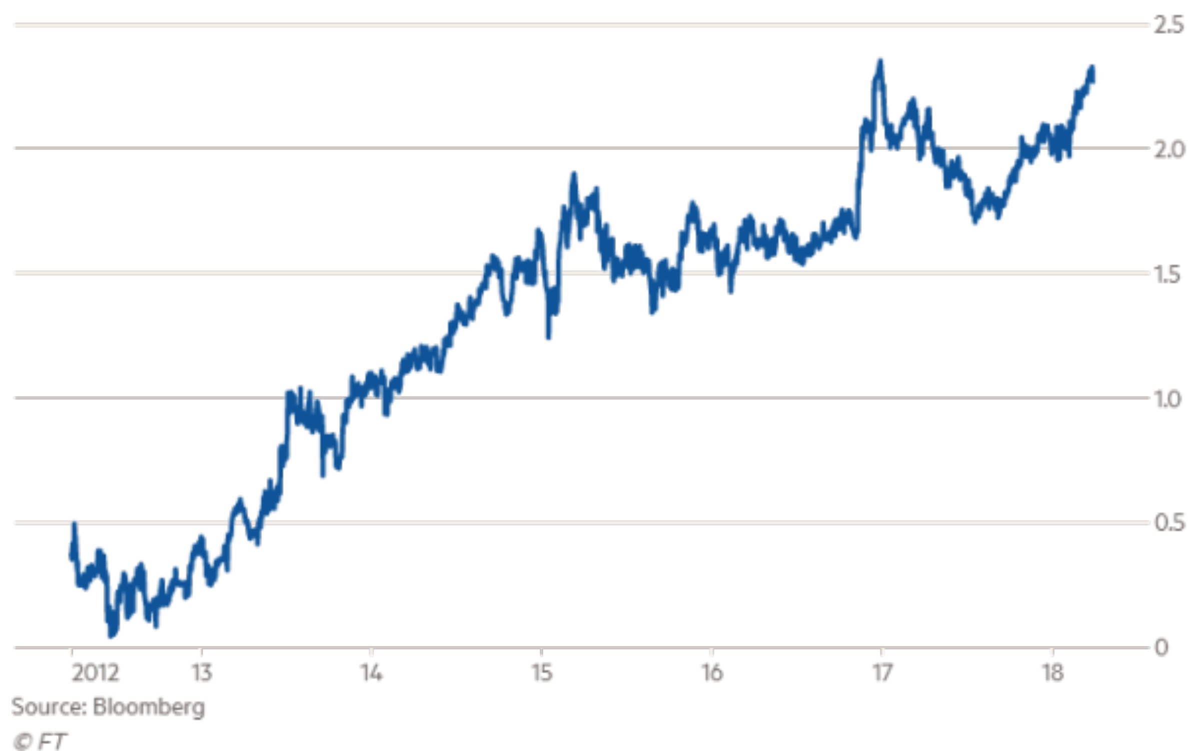
This chart shows the course of the yield curve since President Trump took office, and it tells an intriguing story. The extent that a steeper curve betokens greater confidence in future growth, that confidence surged after his election but then ebbed away. The brief resurgence of excitement after the tax cut was passed last year has now been extinguished. Should the curve reach a new tightest point for this cycle in the next few days, opening up the prospect of a full inversion, that could have a very serious effect on sentiment. This is an important measure to watch.

Expectations for the Fed have shifted noticeably. It is less than a week since the Fed produced projections showing its governors evenly split between hiking rates four times and three times this year. That showed a strong move in favour of more aggressively hiking four times — so of course, in the wake of the meeting the implicit probability of four rate hikes this year has dropped sharply. It is now below 20 per cent if the Fed Funds futures market is to be believed.



Whether this is because bond investors think that the Fed will be cowed by the fall in the stock market, or because they are more nervous about growth and no longer convinced about inflationary pressure, the turn in sentiment is sharp.

Another limit on US bond yields may come from international comparisons. The gap between US and German bond yields has reached what may be an infeasible level and begun to tighten. At this point, and particularly with the dollar at a weaker and more defensible level, it is hard to see why European investors would buy European bonds rather than Treasuries:



A spread that wide is a huge inducement to buy US bonds, and thus to push yields down.

What should we make of all of this? One line is to point out — correctly — that the bull market upward trend in stocks remains intact, that lower bond yields offer more support for stocks, and that there is no recession in sight. That makes an outright secular bear market very much less likely. After a correction, valuations are that much more reasonable.

The problem is that it is still not clear that this correction has corrected much. This is how price/earnings multiples on both a trailing and a prospective basis have moved over the last five years:

It is unusual for prospective (using Bloomberg estimates) and trailing multiples to tell such different stories. On a trailing basis, the correction has barely taken us back to where we were a year ago. On a prospective basis, the correction looks far more substantial.

The difference lies in the corporate tax cut, which sparked such enthusiasm in the first place. That tax cut should definitely increase profits, all else equal, but the markets are priced for perfection. To some extent, it looks as though we have already paid for 2019's wonderfully increased earnings. Any risk lies heavily to the downside. This is what we now expect for 2018, according to consensus estimates gathered by Thomson Reuters:

Exhibit 20. Estimated Earnings Growth for 2018

Sector	Today	1 Jan	1 Oct	1 Jul	1 Apr
Consumer Discretionary	17.1%	9.2%	10.2%	11.9%	12.7%
Consumer Staples	11.4%	8.3%	8.3%	8.0%	8.2%
Energy	69.9%	40.8%	35.5%	43.1%	45.3%
Financials	29.5%	17.5%	12.2%	12.5%	12.6%
Health Care	11.5%	6.9%	8.5%	9.0%	9.2%
Industrials	21.3%	9.7%	10.7%	12.2%	12.8%
Materials	23.2%	17.7%	18.0%	12.7%	10.9%
Real Estate	4.7%	6.0%	7.3%	7.9%	7.9%
Technology	18.1%	13.1%	12.0%	11.5%	11.5%
Telecom	14.2%	1.2%	1.6%	2.0%	3.0%
Utilities	5.1%	4.6%	5.0%	6.3%	6.2%
S&P 500	**19.7%**	**12.0%**	**11.1%**	**11.8%**	**12.1%**

Source: Thomson Reuters I/B/E/S

Such a sharp rise as the year starts is very unusual. There is a reason for it, of course, in the tax cut. But beating these estimates will be tough. Here are estimates for the quarter which is about to end, showing that we should soon have an idea whether the tax cut is flowing through to the bottom line

as hoped:

Exhibit 15. Estimated Earnings Growth for 2018Q1

Sector	Today	1 Jan	1 Oct	1 Jul	1 Apr
Consumer Discretionary	9.4%	4.8%	7.9%	9.2%	14.4%
Consumer Staples	9.9%	9.0%	8.9%	7.7%	9.1%
Energy	71.1%	50.3%	27.9%	49.6%	82.5%
Financials	24.5%	12.3%	10.0%	10.8%	15.1%
Health Care	10.7%	5.6%	6.2%	5.0%	8.7%
Industrials	14.8%	9.8%	13.7%	15.6%	19.6%
Materials	27.7%	21.6%	18.7%	12.5%	16.1%
Real Estate	3.0%	4.8%	6.1%	8.0%	8.9%
Technology	23.4%	19.7%	14.4%	10.7%	12.8%
Telecom	13.0%	-1.1%	2.1%	1.7%	4.7%
Utilities	9.8%	8.1%	5.3%	2.3%	6.4%
S&P 500	**18.4%**	**12.2%**	**10.6%**	**10.5%**	**14.6%**

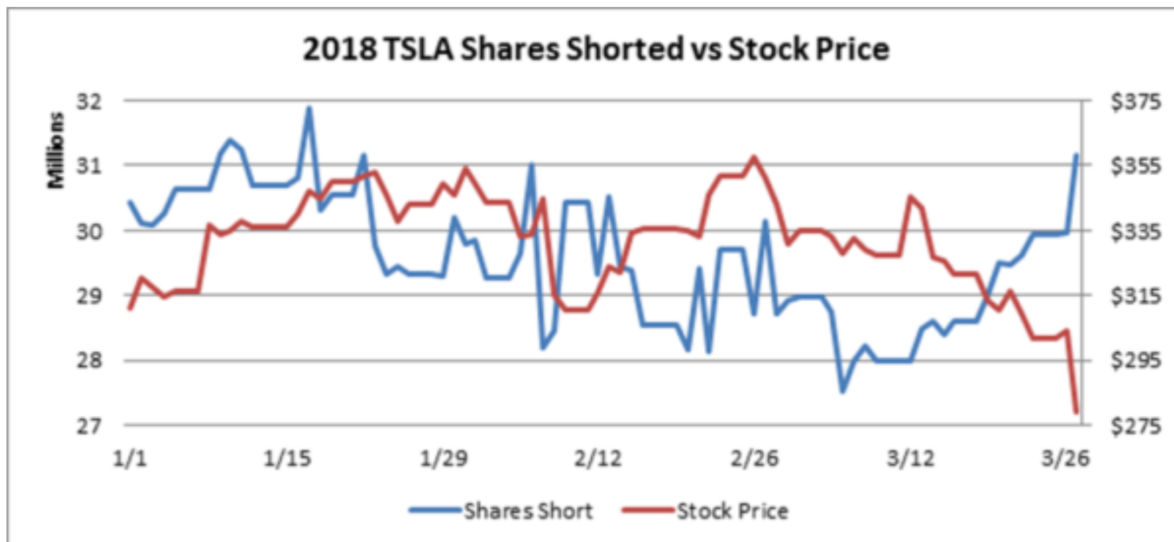
Source: Thomson Reuters I/B/E/S

We have a tense earnings season to look for after spring break.

So, how to explain all of this? Luca Paolini of Pictet suggested as follows:

> *volatility is now where it should be. And when volatility spikes, the most crowded trades (long tech, short bonds) suffer the most. Tech is not extremely expensive (free cash flow yield is about 5%) but investors are clearly worried that we may be about to see a regime change in regulation. History tells us that when a company or sector becomes dominant, it tends to attract the attention of either the regulator (US) or the taxman (Europe). And today the value of many tech names is based almost entirely on intangibles like reputation and brand, so regulation can have a huge impact.*

I think this is right. Everyone was on the bandwagon to push the 10-year yield through 3 per cent, but that will take time. As it stands, various overcrowded plays, in the Fangs and shorting stocks, have played against each other. It is possible that people running to take advantage could find themselves stepping on a rake. Just as people tend to buy as a stock goes up (even though it theoretically grows less attractive as it becomes more expensive), so short-sellers also seem to sell as a stock goes down, which again is the opposite of what should happen. These figures come from S3 Analytics, and show how investors have gained in confidence to short Tesla as its share price has fallen. This has to raise the risk that the shorts will soon lose money:



And it bears repeating that this is a strange pattern of behaviour. The Nasdaq Composite has had four days of more than 2 per cent moves in succession (three down, one up), and the S&P 500 has nearly matched it. There have been big unison swings. While long-term upward trends remain intact, it is also noticeable that there has been a progression over time from the most speculative investments (like the unicorns Theranos and Uber, or cryptocurrency), through smaller internet players like Snap, to a point where angst is now affecting the Fangs. Microsoft, Intel and Apple, huge tech players for a quarter of a century, now appear almost like defensive stocks, and have resisted the rout.

For a very bearish take on this, try Peter Atwater of Financial Insyghts. His analogy, rather unsettlingly, is with the Tacoma suspension bridge, which did this:

(That photo comes from Peter's latest bulletin). Here is how he justifies the analogy:

Troops don't march across bridges. If their frequency is closely matched to the bridge's frequency, the soldiers' rhythmic marching will amplify the vibrational frequency of the bridge. If the mechanical resonance is strong enough, the bridge can vibrate until it collapses from the movement.

> *Last Friday, the markets "accelerated into the close," closing at the lows of the day. Yesterday, the markets "accelerated into the close", closing at the highs. Then, today, the markets "accelerated into the close," again closing at the lows.*
>
> *Whipsaw doesn't do the market action justice. Investors are now marching in unison and the vibration is soaring. The problem with it all is that once viewed as a repeatable pattern* ***— if that hasn't happened already —*** *"accelerating into the close" will become a self-fulfilling event, moving with faster and faster speed with greater and greater oscillation.*
>
> *The narrative that "volatility has returned to the market" woefully understates the current situation. Investors are now moving in a binary fashion violently up and down. Put simply, unless this pattern is suddenly broken, the stock market is going to crash.*

Or, I suppose, they could whip themselves into the enthusiasm to melt up again, as in January.

I am not predicting a crash. But I would suggest that the return of volatility includes a lot of signal to go with the noise, and shows great concern about the underlying strength of the economy and

the corporate sector. An expensive market and optimistic assumptions on growth make for volatility — and I agree with Peter Atwater that this volatility is alarming.

Until the next earnings season, still three weeks away, it is most important for now to watch the progress of bonds. Significant further falls in yields, and flattening in the yield curve, could ultimately provide a cushion for equity valuations, but in the interim would throw out a lot of comforting assumptions. Once next week starts, with inflation suddenly no longer causing concerns, the next dose of macro data also matters. It is no longer a question of worrying about overheating — investors want to see that the world economy has as much puff in it as they had assumed. As this is often a period of seasonal weakness, that suggests a risk of more volatility, in both directions.

Finally, there is the fate of the Fangs. There is a lot of money in Fangs, and there are still very big profits to be booked by selling them. In the case of Facebook, institutions might even be happy not to have to explain that they hold it in their portfolio when they publish their holdings at the end of this quarter. Judging by today's action, they could well park those profits in long-dated bonds, amping up concerns about a flattening yield curve still further.

If the Fangs fall further, it could well feel as though a power switch for the rest of the market has suddenly been thrown out. And that prompts me to end by offering a link to the only song about a power cut that I know:

If the Fangs survive, however, we could all float on OK.

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