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Why the Stock Market Went Loco

By Randall W. Forsyth Updated Oct. 12, 2018 8:12 p.m. ET

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Is this it?

That was the question on investors' minds after a 1,300-point plunge in the Dow Jones Industrial Average on Wednesday and Thursday. "It," of course, is a correction, or worse, in what had been a steady, nearly unstoppable ascent in the U.S. stock market.

While the decline was arrested for the moment Friday, the major averages ended the week with their steepest losses since the week ended March 23. The Dow ended down 4.2%, the S&P 500 fell 4.1%, and the Nasdaq Composite lost 3.7%. That was a far sight better than the 7.6% plunge in the Shanghai Composite but in line with declines in other bourses, from the Stoxx Europe 600 to Australia's S&P/ASX 200 to Japan's Nikkei and South Korea's Kospi.

What turned the U.S. markets around Friday—when the Dow and the S&P 500 managed to pop more than 1% and the Nasdaq Composite bounced over 2%—wasn't much clearer than what set off the slide. Market Semiotics' Woody Dorsey says that his proprietary sentiment polling found a bullish reading of absolute zero on Thursday, a contrarian indication that "panic"

would be short-lived.

Though it's rather unsatisfying, Jason Trennert, who heads Strategas Research, said the proximate cause for the market's dip reflected mainly a desire to book profits in the big winners, notably the FAANG stocks. But there was some "solace" in the absence of pressure from the corporate credit markets. "We all learned the hard way in 2007" about the dangers posed by widening credit spreads, which warned of the financial crisis that lay ahead, he adds.

Cliff Noreen, deputy chief investment officer at MassMutual also notes that the investment-grade and high-yield bond markets performed pretty well, relative to stocks. The iShares iBoxx $ Investment Grade Corporate Bond exchange-traded fund (ticker: LQD) gained 0.5% on the week, while the iShares iBoxx $ High Yield Corporate Bond ETF (HYG) dipped just 0.3%. The corporate credit sector wasn't leading the equity markets lower, as it sometimes does.

That doesn't mean the bull market is ready to resume its run, however. Doug Ramsey, chief investment officer of the Leuthold Group, thinks the Sept. 20 high for the S&P 500 of 2930.75 may well mark the peak for the year, and perhaps even for the historic run that began in March 2009.

For confirmation of that, he's looking for a breakdown in the leadership themes that have defined this bull market: growth stocks over value; U.S. assets over foreign assets; financial assets over real assets; and the relative strength in momentum stocks, which, as Ben Levisohn writes in the Trader column, has already begun to break down. If those other three "paw prints" of the bear are sighted, the beast's return will be confirmed, Ramsey concludes.

Have interest rates ever been such an object of intense, well, interest? Over the past four decades, a span that has seen record-high rates (for the U.S.) above 20% and record-low ones of zero, it's hard to recall another time when the price of money commanded so much attention from so many quarters.

That would include President Donald Trump, who amplified his tirade against the Federal Reserve this past week. "Crazy," "loco," and "out of control" was how he described the central bank's policy of raising its short-term interest rate target. While adding that he wouldn't "fire" Fed Chairman Jerome Powell, the president also declared, "I think I know about it better than they do" in assessing monetary policy, recalling his 2016 campaign boast that "I know more about ISIS than the generals do."

Fed policy is still "accommodative," in Powell's words, even though that

description was omitted from the latest Federal Open Market Committee policy statement. “Accommodative” aptly describes the recently raised federal-funds rate target range of 2% to 2.25%, which is negative in real terms after deducting the 2.7% year-over-year increase in the consumer-price index. In other words, it’s money for less than nothing, for an economy that is far from being in dire straits. The FOMC’s “dot plots” of future fed-funds rates anticipate four more quarter-point increases by the end of 2019, which is hardly Draconian.

What roiled the stock market this past week wasn’t the short-term rate targets set by the Fed, but the longer-term yields set by the bond market. Treasury yields, in particular, have been on an upward march the past month for both fundamental and technical reasons. What’s more important is that the interrelationship between the bond and stock markets appears to be undergoing a basic shift.

Quite simply, the Treasury market no longer has the stock market’s back. That represents a “regime change,” in the words of James Bianco, head of Bianco Research in Chicago. He described that term here earlier this year and expanded upon it at the Grant’s Interest Rate Observer conference in New York last Tuesday.

Since around the turn of the century, stocks and bonds have been negatively correlated; in other words, if equities would zig, bonds would usually zag. A drop in stocks and other “risk assets,” such as junk bonds, would raise expectations of lower interest rates, so Treasury securities’ prices would rise.

This negative correlation has held during what has been a deflationary period since the late 1990s, or since the dot-com bust, and especially since the financial crisis, Bianco explained this past week. But now, “markets are transitioning from a deflation mindset to an inflation mindset,” so the correlation is breaking down.

The last time stock and bond prices moved in tandem was from the late 1960s through much of the 1990s. The inflationary 1970s saw simultaneous bear markets in stocks and bonds, as interest rates soared. The great bull markets of the 1980s and 1990s saw bond yields decline from record highs, which lifted stocks.

This past week’s sharp drop in stocks followed Treasury yields’ breakout above their previous highs for the year, with the benchmark 10-year note surging as high as 3.231% on Oct. 5 and the 30-year bond also hitting 3.405%.

Like Sherlock Holmes' dog that didn't bark, the long end of the Treasury market didn't see prices rise and yields slip while stocks were in full retreat Wednesday. The Treasury market sent yields down a bit on Thursday, while stocks continued their slide, but that is a far cry from the bond rally that once was automatic when stocks sold off.

That reliable relationship was critical to two popular investing strategies of the past two decades: the venerable 60/40 stock/bond portfolio and so-called risk parity, which leverages lower-volatility bonds to produce returns like riskier stocks.

A shift in the relationship would have major implications, which became apparent in the recent simultaneous backup in bonds and stocks. Billions of dollars in institutional portfolios, from pensions to endowments, are predicated on the recent history that a stake in high-grade bonds like Treasuries would protect them from a downturn in risk assets. It seems as if it's different this time.

Another, more technical aspect is also driving up bond yields, and it has the potential for triggering a crisis along the lines of the one of a decade ago.

David P. Goldman, who headed credit research on Wall Street while the housing bubble inflated, details the dangers in an Asia Times blog post that asks, "Has the derivatives volcano already begun to erupt?"

Investors abroad hedge the currency risk of their purchases of higher-yield dollar assets by going to their banks to swap greenbacks for local currencies. The banks borrow dollars for euros and yen, and sell the dollars in the forward market. But there's a problem.

"European banks are running out of borrowing capacity," Goldman writes. "After five years of negative short-term rates, their profitability is low, their stock prices are falling, and their credit is deteriorating. They can no longer borrow the dollars required to construct the hedges that local investors need."

The Bank for International Settlements estimates that non-U.S. banks owe $10.7 trillion—with a T—in dollars, which doesn't show up on their balance sheets. The BIS estimates that these foreign-exchange swaps total $13 trillion to $14 trillion.

The banking system may no longer be able to support such flows, Goldman says. "In a volatile market, European banks might not be able to roll over nearly $11 trillion of short-term obligations—and might default."

"If overseas investors can't recycle the half-trillion U.S. current account deficit into dollar-based securities because the banking system can't profit from the foreign exchange hedges, U.S. yields will rise, perhaps sharply," he writes. Still, he doubts that European governments would let their banks default on their dollar obligations, preferring to arrange "shotgun mergers and emergency capitalizations."

In sum, stock markets may be reacting to the realization that interest rates might not provide the cure for whatever ails them.

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