Inflation Talk

2018 Update and the Future Paths of Growth

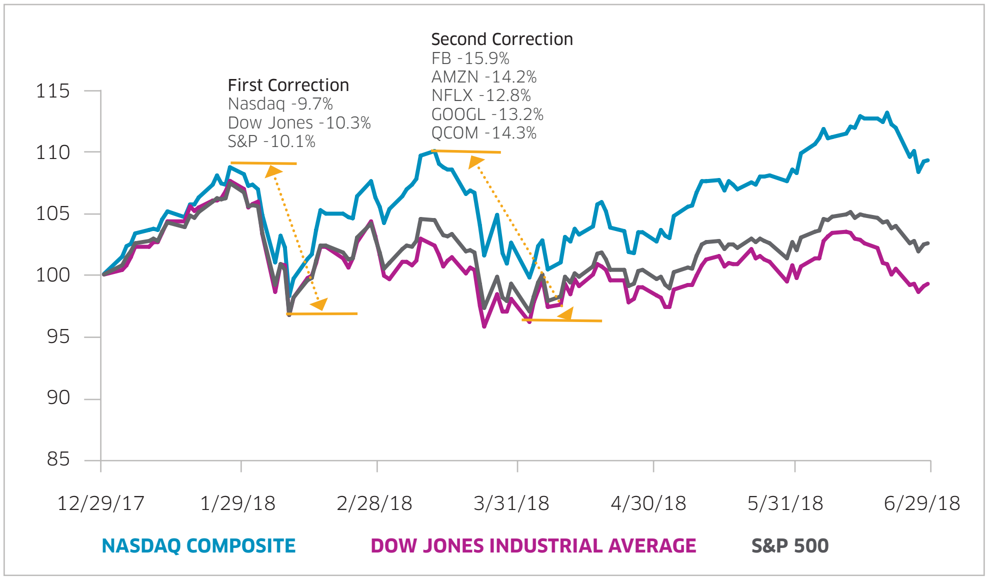
BY RICHARD LIN, CFA, NASDAQ GLOBAL INFORMATION SERVICES

Stock market performance in the first half of 2018

2018 will prove to be a year full of surprises.

The U.S. stock market was fueled by exuberance in the first month of 2018 as the three major stock indexes all touched new highs. Then, the short Volatility (VIX) trades at the beginning of February collapsed under pressure and the stock market turned into correction mode, dropping more than 10% over the course of a few weeks. In the weeks that followed, the market was able to shake off the correction and resume climbing to new highs with a much stronger earnings outlook, thanks to the momentum from this administration's generous tax plan. Then, the trade war threat emerged. Technology stocks got smashed from their new peaks in March and the market fell more than 10% again for the second time in the year. The outbreak of a world trade war is the major concern, as most of the economists predicted that it has the ability to cause a global recession, and it has since dominated the sentiment of the market today. Inflation, consumption and employment are the other pieces of information that the market is paying attention to, as investors worry that any over-hawkish fed movement will be sufficient to derail the yet-sluggish recovery.

The Choppy Year of 2018



Source: Bloomberg, Nasdaq

Executive Summary

The current equity market rally extended into 2018 but with much higher volatility. The bumpy path of the stock market reflects investors' deep fears of the head and tail winds that can derail the current robust growth of US economy: rising inflation and trade war. We expect a full blow-out of trade war is unlikely, but the risk associated with the continuous rising inflation is easy to be underestimated. Either an inflation spike or an over-hawkish Fed can negatively impact the economic growth and even cause a recession. In terms of portfolio implications, this research explains why DAA and DAY, which all belong to the Nasdaq Dividend Achievers index family, can be better substitutes to the pure beta broad market equity indices at this uncertain time.

Geopolitical unrests, such as North Korea, the Iran nuke deal and/or Italy election, often occupy the media's headlines but only produced marginal and temporary volatilities to the US stock market. Investors should still focus on understanding the fundamental picture of the economy in order to make the right strategic investment decisions.

The fundamental picture of the US Economy

Trump Economy

The current administration is clearly pro-growth. It continues to stimulate the economy with very aggressive fiscal policies such as the $1.5 trillion tax cut, the roll back of Dodd-Frank Act, and the scheduled $200 billion infrastructure plan. On the flip side, Trump has also laid out very controversial trade policies in order to push a renegotiation of NAFTA, impose Steel and Aluminum Tariffs on most of the United States' major trading partners, and on a much larger level, slap tariffs on $200 billion worth of Chinese goods and on imported European cars. All these trade policies will have significant impact in driving up costs for imported goods and eventually hurt US consumers.

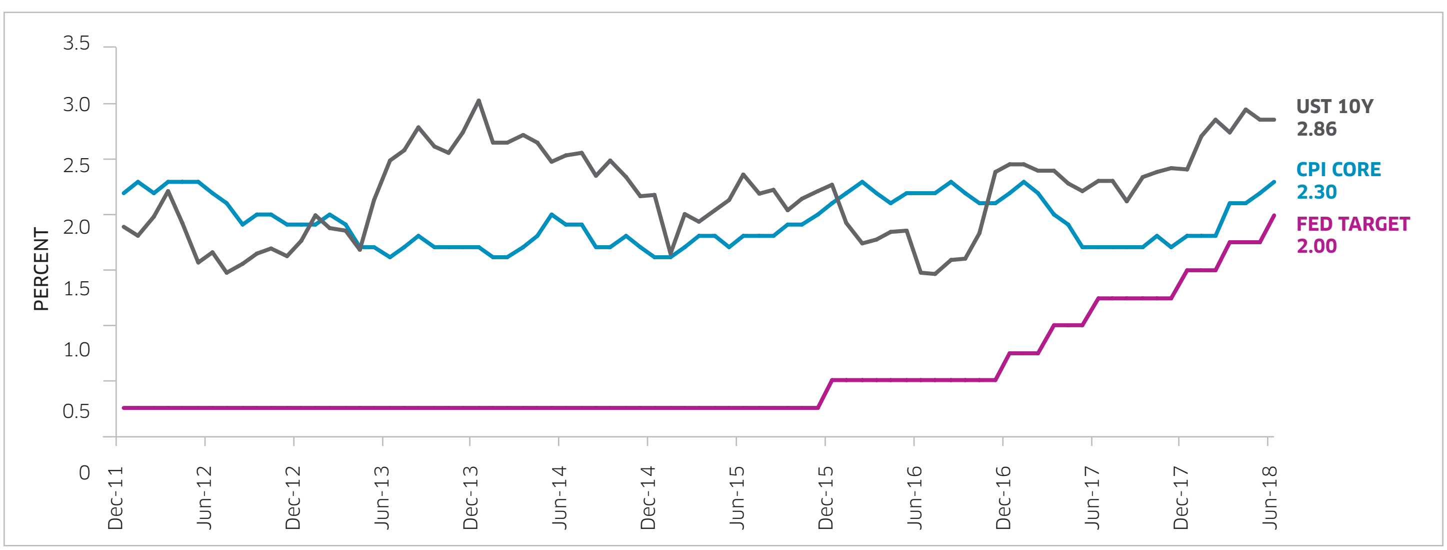
Rising Inflation

The US economy is continuously performing well despite the trade conflicts. With an upbeat economy, inflation has finally climbed back to 2% and unemployment rate has dropped to an unprecedented level of 3.8%. Wage growth is still low but consumer sentiment is rising to a new high. Internationally, both developed and emerging market economies are enjoying the same synchronized growth with the United States. The current economic environment is referred to by economists as a goldilocks economy, meaning almost every economic data is nearly perfect, supporting a sustainable growth pattern. But we should understand, that everything staying nearly perfect is not sustainable, the world continues to be extremely dynamic.

Rising Rates

The first backfire of inflation people can feel, comes with interest rates. The Fed has finally started to take actions to normalize interest rates. The US 10-year Treasury yield finally touched 3% in May, a level that was last seen more than four years ago. The market also predicts that the Fed will raise interest rates 3 to 4 times this year, making the fed fund rate approach well above 2% this year and close to 3% in the coming two years. This happens at a time when central banks are also discussing unwinding the mountain of balance sheet assets, which accumulated during the great financial crisis period. The combination of a slowing trend in technology advances, but an accelerating trend in aging demographics, cause the world to be reliant on heap financing for growth. The Central banks' actions of "Quantitative Tightening" (QT), if not approached with exceptional caution and sufficient collaboration, will deem to be very challenging for the current growth to be maintained.

Inflation, Fed and Treasury Steadily Rising together



Source: Bloomberg

The Future Paths of Growth

Trade wars hurt everyone. It is with the hope of a clear and mutual understanding of the devastating outcome that we could eventually avoid a full-scaled trade war.

In the near-term, before 2020, the major head wind risk is going to be rising inflation. With an already bottomed unemployment rate, the continuously improving economy will add heavy upward pressure to future wage growth. A strong demand for wage growth, at the time when the abundant tax credits are returning to corporates and individuals, can make inflation easier to overshoot. This puts the Fed's surveillance responsibility at a critical function for guaranteeing the healthy growth of the US economy. The Fed will consistently face the same challenge in the coming years: to hike or not to hike?

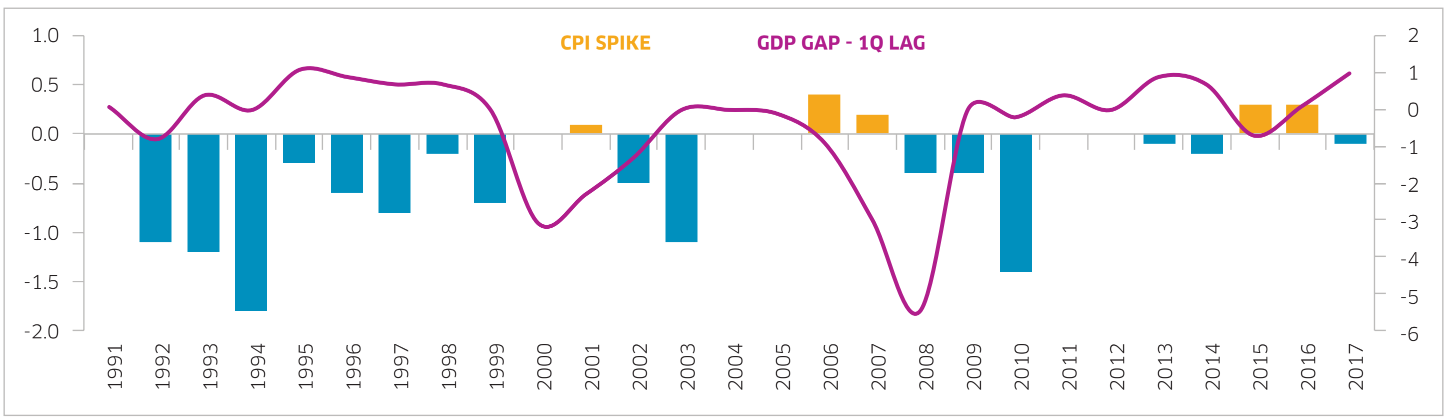
Not to hike (A Dovish Fed):

The Fed could choose to take a dovish approach to curb the rate hike path in order to support the current growth. But, that comes with the risk of growth reversion in the future.

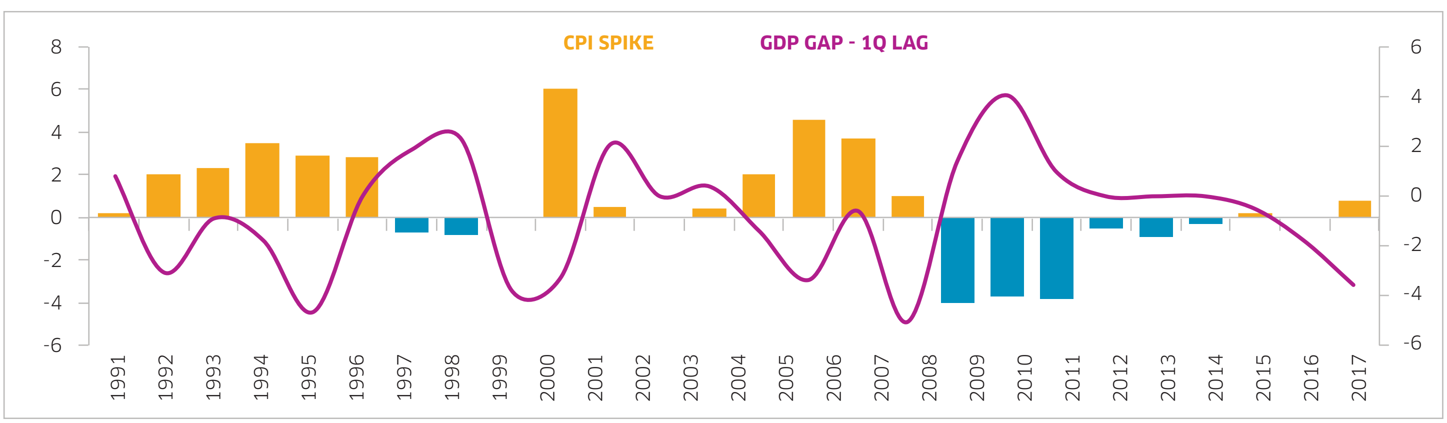
We have been in a low inflation environment since the great financial crisis and people may have forgotten that inflation is still a critical factor to impact the growth. The relation between inflation and (real) growth are negative rather than positive: when the current inflation is higher than what people get used to, it comes as a shock (CPI spike) to consumers and the coming real GDP readings are likely to be lower than the normal trend (GDP Gap).

We have not seen many inflation shocks since the 90's, but it was a common phenomenon from the 60's to 80's. As we illustrated below, with all the available observations, there's a clear indication for inflation surprise as the drag for real growth.

Relationship between Inflation and Growth in a low inflation environment (1991 to 2017)



Longer Term Relationship between Inflation and Growth (1966 to 1990)



Source: Bloomberg

CPI Spike – the differential between current inflation and the past 7 year median value

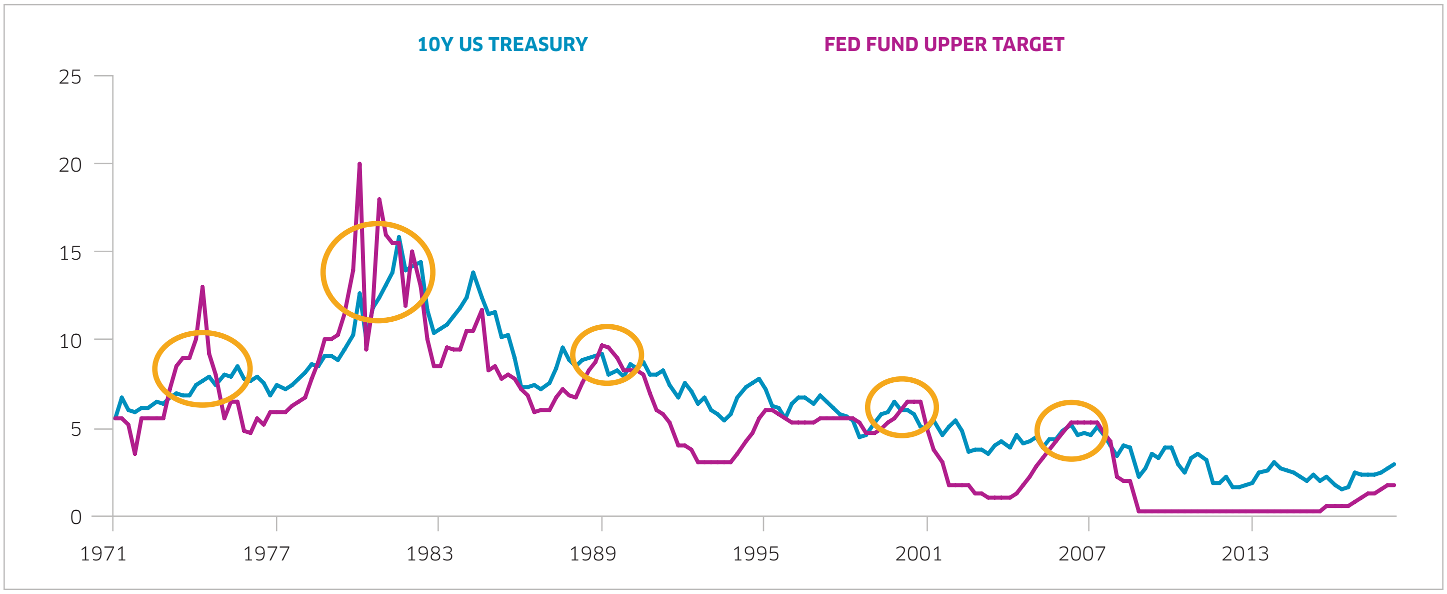
GDP Gap - the differential between current real GDP growth and the past 7 year median value

To hike (A Hawkish Fed):

One of the major reasons behind the Fed's decision to rush into hiking rates is their concern of lacking "ammunition" when a recession hits. The "ammunition" referred here are monetary policies such as cutting interest rates. Scale matters in this case. If the Fed raises the short-term rates too high and too quick, without enough correspondence on the far end of the curve, it will cause a narrowing term spread. From more than 40 years of a monetary history prospective, a negative term spread, or a reversed yield curve, is most certainly a de-facto check for an upcoming recession.

One may wonder why. It may be possible that a negative term spread indicates that the hiking financing costs (both consumer and corporate) bypass the long term returns from investment (as indicated by the long term rates). Although an effective way to curb inflation, hiking rates will also have the side effect of discouraging investment.

Every Recession is Associated with the Negative Term Spread



Source: Bloomberg

The Implication for equity investors

To briefly summarize the previous sections, we have outlined both the head and tail winds that are with high potential to derail the current robust growth of the US economy: rising inflation and trade war. We expect a full blow-out of a trade war is unlikely, but the risk associated with the continuous rising inflation is easy to be underestimated.

Free rising inflation can cause growth to slow down and increase long term volatility in the economy and is eventually reflected in the capital markets. The Fed hopes of timing crises and managing hike interest rates "at the right time with the right pace" will be very challenging. On the contrary, the aggressive actions by the Fed may also discourage investment and cause recessions.

For equity investors, it may still be too early to sell, as the most recent fundamentals still support that the current rally may extend multiple periods in the future. But, blindly longing beta, pumping cash into well known and loved large cap names, may suggest bearing unnecessarily larger tail risk in your portfolio. Hence it might be a good time to investigate a more balanced strategy to position in this late cycle rally.

In our blog post, "Inflation Talk – where we are and what investors should be aware of,"[1] published a year ago, we suggested looking at Nasdaq's Dividend Achievers Index as an effective risk balanced equity strategy that can potentially outperform in two potential tail risk events: rising inflation and recession.

https://indexes.nasdaqomx.com/docs/1390-Q17%20Inflation%20Talk%20Research_0713c_Fnl.pdf

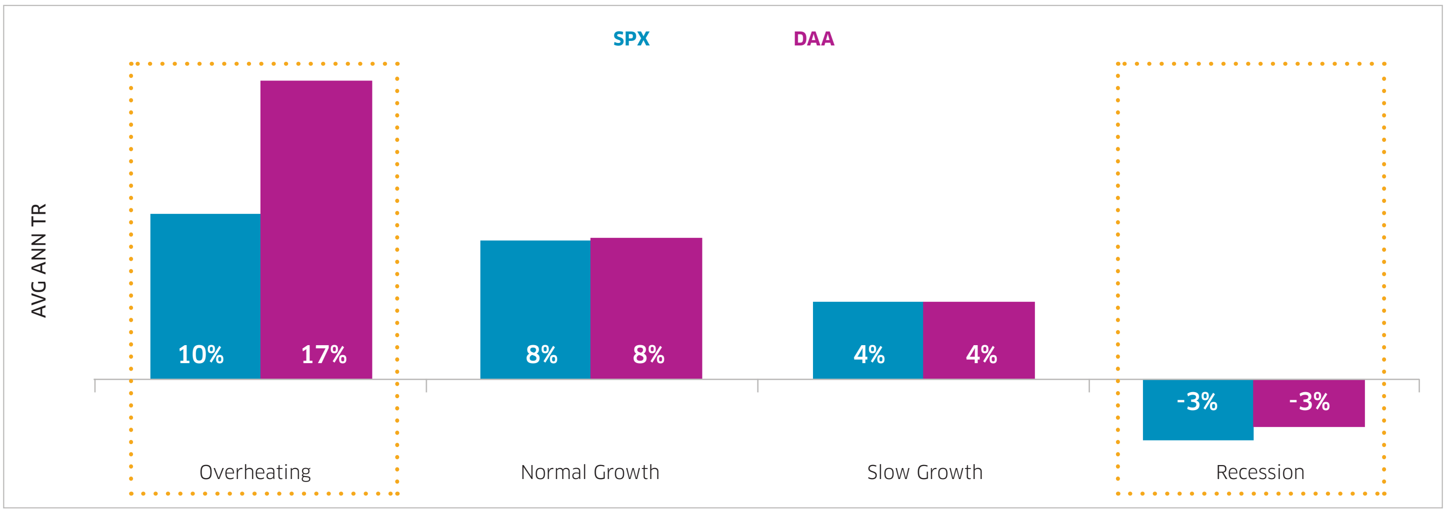
Our analysis is based on the following two popular large cap equity benchmarks:

DAA – The NASDAQ US Broad Dividend Achievers Index is comprised of US-accepted securities listed on Nasdaq, NYSE or AMEX with at least ten consecutive years of increasing annual regular dividend payments.

SPX – The Standard & Poor's 500, or S&P 500, is an American stock market index based broadly on the market capitalization of 500 large companies with a common stock listing on the Nasdaq or NYSE.

In facing the risk of sharp rising inflation (Overheating), corporations are incentivized to also raise dividend payments to keep their dividend yield attractive. Moreover, we don't think corporations who have a proven long history of consistently keeping or increasing the level dividend payments are less efficient capital allocators, but rather disciplined financial planners with an always nimble balance sheet to better prepare for rainy days (Recession).

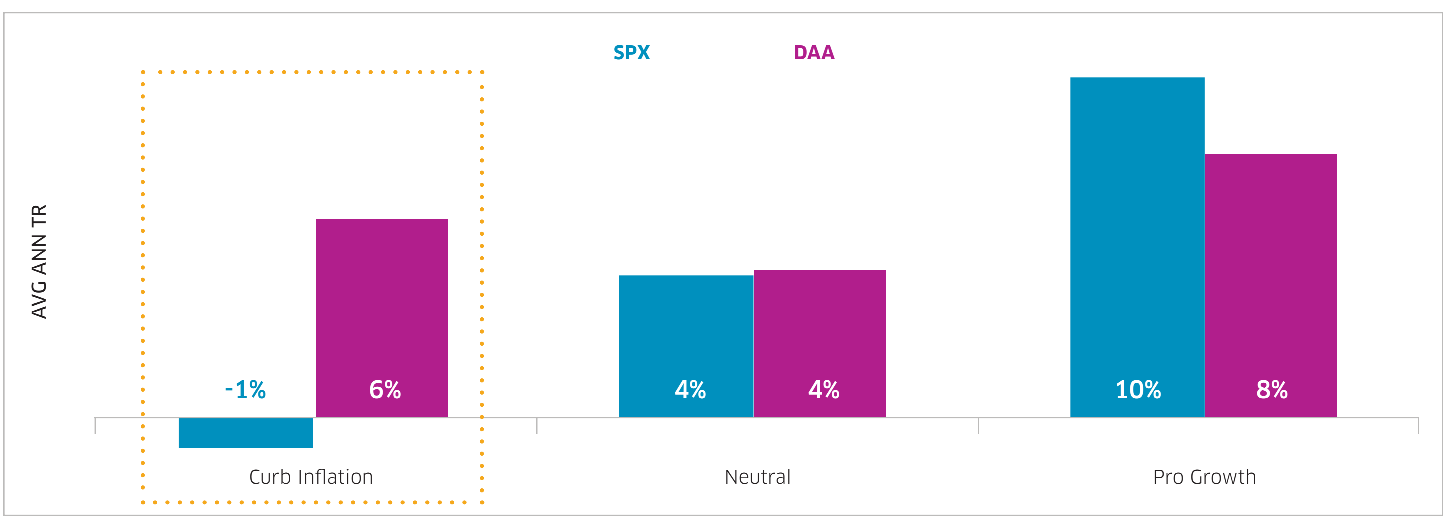
Dividend Achievers (DAA) can better perform in an overheating environment and has realized less loss during recessions historically



Source: Bloomberg, Nasdaq

If Fed is taking aggressive actions to raise the target rate above inflation (>1%), a scenario we called "curb inflation", the liquidity condition will be severely squeezed. The broad equity markets such as the S&P 500 tends to react negatively to this. But corporations with financial disciplines, as represented by Dividend Achievers, could still do well and significantly beat the market.

Dividend Achievers (DAA) can significantly beat the S&P 500 during a "Curb-Inflation" Scenario

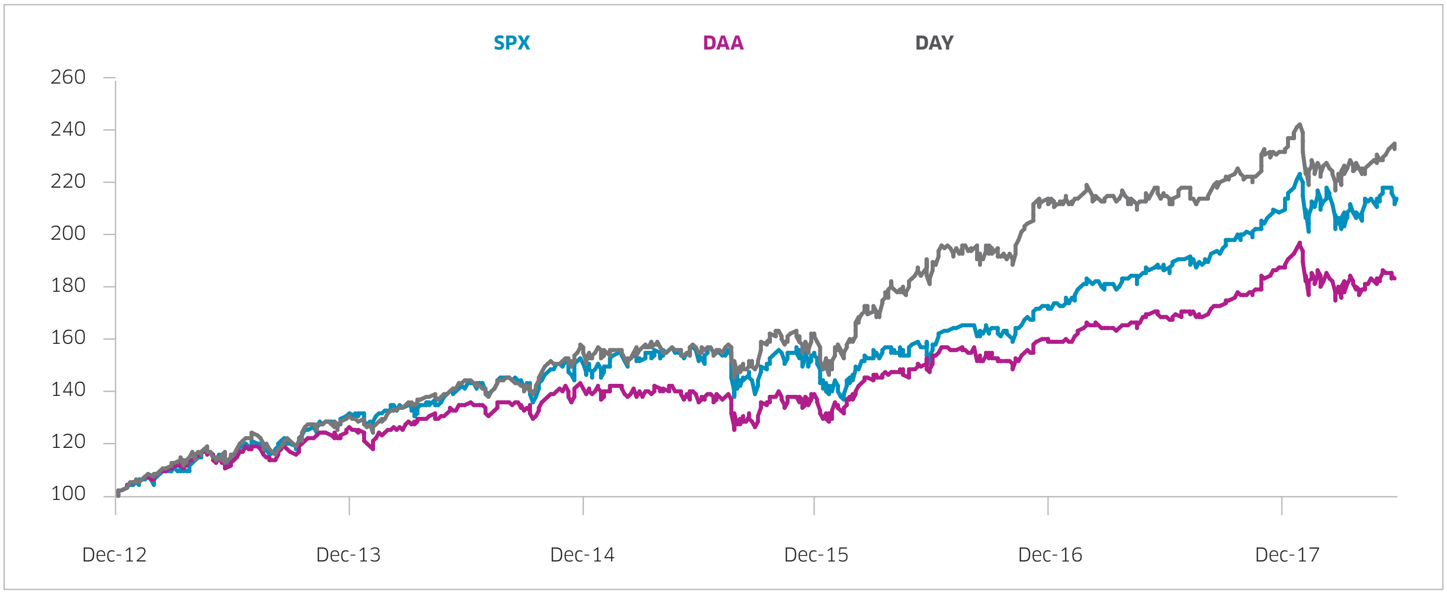


Source: Bloomberg, Nasdaq Calculation

Performance Review

Let's look at the index performance since our last update. Similarly, we are comparing the performances of the S&P 500 (SPX), NASDAQ US Broad Dividend Achievers (DAA) and NASDAQ US Dividend Achievers 50 Index (DAY). DAY is comprised of the top 50 securities by dividend yield from DAA, for investors favoring more concentrated active shares and richer dividends.

Historical Performance of SPX, DAA and DAY



Source: Nasdaq, Bloomberg. Data from 2012/12/31 to 2018/06/30

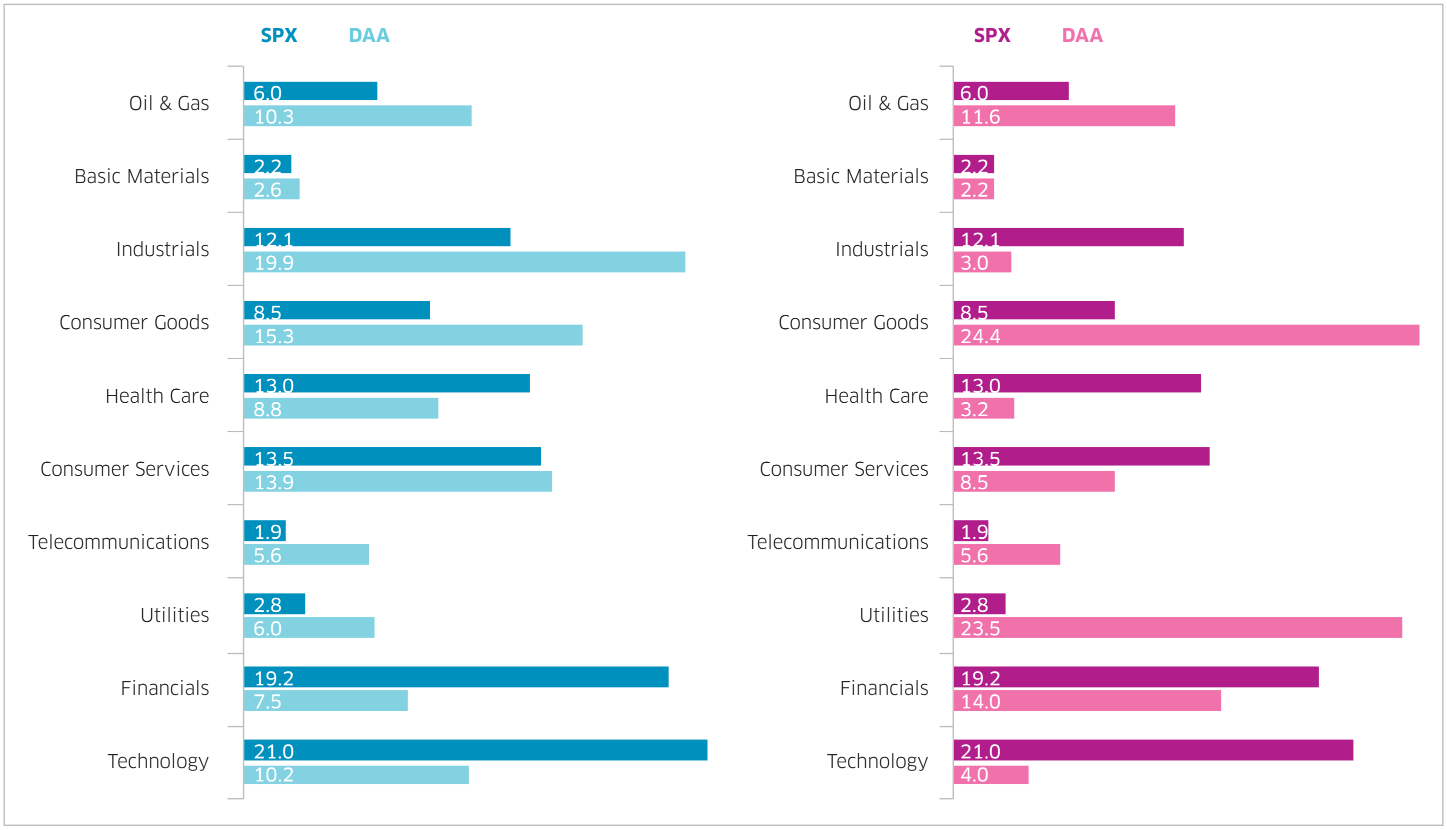
Index Historical Performance

YEAR	SPX	DAA	DAY	SPX	DAA	DAY	SPX	DAA	DAY
	ANNUAL TOTAL RETURN			ANNUAL VOLATILITY			ANNUAL SHARPE		
2013	32.4%	26.3%	31.1%	11.1%	10.0%	11.2%	2.92	2.62	2.77
2014	13.7%	11.8%	18.4%	11.4%	9.9%	9.8%	1.20	1.19	1.88
2015	1.4%	-2.6%	3.1%	15.5%	14.2%	13.8%	0.09	-0.18	0.22
2016	12.0%	15.2%	32.2%	13.1%	11.1%	14.4%	0.91	1.37	2.23
2017	21.8%	18.0%	9.2%	6.7%	5.8%	7.5%	3.27	3.09	1.23
2018H1	2.6%	-1.7%	1.0%	16.5%	14.5%	12.5%	0.33	-0.23	0.16
1Y	14.4%	9.2%	9.1%	12.4%	11.0%	10.1%	1.16	0.84	0.90
2Y	16.1%	9.4%	10.8%	10.5%	9.4%	10.1%	1.54	1.00	1.07
3Y	11.9%	10.5%	14.6%	13.1%	11.5%	12.5%	0.91	0.91	1.17
4Y	10.8%	8.0%	12.7%	12.9%	11.4%	12.1%	0.84	0.71	1.05
5Y	13.4%	10.2%	14.9%	12.4%	11.0%	11.7%	1.08	0.93	1.28

Source: Nasdaq, Bloomberg. Data from 2012/12/31 to 2018/06/30

Despite the higher quality and lower realized volatility, the DAA hasn't been able to pick up its performance in the past 5 years due to the ultra-low rate environment. Instead DAY, the high yield version of DAA, has benefited the most from 2014 to 2016 when the 10 Year rate fell. The currently low rate and moderate inflation environment actually favors growth stocks. As we can see with SPX outperformance that was largely tied to the over 20% weighting in the Technology sector. But it appears that the regime is changing. With inflation and interest rates continuously trending up, we are closely watching on behalf of risk-averse investors.

DAA and DAY Industry Breakdown (6/30/2018)



Source: Nasdaq, Bloomberg.