Morgan Stanley

INVESTMENT MANAGEMENT

Tales from the Emerging World

Why Wall Street Has the Jitters

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Journalists have never been able to resist explaining daily stock market moves as a reaction to the news of the moment, which gives them a random chance of getting the story right. If the big news happens to be about fundamental drivers of markets, they may get the "Why" right. If it's not, as is so often the case, the media explanation misses the real drivers of the market. This inability to distinguish the fundamental from the irrelevant has been magnified by the media obsession with news out of the Trump White House, which is often random and chaotic.

The fog around media coverage of the markets seems to have deepened since February, when the long calm bull run in stocks first began to crack. The media continues to link daily price action to Trump's tweets and bluster, underplaying the fundamental drivers of the stock market: economic growth and the money available for people to invest.

Early this year we described how markets worldwide had gone many months with barely a hiccup, driven by a synchronized global boom and record low interest rates, which had all but eliminated volatility. Not only was such a long run of calm unnatural for the market beast, but at that point, interest rates were already rising, and there were signs that the global boom was poised to slow. Teetering at "peak calm," we argued that the markets were bound to return to a more normal level of volatility in 2018.

Within weeks it was happening, but the media's coverage ascribed the return of market volatility to the daily news about their favorite subject, Mr. Trump. Down moves were linked to his trade threats against China, or his tweet campaign against American corporate giants like Amazon. Up moves were explained by signs the trade wars and the Twitter tirades were receding.

These storylines still linger, though the journalists behind them cannot explain how Trump's tariff threats contribute to market volatility when the volatility preceded the threats, or how his latest rhetorical attacks on big corporations could undermine their stocks when the drumbeat of similar attacks he issued last year had no such effect.

The answer is that when fundamentals are solid, markets ignore distractions like Trump. When fundamentals weaken, markets will show their jitters at the slightest provocation. The combination of peak growth and peak liquidity was bound to be a downer for a market trading at close to peak valuations. So the market likely would have grown more volatile this year even if Trump had shut down his Twitter account, indeed even if he were not president.

Then last week, the headlines seemed to catch up to the fundamentals, if belatedly and perhaps accidentally, connecting down days in the market to the rise of the 10-year treasury to the psychologically important barrier of 3 percent.[1] We suspect, however, that journalists will lose sight of the dry fundamentals as soon as attention shifts back to the colorful White House.

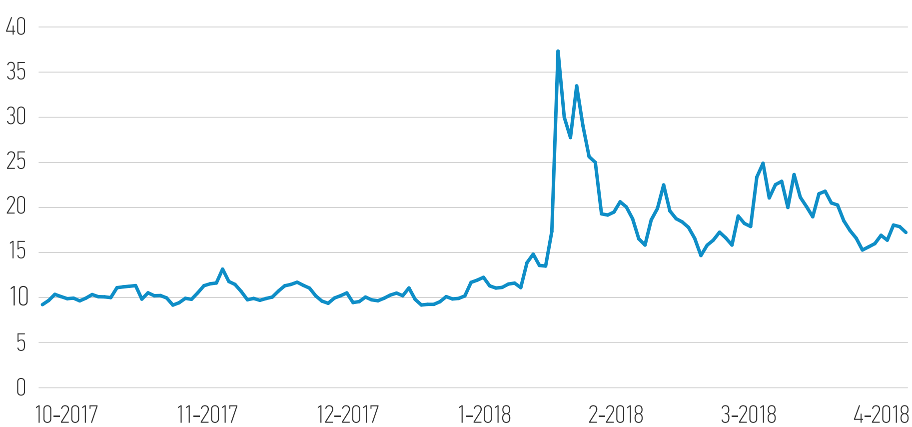
Meanwhile, the fundamentals point to further volatility. The markets came into this year giddy over the global economy, which was growing at a pace of nearly 4 percent.[2] Economic growth in every region looked surprisingly strong, leading analysts to predict a return of the good times that preceded the global financial crisis of 2008. Instead, so far this year economic data from purchasing managers surveys to consumer spending has come in weaker than expected, rattling the market out of its complacency.[3]

Most economists change views slower than the markets do, and they are explaining away the data as a temporary downshift before the economic boom resumes, ignoring other drags to growth. For one, the U.S. is in the midst of its second-longest economic expansion in history, and no expansion lasts forever. There are many signs that this one is in its last stages, from reports of labor shortages to high corporate debt—which will be harder to service as interest rates continue to rise.

DISPLAY 1

Volatility Came Back in February, Before Trump's Tariff Threats

Chicago Board Options Exchange Market Volatility Index



Source: Bloomberg, as of April 2018.

The end of an extended era of easy money represents a major shift for markets. The U.S. Federal Reserve (Fed), which is effectively the world's central bank since it controls the world's reserve currency, is now increasingly keen to restore some sense of normalcy to the price of money. After holding interest rates at close to zero since 2009 in an effort to boost employment, the Fed now faces very low unemployment and signs wages are starting to rise and inflation is beginning to creep back to its target of 2 percent.[4] That combination leaves the Fed more comfortable raising rates to fight inflation.

U.S. short-term interest rates have risen to around 2 percent.[1] That is quite low by historical standards, and barely enough to compensate for inflation. Still, it means investors now have at least some incentive to hold a portion of their assets in the safety of cash and avoid risky assets such as stocks. When interest rates were zero or even negative, investors could borrow money for nothing, an invitation to take unlimited risk. Most came to see "cash as trash," and went all in on risky assets like stocks and bonds.

The amount of money borrowed by retail investors to buy stocks rose to the highest level ever as a share of the overall stock market. At the start of this year, U.S. pension funds, mutual funds and global sovereign wealth funds were also about as light on cash and heavy on risky assets as they had ever been.[5] Cash levels are at historic lows for households as well.

There is always the possibility that the market optimists are right, that global growth will bounce back and the current market turmoil will pass like a spring shower. They ignore, however, just how dependent the stock market has become on cheap money. The current bull market dates back to 2009, and in that period it has suffered half a dozen serious setbacks. In every

[1] Bloomberg, MSIM, as of April 2018.

[2] IMF, World Bank, MSIM, as of April 2018.

[3] Bloomberg, MSIM, IMF, World Bank, as of April 2018.

[4] Bureau of Economic Analysis, Department of Labor, MSIM, as of April 2018.

[5] Ned Davis Research, MSIM, as of April 2018.

instance it started rising again only after the Fed provided even more cheap money or backed off from raising rates. This time is different, because inflation is inching higher, so the Fed can't afford to back off again. It would take a much bigger drop in stock prices for the Fed to reverse course on rates, and that prospect is a long way away.

The Fed matters more for the market than Trump does, which puts the market in a bind. Yes, Trump's conflicts with China and big corporations are making the market more volatile, but only because it has a fundamental case of the jitters. If global growth were not disappointing and rates were not rising, the market would go back to ignoring Trump's threats as political noise.

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