Monday Morning Update Mar 12, 2018

Credit is repricing. Plain and simple. When interest rates change in aggregate, credit is repricing. When the interest rate for a specific maturity changes, credit is repricing. When the interest rate for long-term maturities changes by a different amount than the change in the interest rate for short-term maturities, credit is repricing. When credit is repricing, everything else also has to reprice. Equities have to reprice themselves. Commodities have to reprice themselves. Higher leveraged companies have to reprice the credit in their balance sheets. The multiples that investors are willing to pay for earnings have to be repriced. Profit margins have to be repriced. When a balance between fiscal stimulus and monetary tightening is taking place, credit has to be repriced. Small business and consumer optimism has to be repriced. Repricing usually happens in a relatively short time horizon.

Traders and investors have had fun repricing their varied assets these past few weeks. When the Dow was moving up and down 300-400 points in a single day, the price of credit for a risk-free 2-year term moved a couple of basis points higher; there was little if any "flight to quality" trade that was evident in the 2-year Treasury market. The price of credit for a risk-free 10-year term barely budged. While the price of credit for highly leveraged companies has gradually moved higher the past few weeks, the vast majority of the higher yield is from an increase in interest rates, not from a weakening credit quality profile. When this crazy and arguably insane tool to measure volatility bounced extremely high, the yield on the risk-free 2-year term moved higher, not lower. The risk-free 10-year was still yawning.

And the S&P 500 is only 3% below its all-time high.

The media has opined that the yield on our 10-year Treasury is going to 3.00%, and then much higher. The 10-year has bounced just below 3.00% for the past 3 weeks. Can we call it a game and say we are here ? What is the real difference between a 2.85% and a 3.00% yield on the 10-year ?

How about a 1.25% drop in price ? You lose 45% of your first year's income with this drop in price caused by an increase in yield from a 2.85% to the magic 3.00%. Income investors don't mind the change in value on their month-end statement. Total return investors care a whole lot.

These past few days have been a good few days for a refresher on where global credit repricing stands. The ECB met. Draghi removed an important phrase in the ECB's concluding statement, communicating a mild form of a QE reduction. The Bank of Japan met. They want to continue their NIRP (Negative Interest Rate Policy) for a very long time. Canada has begun their rate adjustment, but decided to hold off on any new moves higher, at least until summer. Yields across the globe have dropped 12-18 bps, except for here in the US. Over the past few days, our 10-year Treasury yield has barely budged more than a basis point or two thru all the volatility in equities and thru all the political shifts in DC. Amazing !

The yield differentials between US Treasuries and global sovereigns are getting huge. Our 10-yr Treasury yields more than 225 bps above the German 10-year. And we are 285 bps higher than the Japanese 10 yr. We pay investors an extra 140 bps versus British bonds. This yield differential will bring in buyers to help offset the reduced demand that is coming from the U.S. as result of our reduction in our own QE policy.

An increasing rate of economic growth across the globe, stable energy costs, stable wage and price data, supportive monetary policy, incentive-driven fiscal policy coming out of Washington, and still low on an historical basis interest rates can support a P/E on the S&P 500 between 17-18. Earnings of $170-$175 for 2018 puts the S&P at 2890 – 3150. A level of 3,000 on the S&P is very easy and realistic. The real problem for 2019 and 2020 is the extremely difficult comparisons earnings will have to contend with to keep P/E's from declining. Investors and traders will have 10-15% earnings growth rates as comparisons for earnings in 2019 and 2020. Another 10% growth in earnings for 2019 from 2018 levels gives the S&P another 170 points. Another 15% growth in earnings for 2020 gives the S&P another 270 points.

Will the S&P 500 be at 3600 at the end of 2020 ?

Or will the S&P be at 2625 at the end of 2020 ?

All you have to do is get the P/E right.

And the earnings per share.

PDR Advisors 4033 Ivystone Ct. Charlotte NC 28277 704 845 2303