This Is A Normal “Reversion To Mean” Stock & Bond Market Correction!

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Summary:

- Outperforming tech stocks are “reverting to trend” with the rest of the S&P 500 stocks.
- 10-year bond yields are now normalizing and going up.
- Higher bond rates will not drive investors out of the stock market – for now!

2016 & 2017 Stock Market Performance Dominated By Five Tech Stocks!

Less than a month ago, on September 20th, the S&P 500 Index hit a record all-time high.

However, as of the end of August 2018, five different individual tech stocks were driving most of the S&P 500 Index performance since 2016.

These five individual tech stocks, Apple, Alphabet, Facebook, Amazon, and Microsoft made up an enormous +47.6% of the total S&P 500 Index year-to-date performance gains according to Standard & Poors.

As of August 31, 2018, the S&P 500 Index was up 9.94% YTD. During that same period, the five tech stocks mentioned above made up 47.6% of that performance. Without those five tech stocks, the other 495 stocks that made up the S&P 500 Index were only up 5.2%.

Year-to-date, as of August 31, 2018, the Dow was up 6.73% YTD. If the performance of those five tech stocks were deducted, the performance YTD for the Dow would have only been up 3.53%.

A Major Stock Market Anomaly!

This has been a significant stock market anomaly since 2016. Never before in stock market history have five mega-cap stocks so dominated the performance of both the Dow and the S&P 500 indexes.

On October 10, 2018, the Dow dropped 832 points (3.2%). The S&P 500 Index plunged 3.2%. BUT, the tech-dominated NASDAQ Index declined 4.1%continuing to underperform the Dow and S&P 500 over the past few months.

When five tech stocks represent over 47% of the stock market performance of the S&P 500 Index, this is a historical anomaly and MUST eventually revert to its historical mean closer to the overall performance of the stock market as a whole.

Summary: This correction is NOT about concern over Chinese trade. President Trump, (no matter what you think of his tactics and rhetoric) is winning on trade issues with all of our other trading partners and will eventually force China into reforming many of its illegal trade policies.

This correction is merely a "reversion to mean" of a completely unbalanced internal stock market performance track record in order to bring those five outperforming tech stocks into balance with the rest of the 495 stocks that make up the S&P 500 Index.

Bond Market Normalization

A month or so ago, everyone on cable business news stations was breathlessly predicting a recession because of an inverted yield curve!

The 10-year yield curve is considered a leading economic indicator. Analysts had been concerned that long-term interest rates like the 10-year US treasury bond were trending lower compared to short-term US treasury bonds. That is the definition of an inverted yield curve.

Analysts and commentators were "befuddled" because no one could understand or explain why and how this could happen when (1) the Federal Reserve was raising rates, and (2) the US economy was booming.

This was a bond market anomaly!

However, commentators and analysts are now wringing their hands and seem confused that the bond market is now reacting (OMG!) "normally." Typically, when the Fed raises rates, the longer-term bonds should start going up.

That is what is happening now! NORMAL!

Stock Market Volatility: Investors Need To Distinguish Between "NOISE" and "ECONOMIC FUNDAMENTALS."

At almost ten years, the current economic recovery is one of the longest on record. Personal income, consumer spending, household assets, and net worth, are all at record highs. Corporate profits are within striking distance of all-time highs. Almost all the leading economic indicators are in positive territory and, according to the IMF, world growth is expected to rise this year to 3.5% and, in 2018, to 3.6%.

Despite short-term stock market volatility caused by too much good economic news, or by political and foreign policy issues, the facts are: the U.S. and the global economies are powering upward in a stable and robust march forward.

Investors always need to be able to distinguish whether stock market volatility is caused by (1) political or foreign policy issues or (2) more serious underlying economic issues.

Investors always need to ask the question, "Does today's "breaking news" change the outlook for the economy or corporate profits? Are people still going to go to work tomorrow in Detroit and Atlanta?"

If the issue doesn't affect the underlying U.S. economy or a person's ability to work, investors should ignore the stock market volatility and not panic. When the stock market goes down because of political or foreign policy issues, it is almost always a short-term correction if the problem does not affect the long-term economic fundamentals of the overall economy.

These stock market corrections and pullbacks usually last only a month or two, and, when investors see that the issue does not impact the underlying economy, the market recovers quickly. In these situations, investors who panic and sell, almost always lose money.

Will Higher Bond Rates Drive Investors Out of the Stock Market NOW?

Why is the 10-year U.S. Treasury bond yield important?

The 10-year Treasury Yield is currently at 3.21% (10/10/2018). Yield is the current income return you receive when you own a bond, as measured by a percentage. If the bond you bought for $1,000 pays you $30 per year — that's a 3% annual yield.

The yield on the 10-year Treasury is closely watched in the financial world because many view it as a window on where the economy is headed: up, down or sideways. Mortgages, corporate debt and a lot of other interest rates are tied closely to this government bond.

The current concern is that if the yield on the 10-year bond stays over 3%, then inflation is gaining steam, global economic growth could slow, mortgage rates are going to rise, and investors will move money from equities into bonds.

Some see this as an indicator that the ten-year bull market could soon be over!

Many analysts and investors believe that going over 3% is the point at which investors will flee the relatively risky stock market for the relative safety of bonds. A 3% yield on bonds is considered a decent return, compared with the current dividend yield of 1.76% on the Standard & Poor's 500-stock index, even though stocks have much more upside because of their earnings potential.

The Answer: Is The Current 4% Yield The New 3%?

Because of record corporate earnings and consensus Wall Street analysts estimates of a 10% gain in the S&P 500 Index over the next 12-months, I believe the 10-year Treasury would need to move above 4% to become serious competition against stocks.

The reasoning for this is that stock prices are driven by earnings, and the S&P earnings yield (not dividend yield) is currently 4.37%.

This means the earnings yield on stocks at 4.3% is higher than the 10-year Treasury bond returns at 3.21%.

SUMMARY: In the past, the 10-year yield of 3% has preceded a move by investors moving out of equities in the stock market, as investors get the higher 3% yield in the bond market. But with the recent tax cuts that have boosted corporate earnings, the current S&P 500 earnings yield at 4.47%, investors would be "crazy" to switch from a 4.47% earnings yield in the stock market for a lower 3.21% yield in the bond market.

Disclosure: I am/we are long AAPL.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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