Investors have been blinded by pessimism

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As we settle back in following a summer of volatility, the markets have struck a note of cautious optimism.

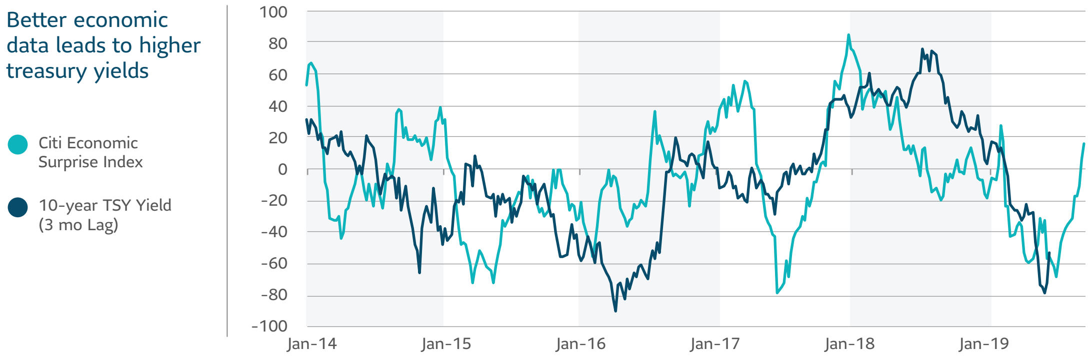
This uptick promises to be more than a fleeting relief rally. There are nascent indications that the recovery in equity prices and Treasury yields are justified by fundamentals, and that investors have been too slow to adjust to a more positive narrative.

After months of negative headlines, investors were blinded by the high beams of global geopolitical risks, and unable to focus on the more granular developments of the US Economy. It is understandable, as the threats emanating from Europe (Brexit, a recession in Germany, and political breakdown in Italy) and China (escalating tariff wars and protests in Hong Kong) commanded all of investors' attention. If we look at recent changes in investor behavior through a psychological lens, according to Abraham Maslow's hierarchy of needs, people are not able to focus on their higher-level needs until their most basic and existential needs are met. With investors facing multiple perceived existential threats to global growth, they were left unable to focus on higher-level details such as the subtle changes in domestic data.

On balance, domestic growth is beginning to outperform expectations. Consider the rapid recovery in the past 3 months of the Citi Economic Surprise Index, which measures how economic data performs versus market expectations. The Index returned to positive levels (+16.6 as of 9/12/19) after spending six months in the red and reaching a low of -68 in June.

The last time the Index hit these levels was in February 2019, when 10-year Treasury bonds were yielding close to 2.70% – about 100bps higher than where they are today. The Index is typically a good indicator of the future path of 10-year Treasury yields, and based on this, it looks like investors have missed the positive shift in domestic growth (see graph).

Better economic data leads to higher treasury yields



Recent data releases have helped to propel this Index higher, including growth measures such as The Institute for Supply Management (ISM) Non-Manufacturing and Nonfarm Productivity, as well as inflation measures such as Unit Labor Costs, Core Producer Price Index (PPI), and Core Consumer Price Index (CPI), all of which beat market survey expectations. Even seemingly weak numbers, such as the recent Nonfarm Payrolls number, contained some positive surprises, including an increase in the Labor Force Participation Rate and higher Average Hourly Earnings.

Additionally, each of the existential global threats seem to have receded from their peaks.

In the U.K., concerns have been somewhat allayed by recent parliamentary measures aimed at preventing a "No Deal" Brexit, and Italy has moved closer to forming a governing coalition that excludes the disruptive and anti EU Northern League.

In China, there are signs that the protests in Hong Kong could be calming down, with Carrie Lam announcing that the proposed extradition bill will be permanently shelved. Tariff wars also seem to have moved in a slightly more positive direction as well, with Trump recently agreeing to delay the imposition of an additional 5% tariffs until after the October 1st celebration of the 70th anniversary of the founding of the People's Republic of China.

With these more pressing concerns fading, and the sunspots beginning to fade from investors eyes, they should take a long look at the recent improvement in domestic data, and see that there is more room to run for risk assets and Treasury yields.