Basis Points – October 9, 2018

westwoodgroup.com/weeklyblog/basis-points-october-9-2018/

Above the Fold

> Volatility in the equity markets has spiked in recent days as bond prices have declined and yields have risen sharply. The yield on the 10-year T-bond has increased from 3.05 percent just a week ago to 3.25 percent on Friday. The reasons for a rally in yields include continued strong economic growth and low unemployment seen in recent economic reports. Trade tensions have eased somewhat lately with the new trade agreement with Mexico and Canada, which had held yields down with the worry of a global trade war. And China boosted its economic stimulus package this summer, which seems to be filtering through the Chinese economy and spurring stronger economic growth there.

Three Things

- Interest rates are rising. But why are higher rates inherently bad for stocks if their rise is mainly due to a strong economy? For three reasons: First, higher rates raise the cost of borrowing for corporations who use debt to finance their businesses. Increased costs to borrow leads to lower corporate profits. Second, the dividend yield on stocks, such as the 1.8 percent yield on the S&P 500 index, becomes increasingly less attractive relative to risk-free alternatives such as the 10-year bond, which now yields 3.2 percent. Third, higher rates can decrease the spending power that consumers have in the economy, if rates on home mortgages, auto loans and credit cards rise. This decrease in consumer spending could slow the rate of economic growth.
- The "neutral rate of interest" is the rate which neither spurs economic growth nor hinders it. It is the preferred state for the Fed, as they see this condition as necessary for economic growth to be on a sustainable path, and not headed toward overheating or slowing toward a recession. While both rates and market volatility have risen lately, the real Fed Funds Rate is currently near zero, and a recession has never started with a real Fed Funds Rate near zero. As examples, we can look at the last three recessions: a recession began in December 2007 with real rates at 1.91 percent; in March 2001 with real rates at 3.54 percent; and July 1990 at 4.08 percent.
- While stocks in general have declined over the past week, the growth area of the market has fared much worse than value. The S&P 500 index has declined 1.5 percent this quarter, while the large tech names have driven the FAANG index to a loss of -6.4 percent this quarter. However, the Russell 1000 Value index has risen 0.1 percent after underperforming the Russell 1000 Growth index by a wide margin over the past two years.

Did You Know

We have recently discussed the advertising and business power of 20-year-old Kylie Jenner, with a huge social media following that generates great focus on her own brands and wields great power from advertisers and product-placers. But online stars such as Jenner, Selena Gomez and Taylor Swift can now be seen as old geezers compared to the newest young social media powerhouse, simply known as Giana. She is 9 years old and is Instagram's most famous and powerful "mini-influencer." Her 23,800 Instagram followers know her as *Dear Giana*, and they follow her fashion, art and activities daily.

The *WSJ* reports that Giana lives in Dallas and got her start at age 5 when she tore pages from her mother's *Vogue* magazine and customized the pictures with crayons, pencils and markers. Her mom began posting the images on her Instagram account, which caught the attention of a children's clothing brand. Giana has recently signed agreements with Nike, Vogue and Louis Vuitton to help design and promote products on her Instagram page.

Nike has collaborated with Giana on three t-shirts to be released on Oct. 11, and Nike is working with eight other young "athlete influencers" to design children's versions of their adult shoe products. These "mini-creative" child stars are gaining traction as marketers strive to reach

Generation Z, the roughly 67 million people born from 2000 to today. Gen Z'ers have about $44 billion in purchasing power, and thanks to Instagram, they can view a staggering amount of merchandise to help them decide exactly what to buy from a huge global market of products.

Generation Z does not watch TV. If advertisers want to reach them, they must reach into their phones. Gen Z is the most digitally wired generation in history, and through their focus on YouTube, Musical.ly, Instagram and Snapchat, they are wielding influence in global merchandising in ways unimagined only 10 years ago. And contrary to what older generations fear about these young, uncommunicative phone zombies, they are in fact a very social, creative and in-touch generation. Whether learning how to make crafts on YouTube, producing their own music videos on Musical.ly, learning how to influence consumers on Instagram or following world events on Twitter, Gen Z is a very awake and informed generation that knows no boundaries between them and the outside world of entertainment, business and mentorship.