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Market Note | December 27, 2018

"Why did the market go down today?"

"Because there were more sellers than buyers."

Have you ever heard this exchange? There is a flaw in the logic because in markets, there is a buyer for every seller. What the response should have been was "Because there were more sellers than buyers at a given price level, so sellers had to continue lowering the price until they discovered a price that would entice a buyer to enter the transaction that they did not want to consummate at higher prices."

It's not as pithy.

Markets have been a bit crazy this month, and generally negative for the fourth quarter of this year. There are still a couple of trading days left in 2018, but we wanted to send out a comment sooner rather than later that discussed the market volatility. If you allow rounding, we can say that the S&P500 entered a bear market, dropping 20% from its high in September to the low reached a couple of days ago. International markets also reached bear market status this quarter. It is generally unpleasant. Why are prices dropping? Are we in a recession? What should we do?

It is worth stating that in bear marketsthe average company's ability to generate earnings over the long term does not change. What changes is the marginal investors' willingness to pay today for that company's earnings.This statement begins to answer the third question posed above. As long as we have the correct exposure to stocks for our long term objectives, there is no reason that we have to participate (by selling stock) in the temporary selling frenzy.

Who sets the price of a stock?

The price of a stock is set by the last people that trade. These last people that sell and buy set the price for everyone else. Consider Emerson Electric. Emerson has about 635 million shares of stock outstanding. On the first trading day of July 2018, about 2.5 million shares of Emerson stock traded (let's call it 0.4% of the shares). The prices for those 0.4% of the shares traded set the price for all of the 635 million shares.

What happens when 20 times that number of shares is traded during the first ten trading days of December? And what happens when a similar thing happens across most companies? Referring back to the first regular paragraph above, sellers need to lower prices enough to entice buyers to pay for the shares being offered for sale. That is what is happening now. In the case of Emerson, about 15% of the shares have been traded over the 18 trading days of December. Prices have had to adjust down to accommodate this higher than normal desire to sell. I don't mean to pick on Emerson. The increased desire to sell is across most stocks in the market. But note that it is not the majority that is setting prices for the rest of us. Collectively, the shares being sold are a minority of all shares, but it is these "I must sell now" trades and prices that dictate the value today of our holdings for the rest of us.

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I repeat what I said above: the earnings generating potential of companies really has not changed.

Does this mean that we are in a recession?

The first point to make is that a bear market in stocks does not mean that we are in a recession. Historically, bear markets have been accompanied by one of the following: recessions, commodity price spikes, extreme valuations, and an aggressive Federal Reserve. What is true is that experiencing a decline in market values feels lousy, and being in a recession usually also feels lousy, but a bear market does not a recession make.

Even though some commentators are speculating about the next recession (later next year or 2020), it remains speculation. I don't believe that we are in a recession. Nor are we experiencing a commodity price spike. Valuations were not extreme to begin with. That leaves an aggressive Fed as the reason for the bear market. I believe that this is the cause:a belief that the Federal Reserve is being too aggressive.

The Federal Reserve is doing (and has been doing for about a year now) two things that generally work against economic growth: raising interest rates and shrinking the size of its balance sheet by letting some of the bonds purchased during the Quantitative Easing era to mature without reinvestment. Now both of these things need to be done, and they have been occurring during a period of positive economic growth, which has provided some 'cover'. Just as it is easier to save when you have income, as a Central Bank, it is easier to shrink your balance sheet (working against economic growth a bit), when overall economic growth is strong.

What is the big deal then? We have a relatively new Federal Reserve Chairperson (meaning no history to refer back to when we try to guess what he is thinking, or how he has acted in the past) that came into this season stating that rates would be increased this year and next no matter what. The 'no matter what' part was somewhat inferred by the market.

What the market was hoping for was some crack in this stubborn façade. They wanted to hear that the Fed would consider what was going in in the broader markets, and that they might change their rate rising plans and/or their planned shrinkage of the balance sheet if conditions were not benign. The market did not hear this message when the Fed held its press conference this month.

Well, when the cost of borrowing has been so low for so long, and markets have done fairly well for a long time, you can expect that some percentage of investors will be deploying various investment strategies that involve borrowing money in some form to invest in stocks. Other investors might just have too much stock in their portfolios. When the cost of that money increases, and when market volatility picks up, these groups can line up in a hurry to sell stocks, right now and today. Because these marginal sellers set the prices for all of us, we need to be patient while they complete their forced selling, so that prices can recover back to a more normal level.

Again I will state that I don't think we are in a recession today. The thing about recessions is that it can take a longer time period for stock pricesto recover. This is because earnings also fall along with the prices that people are willing to pay for stocks, and you usually have to wait around for earnings expectations to recover (and the economy to recover) before stock prices will. This could take a year or two.

I believe that some bear markets are more attitudinal, like the current one. There is a fear of recession, and a fear that the price of money (interest rates) will go too high, or that the Federal Reserve will collapse the economy through its actions. Once these fears abate, and the short term sellers move out of the market, the markets can experience meaningful price recovery fairly quickly.

The strong earnings gains during 2018 brought down the valuation of the market by double digits even before this fourth quarter sell off. Now, valuations seem to incorporate a whole bunch of negative things happening. Earnings growth is slowing from its strong pace this year, but earnings are still expected to grow about 10% next year. In a couple of weeks, companies will begin reporting exactly how they did in 2018, and what they see for 2019. They may well state that things are murky (they don't know how Brexit will play out, or what resolutions to the trade war might occur etc.), but changing expectations for earnings gains from positive 10% to zero or negative seems unlikely.

Regards,

Peter B. Harre, CFA