



The fourth quarter of 2018 was filled with unsettling events that by Christmas Eve triggered the largest stock market decline on record for December and the largest decline on Christmas Eve itself. The plunge further pushed the decline from the market peak to the edge of Bear Market territory, understandably adding to investor fears. Yet should investors head for the exits in anticipation of the decline's continuation? Our answer is resoundingly "no."

Looking back over the ups and significant downs of 2018, we have decided to offer a more extensive discussion of what has been driving markets into such crazy volatility. Hopefully, you will find the exercise to be enlightening and perhaps comforting.

SKBA has often stated the normal pattern of both stock markets and individual stock price movements is to "overshoot" the true change in underlying fundamentals. Why does this happen, and why has it occurred with such stunning swiftness this quarter? Certainly Wall Street analysts and investors get overly optimistic during the good times and equally pessimistic as the good times fail to be sustained. Swings in emotional sentiment inherently drive the price movements that overshoot the underlying long-term fundamentals of a company or of the overall market. We take advantage of these swings when buying and selling securities.

Yet the vast advance in data processing capabilities to analyze financial data and the creation of financial securities to supposedly manage risk, rather than creating more stable markets have instead created additional risk in the market. The market crash of 1987, for example, was driven by the spectacular failure from the interaction of two quantitative techniques: program trading and portfolio insurance. The 2008 financial crisis came out of the inherently unstable and unsustainable leverage in subprime mortgage-backed securities. Yet with the attempts to push further into the frontier of quantitative analysis and to apply AI (artificial intelligence) and "machine learning," today's quants have become sophisticated programmers that model computer responses to new market information. Programmers now model the markets to identify micro trends to buy and sell. As a result, today's technology pits one big trader's computer-based algorithms against another's without the intervention of human decisions. The result is hyper trend following behavior.

Not surprisingly, the result has been unfettered short-term volatility in markets, pushing up further the range of the "overshoot" phenomenon. In our view, the stock market's decline in the fourth quarter was far greater than the true change in the performance of the underlying economy and corporate profits. It is folly to attempt to respond to such movements hastily.

An exercise for you to consider. Which was a correct indication of the market and economy's direction: the algorithms that drove the Dow Jones Industrial Average down 650 points (-2.9%) to its worst ever return on Christmas Eve day, or the algorithms that drove the Dow up an all-time one-day record 1086 points (+5.0%) on December 26th? The answer is neither! Few, if any, investors or firms can successfully "trade" such moves.

It appears that much of the blame of the market's decline has been placed on the Federal Reserve Board and its new chairman, Jerome Powell. In the Fed's defense, Fed policy and the market and economy's response to it is in uncharted territory, and some caution as to how markets react to the Fed's actions is appropriate. Yet, the Fed suppressed interest rates for eight years with its Zero Interest Rate Policy (ZIRP) and free money distorts market responses. This was a policy

error that triggered excessive risk-taking to capture higher yields and returns in market sectors like “junk bonds.” Over the last three years, the Fed has been on a path to “re-normalize” interest rates, but borrowers have become used to low borrowing costs and accommodation. Thus, the steady rise in short-term interest rates each year has finally created some indigestion in the market.

What is that mystically “normal” T-Bill rate? In our view, six-month T-Bills should yield the expected rate of inflation plus about 50 basis points (0.5%). With inflation near 2% and adding in the low real rate of return should today result in a yield of about 2.5%. With the December increase in the Fed Funds Rate (25 basis points), the result of a unanimous decision by the voting Fed governors, the market is nearly there. What’s all the fuss then? ZIRP did not lift GDP growth above 2% during the Fed’s eight-year experiment, and there’s little reason to believe that a low nominal interest rate around 2.5% (or even higher) would throw the economy into recession.

Chairman Powell is simply following in the footsteps of his predecessor, Chairman Yellen, in attempting to restore the normal functioning of credit markets and the pricing of credit risk. Yet the Fed has never made such a critical transition, and so it has reason to move cautiously. Today’s market indigestion, while it should be temporary, cannot be allowed to turn into a rout in the corporate bond markets, disrupting the willingness of investors and banks to lend to corporate borrowers. The president’s twitter finger is not helpful in maintaining market confidence in the independence of the Fed to pursue a sound monetary policy, not simply to sustain low interest rates.

Our bigger concern has been trade issues. While reaching an agreement on modifying NAFTA was important, the ongoing battle with China is equally if not more important. China has not lived up to its promises since being allowed to join the WTO (World Trade Organization) in 2001. What makes the negotiations so difficult is the U.S. attempt to tackle protecting the intellectual property (IP) rights of U.S. corporations from the technology transfers forced by China’s government and outright theft of IP by government hackers. Both the recent rhetoric and the actions of the U.S. and China have had consequential impacts on corporate investment decisions. How can a company make major capital expenditure decisions when it doesn’t know what tariffs and/or trade barriers will be in place in the next six months or six years? The recent slowdown in corporate investment plans appears to be a direct result of this uncertainty.

Almost all of the other problems—concerns about slowing world economic growth and recession risks—would be resolved or at least lessened by reaching high-level agreement on key issues during the first half of 2019 as planned. Despite promising statements from China, which have been completely ignored so far by the markets, there is no assurance of success in this process. This is what keeps us on the edge of our seats. If the framework of a deal can be reached, however, expectations about world economic growth would likely be pushed higher again. Corporate investment decisions would be taken off of today’s holding pattern, and higher real growth would stimulate demand for all kinds of goods, services and commodities.

None of today’s financial and economic data suggest we are on the verge of repeating the financial crisis of 2008-09. Yet the stock market is acting as if we are. The tax rate cuts in December of 2017 were the most significant incentive shift promoting the investment in the U.S. since the tax reform during the Reagan administration. Along with reductions in the number and scope of federal regulations, and if we can avoid a prolonged trade battle with China, we believe sustained real economic growth of 2.5% or better is both possible and likely. The possible resolution of some of these issues that have driven markets sharply lower could be resolved even within a few months. And even if they linger longer than this, future rates of return for the stock market have risen as a result of the lower valuations that now exist in the market. We will be on the lookout for them.

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