Why Stocks Fall

The Dow's 800 point drop on Tuesday resulted in the WSJ's front page headline on Wednesday, **Stocks Tumble As Trade Fears Jolt Investors**, followed by this weekend's:

Stocks Tumble to End Volatile Week

By Corrie Driebusch

Investors' retreat from U.S. stocks turned into another rout Friday, leaving major indexes down more than 4% for the week as the November jobs report failed to offset persistent anxiety over the U.S.-China trade dispute and the global economic outlook.

The slide pulled the Dow Jones Industrial Average down as much as 663 points and put the blue-chip index and the S&P 500 back into the red for the year.

The indexes, along with the Nasdaq Composite, suffered their biggest one-week point and percentage declines since March, and all three are off to their worst start to a December since 2008.

Stocks opened with slight gains but steadily declined throughout the session as the jobs data showed wage growth matched the highest rate in nearly a decade, but U.S. employers slowed their hiring in November.

Nonfarm payrolls increased a seasonally adjusted 155,000 in November to cap the slowest three-month growth rate in a year, a sign the economy could be losing some momentum after a strong year. (Or, perhaps, that we are at full employment. At 3.7%, the unemployment rate matches the lowest since December 1969.)

The brief optimism over the data gave way to renewed fears about the impact of tariffs on the U.S. economy. ...

The selloff accelerated after Trump administration officials reiterated they plan to take a tough stand in their 90-day trade negotiations with China or impose further tariffs, reigniting concerns about global trade.

The blue-chip index lost 558.72 points, or 2.2%, to 24388.95, and the S&P 500 declined 62.87 points, or 2.3%, to 2633.08. The tech-heavy Nasdaq fell 219.01 points, or 3%, to 6969.25.

The Dow industrials posted a 4.5% weekly loss, while the S&P fell 4.6% and the Nasdaq dropped 4.9%. Those declines are the indexes' worst start to a December since 2008 ....

When stocks opened for trading Friday, some investors were optimistic that the mayhem of earlier in the week had calmed. The Dow industrials had clawed back a nearly 800-point decline Thursday to end the day only slightly lower after a report from The Wall Street Journal eased worries about how fast the Federal Reserve could raise interest rates. The jobs data offered another initial bounce. ...

"The list of worries is very, very long these days," said Erik Davidson, chief investment officer for Wells Fargo Private Bank. "Investors are on pins and needles worried about something at all times, whether it's the China trade deal, Brexit, the inverted yield curve (On Tuesday, the front end of the yield curve inverted. However, it is the 10-year minus 3-month spread that is the most predictive, as discussed below.) or monetary policy."

Meanwhile, Friday's agreement between the Organization of the Petroleum Exporting Countries and a coalition of other oil producers to join in a production cut offered a reprieve for oil prices, which have tumbled about 30% over the past two months

The price of U.S.-traded crude oil climbed 2.2% to $52.61 a barrel, versus a high of more than $75 a barrel in early October. ...

U.S. government bond yields fell Friday, with the yield on the benchmark 10-year U.S. Treasury note at 2.851%, compared with 2.872% Thursday. It marked the biggest one-week yield decline since October 2015. ...

From The Washington Post:

The hard truth for investors: Stocks fall because they fall

By **Steven Pearlstein**

December 6

Whenever stock prices rise or fall sharply, there is a natural instinct to ask what happened in the world to suddenly change perception of longer-term investors and shorter-term traders about the prospects for the economy.

After all, economic theory — the so-called efficient market theory (see my White Paper under the IVA System tab on our website for a more thorough critique) — would have us believe that the previous level of stock prices reflected a valuation by millions of sophisticated investors based on all the available data. So the only thing that can explain the new valuation is some new information, in this case prompting all sorts of theories about oil prices or the slowdown in home sales or increased trade tensions that will lower global economic growth.

Or maybe the movement in stock prices, in fact, has very little to do with that. Yes, some of those developments have altered the outlook for the economy and corporate profits. But more likely those are triggering events than the underlying cause of the wild swings in stock prices — matches thrown on a pile of dried wood.

The real change is that investors have gone from people (and computers) buying stocks on the expectation that stock prices would continue their steady climb over the last years, to people (and computers) selling stocks because they no longer believe that to be true.

Or put another way, the market is making the transition from people buying stocks because everyone else is buying them to selling stocks because everyone else is selling them. It goes by the name of herd behavior, or momentum investing, and it is the only thing that can explain why, in the 16th century, people were paying as much for a single tulip bulb as they would pay for four fat oxen, eight pigs, two tons of butter or a thousand pounds of cheese.

Did those crazy Dutch really think a tulip bulb was as valuable to them as a thousand pounds of cheese? Of course not. On financial markets, as the great British economist John Maynard Keynes observed, the task of the trader isn't to calculate the genuine economic value of an asset based on all the information available. Rather, it is more simply to figure out what some other fool will pay for it in the next minute, the next hour, the next day or the next month. (As previously shared, Keynes described the action of rational agents in a market by using an analogy of a beauty contest, in which to win you must pick what the average opinion of the judges will be: **"It is not a case of choosing those that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."-** Keynes, General Theory of Employment Interest and Money, 1936) Rather than being rationally efficient, financial markets have a predictable (?) tendency to be irrationally inefficient, driven by self-reinforcing cycles of fear and greed in which buying begets more buying and selling begets more selling.

Everyone (hardly) on Wall Street knew that a bubble (Bitcoin) had developed in stock (FANG), bond (rising interest rates were easy to predict, as we did, much more difficult to time, as we can attest) and real estate (no evidence that we have seen) markets, one that was made possible by lots of cheap credit provided by the Fed and other central banks, and that a correction was inevitable ("bubbles" don't end in a correction). But as with any dynamic that feeds on itself, you never know when that will happen — and if you bail out too early, you can miss a lot of upside. Indeed, the wise trader (neither of us have ever met one) knows that these movements up and down always last longer than people think possible (corrections usually not, unlike bear markets) — so long, in fact, that the early skeptics give up and throw in the towel. It's only when these skeptics finally capitulate and rejoin the herd that markets turn and head in the other direction.

For if a market peak or bottom were really obvious and predictable, then in a forward-looking market it would have already happened.

I'm sure that as you are reading this, there are bullish analysts on Wall Street assuring clients and the media that investors are being irrational, that the market is now oversold (a technical condition that can be measured, and it is, which doesn't mean stocks can't continue to fall), that prices have swung too far below economic fundamentals.

But remember that just as the economic fundamentals drive the markets over the long run, markets can drive the economy in the short run. Whether justified or not, falling stock prices cause consumers and businesses to pull back on their spending, which will eventually cause the economy to slow, causing forward-looking stock prices to fall even farther. In that way, the downward spiral feeds on itself. (The so-called "wealth effect" is debatable, especially with regards to the stock market.)

Moreover, this vicious cycle is apt to accelerate even more when those who have bought stocks with borrowed money are forced to sell by lenders whose collateral — the stock — is now valued at less than the original loan. In that way too, selling begets more selling.

This is what a bear market looks like: Four steps down, two steps back up, then four more steps down. And just as on the way up, it won't be over until market sentiment becomes overwhelmingly bearish (it already is) and the dwindling number of bulls finally throw in the towel. We're still a long way from that point. And until we get there, you might want to save yourself the time and aggravation of trying to figure out why the Dow Jones average just fell 600 points while you were having lunch. And if we in the business press were being honest, the headline on the story that day would be the same as it was the day before, and the week before that:

"Stocks fall because stocks fall."

Pearlstein is a Post business and economics columnist. He is also Robinson Professor of Public Affairs at George Mason University. His book "Can American Capitalism Survive?" was published this fall by St. Martin's Press.

Our thoughts

Friday saw the S&P 500 once again retesting its October 29th intraday low. **"[Y]ou often hear financial professionals say such things as 'forecasting market direction from here is exceptionally difficult' in a tone conveying 'gee, this is really strange.' Well, I think forecasting the market over short-term horizons is always exceptionally difficult. If they said, 'Our market-timing forecasts are mostly useless most of the time, but right now, they are completely useless,' I suppose I'd be OK with it, but I'm not holding my breath that they will."** - Clifford S. Asness, "My Top 10 Peeves," Financial Analysts Journal, volume 70, number 1 (January/February 2014) Despite the above quote, some analysis from Friday's weekly issue of BCA Research's Global Investment Strategist:

Trade War Roller Coaster

Investors breathed a short-lived sigh of relief following the G20 summit in Buenos Aires this past weekend. During the course of a two-and-a-half hour dinner on the sidelines of the summit, President Donald Trump agreed to postpone raising tariffs from 10% to 25% on $200 billion of Chinese imports by two months to March 1st. For his part, President Xi Jinping pledged to engage in substantive talks to open up the Chinese economy to U.S. imports, while addressing U.S. concerns about forced technology transfers and IP theft. In one of the more ironic moments in history, China also agreed to restrict opioid exports to the West.

Unfortunately, the euphoria did not last very long. By Tuesday, President Trump was back to his old self, calling himself "Tariff Man" and ominously warning that "We are going to have a REAL DEAL with China, or no deal at all – at which point we will be charging major Tariffs against Chinese product being shipped into the United States." News reports indicated that the Chinese were "puzzled and irritated" by Trump's change in tone. ...

Political Stumbling Blocks To A Trade Deal

At times like this, it is crucial to focus on the big picture, which is that major hurdles remain to consummating a trade deal that satisfies both sides. As our geopolitical strategists have argued, the trade war is just as much a tech war. China wants access to western technology, but the West, fearful of China's ascent, is reluctant to provide it. The fact that China has had a history of appropriating western technology without due compensation only makes things worse. It is notable that U.S. Trade Representative Robert Lighthizer (who will be heading the negotiations) issued a hawkish report ahead of the summit concluding that China has not substantively changed any of the trade practices that initiated U.S. tariffs.

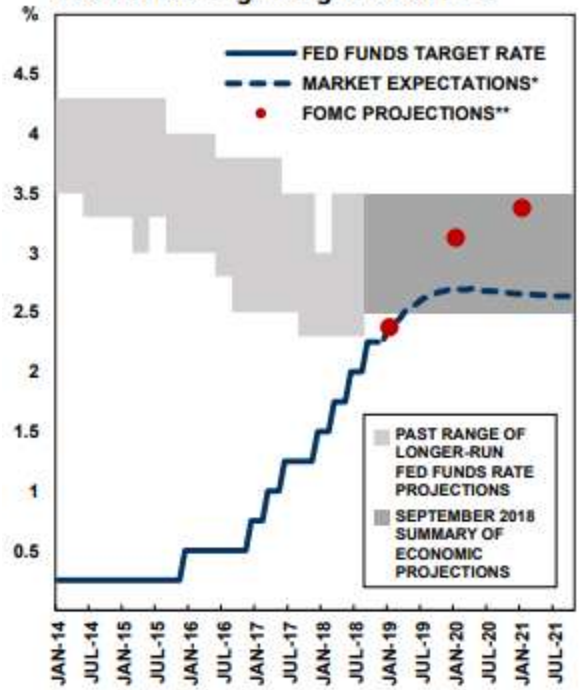
Domestic U.S. politics will also undermine prospects for a lasting trade war ceasefire. Protectionism against China remains popular in the U.S., especially in the Midwestern swing states. If Trump agrees on a permanent deal to end the trade war, who will he blame if the trade deficit continues to widen? (Our view is that Trump has bigger concerns at the moment than his reelection in 2020, and, being desperate for another "win", will settle for any deal that he believes he can claim to be "historic". His North Korean Nuclear Deal is a prime example.) This is not just idle speculation. Trump's trade goals are inconsistent with his fiscal policy. Fiscal stimulus will boost aggregate demand, which will suck in more imports. An overheated economy will prompt the Fed to raise rates (which Trump will blame on Chairman Powell, a sampling of which we have already seen) more aggressively than it otherwise would, leading to a stronger dollar. The result will be a wider trade deficit. ...

No Help From The Fed

The equity sell-off on Tuesday was exacerbated by comments by New York Fed President John Williams who noted that the Fed should continue raising rates "over the next year or so." Williams is regarded as one of the thoughtleaders at the Federal Reserve. He is also generally seen as a centrist on monetary policy. As such, his words often echo the views of the majority of FOMC members.

Williams said that the U.S. economy was "on a very strong path with a lot of momentum." We tend to agree with this assessment. Despite weakness in a few areas such as housing, the economy continues to grow at an above-trend pace. The Atlanta Fed's GDP tracker is pointing to growth of 2.7% in the fourth quarter. Personal consumption is set to rise by 3.4%, one full percentage point above the average during the recovery. The manufacturing sector remains robust. ...
Strong wage growth, lower gasoline prices, and a declining savings rate will boost consumer spending next year. High levels of capacity utilization, easing lending standards, and rising labor costs will also support business investment. Residential investment should stabilize as well, given the recent decline in bond yields. We see the fed funds rate rising by 125 basis points through to end-2019. This stands in sharp contrast to current market pricing, which foresees only 40 basis points of hikes during this period (**Chart 7**).

CHART 7
The Market Is Ignoring The Fed Dots



* REFERS TO EXPECTATIONS OF THE AVERAGE DAILY FED FUNDS RATE DURING THE MONTH AS DISCOUNTED BY THE FED FUNDS FUTURES MARKET.
** FOMC MEDIAN PROJECTIONS FROM SEPTEMBER 2018. SHADED AREA DENOTES THE RANGE OF FOMC PROJECTIONS FOR THE LONGER-RUN FED FUNDS RATE.

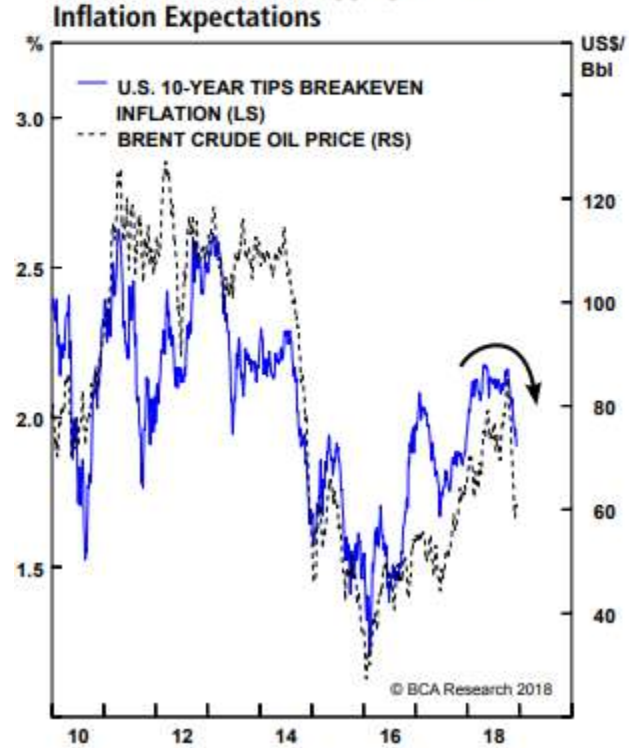
Don't Fear A Flatter Yield Curve… Yet

The flattening of the yield curve would seem like a major rebuke to our positive U.S. economic outlook. The 10-year/2-year Treasury spread has declined to 14 basis points. The 5-year/2-year spread has fallen into negative territory, marking the first notable inversion of any part of the Treasury curve.

How worried should we be? Some concern is clearly warranted. Policymakers have been too quick to downplay the signal from the yield curve in the past. In 2006, they blamed the "global savings glut" for dragging down long-term yields. In 2000, they argued that the U.S. federal government's budget surplus was reducing the supply of long-term bonds. In both cases, the bond market turned out to be seeing something more ominous than they were.

... part of the recent decline in long-term bond yields reflects a fall in inflation expectations stemming from lower oil prices (**Chart 8**). ... lower oil prices should give consumers more spending power without hurting energy capex to the degree that they did in 2015. ...

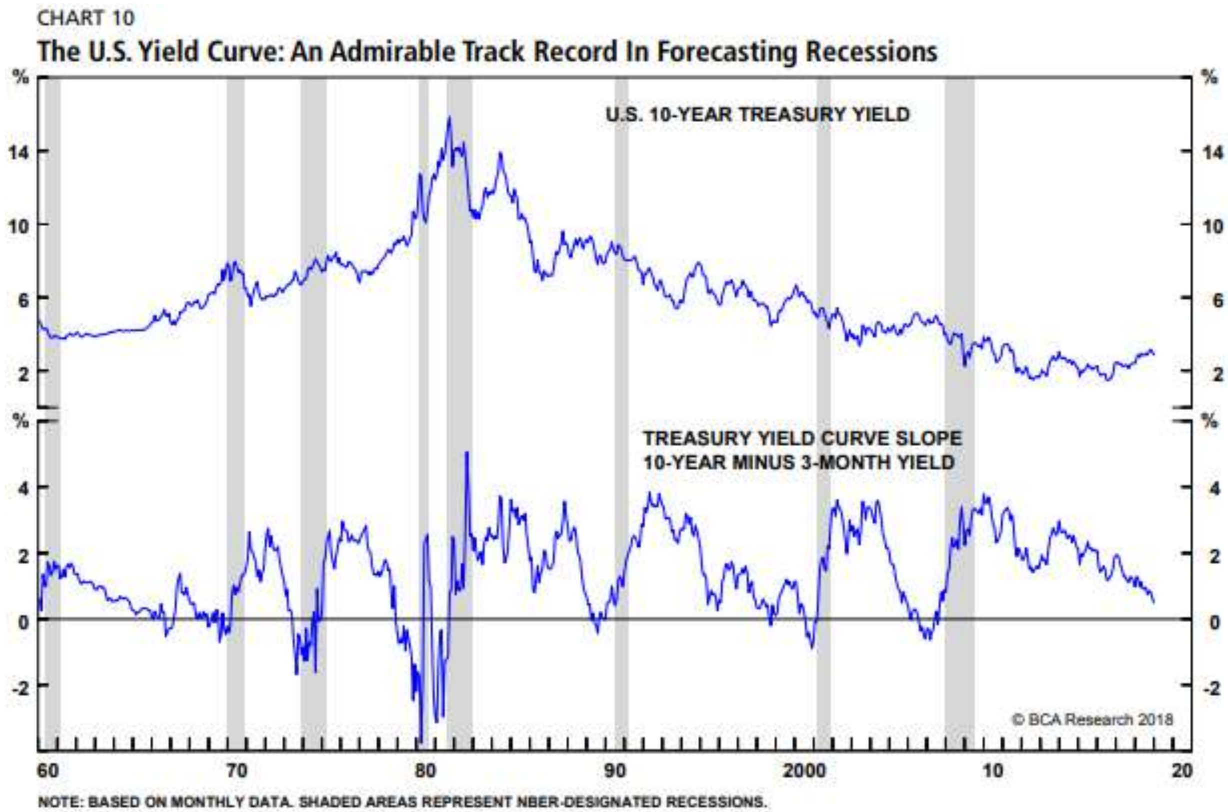
CHART 8
Oil Price Decline Is Dragging Down Inflation Expectations



NOTE: BOTH SERIES SHOWN SMOOTHED EXCEPT FOR LATEST DATA POINT.

Empirically, the 10-year/3-month slope is the best recession predictor of any yield curve measure. It still stands at 50 basis points. If long-term yields stay put and the Fed raises rates once per quarter, this part of the yield curve will not invert until the second half of next year. It usually takes about 12-

to-18 months for an inversion in the 10-year/3-month slope to culminate in a recession (**Chart 10**). In the last downturn, the slope fell into negative territory in February 2006, 22 months before the start of the recession.



This suggests that the next recession will not occur until late 2020 at the earliest.

Investment Conclusions

... If we are correct that China will be forced to step up the pace of stimulus; that worries over Italian debt will fade, at least temporarily, with an agreement over next year's budget; and that U.S. growth will remain buoyant even in the face of higher rates (implying that the neutral rate is higher than widely believed), then global growth should stabilize by the middle of next year. The dollar tends to weaken whenever global growth accelerates, which should provide a further reflationary impulse to the world economy.

Equity bull markets typically end about six months before the onset of a recession (**Table 1**). If the next global recession does not occur for at least another two years, this will provide enough time for a blow-off rally in stocks starting in mid-2019. Hence, investors should stay tactically cautious towards global equities over a 3-month horizon, but be prepared to turn cyclically opportunistic over a 6-to-18 month horizon.

Over the past few months, we have argued that bond yields will temporarily decline due to slower global growth amid widespread bearish bond sentiment. This has indeed happened. Yields are likely to remain under downward pressure into early 2019, but should then begin to stabilize and move higher, ultimately rising much more than expected as global inflation accelerates.

TABLE 1

Too Soon To Get Out

ANNUALIZED REAL RETURNS (%) PRIOR TO RECESSIONS	MONTHS PRIOR TO RECESSION 13-24 MONTHS	1-24 MONTHS	7-12 MONTHS	1-12 MONTHS	1-6 MONTHS	NON-RECESSION MONTHS
S&P 500	Returns tand to be strong in the late stage of the business cycle...				...but don't overstay your welcome	
AVERAGE RETURNS POST-1950s	**14.2**	**6.8**	**8.0**	**0.1**	**-7.8**	**10.1**
JUL 1953 - MAY 1954	21.9	12.0	17.8	2.0	-13.8	14.7
AUG 1957 - APR 1958	15.8	7.1	-17.0	-1.6	13.9	19.3
APR 1960 - FEB 1961	31.3	16.8	6.6	2.2	-2.2	15.8
DEC 1969 - NOV 1970	13.4	-1.3	-11.0	-15.9	-20.7	5.8
NOV 1973 - MAR 1975	16.9	4.9	-11.3	-7.0	-2.7	6.2
JAN 1980 - JUL 1980	0.5	2.2	6.8	5.4	4.0	3.1
JUL 1981 - NOV 1982*	...	...	32.2	10.5	-11.2	4.0
JUL 1990 - MAR 1991	14.3	13.1	22.2	11.9	1.6	14.0
MAR 2001 - NOV 2001	8.9	-0.7	20.0	-10.3	-40.6	12.5
DEC 2007 - JUN 2009	11.6	7.6	13.6	3.6	-6.3	4.0

In more recent business cycles, investors have reaped strong returns in the 7-to-12 months prior to the recession

* FIRST 2 COLUMNS OMITTED DUE TO OVERLAP WITH PREVIOUS RECESSION PERIOD.
NOTE: MONTHLY RETURNS ARE ANNUALIZED AND DEFLATED BY THE CONSUMER PRICE INDEX; CALCULATIONS ARE BASED ON TOTAL RETURN INDEX.