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Perspective on Today's Market Events

It looks like the U.S. stock market will finally get something that happens, on average, about once a year: a 10+% percent drop—the definition of a market correction. The last time this happened was a whopper—the Great Recession drop that caused U.S. stocks to drop more than 50%--so most people today probably think corrections are catastrophic. They aren't. More typically, they last anywhere from 20 trading days (the 1997 correction, down 10.8%) to 104 days (the 2002-2003 correction, down 14.7%). Corrections are unnerving, but they're a healthy part of the economy—for a couple of reasons.

Reason #1: Because corrections happen so frequently and are so unnerving to the average investor, they "force" the stock market to be more generous than alternative investments. People buy stocks at earnings multiples which are designed to generate average future returns considerably higher than, say, cash or municipal bonds—and investors require that "risk premium" (which is what economists call it) to get on that ride. If you're going to take more risk, you should expect at least the opportunity to get considerably more reward.

Reason #2: The stock market roller coaster is too unsettling for some investors, who sell when they experience a market lurch. This gives long-term investors a valuable—and frequent—opportunity to buy stocks on sale. That, in turn, lowers the average cost of the stocks in your portfolio, which can be a boost to your long-term returns.

The current market downturn relates directly to the first reason, where you can see that bonds and stocks are always competing with each other. Monday's 4.1% decline in the S&P 500 coincided with an equally-remarkable rise in the yields on U.S. Treasury bonds. Treasuries with a 10-year maturity are now providing yields of 2.85%--hardly generous, but well above the record lows that investors were getting just 18 months ago. People who believe they can get a decent, relatively risk-free return from bond investments are tempted to abandon the bumpy ride provided by stocks for a smoother course that involves clipping coupons. Bond rates go up and the very delicate supply/demand balance shifts, at least temporarily, in their direction, and you have the recipe for a stock market correction.

This provides us all with the opportunity to do an interesting exercise. It's possible that the markets will drop further—perhaps even, as we saw during the Great Recession, much further. Or, as is more often the case, they may rebound after giving us a correction that stops short of a 20% downturn. The rebound could happen as early as tomorrow or some weeks or months from now as the correction plays out.

Once it's over, no matter how long or hard the fall, you will hear people say that they predicted the extent of the drop. So now is a good time to ask yourself: do I know what's going to happen tomorrow? Or next week? Or next month? Is this a good time to buy or sell? Does anybody seem to have a handle on what's going to happen in the future?

Record your prediction, and any predictions you happen to run across, and pull them out a month or two from now.

Chances are, you're like the rest of us. Whatever happens will come as a surprise, and then look blindingly obvious in hindsight. All we know is what has happened in the past. Today's market drop is nothing more than a data point on a chart that doesn't, alas, extend into the future.

Should We Be Alarmed?

Suppose somebody came up to you and shouted: "I have terrible news about the economy. I think you should sell your stocks!"

Alarmed, you say: "Oh, my God. Tell me more!"

And this mysterious stranger shouts: "Run for the hills! The American economy just added 200,000 more jobs—more than expectations—and the U.S. jobless rate now stands at 4.1%, the lowest since 2000!"

You blink your eyes. So?

"There's more," you're told. "The average hourly earnings of American workers have risen a more-than-expected 2.9% over a year earlier, the most since June of 2009! You should sell your stocks while you can!"

Chances are, you don't find this alarmist stranger's argument very persuasive, but then again, you don't work on Wall Street. After hearing these benign government statistics, traders rushed for the exits from the opening bell to the closing, and today the S&P 500 stocks are, in aggregate, worth 2.13% less than they were yesterday. The Nasdaq Composite index fell 1.96% and the Dow Jones Industrial Average, a somewhat meaningless but well-known index, was down 2.54%.

To understand why, you need to follow some tortuous logic. According to the alarmist view, those extra 200,000 jobs might have pushed America one step closer to "maximum employment"—the very hard-to-define point where companies have trouble filling job openings, and therefore have to start offering higher wages. No, that's not a terrible thing for most of us, but the idea is that if companies have to start paying more, then they'll be able to put less in their pockets—and the rise in the hourly earnings of American workers totally confirmed the theory.

If you're an alarmist, it gets worse. If American workers are getting paid more, then companies will start charging more for whatever they produce or do, which might raise the inflation rate. "Might" is the operative word here. There hasn't been any sign of higher inflation, which is still not as high as the Federal Reserve Board wants it to be. But if you're a Wall Street trader who thinks the market is in a bubble phase, you aren't necessarily looking at facts to confirm your beliefs.

Suppose you're not an alarmist. Then you might notice that 18 states began the new year with higher minimum wages, which might have nudged up that hourly earnings figure that looked so alarming a second ago. And some companies have recently announced bonuses following the huge reduction in U.S. corporate tax rates, whose amortized amounts are also finding their way into wage statistics.

Meanwhile, those same government statistics are showing a resurgence in factory activity and a rebound in housing, which account together for more than 50,000 of those new jobs.

So the question we all have to ask ourselves is: are we alarmists? Selling in anticipation of a bear market has never been a great strategy, even though stocks are admittedly still priced higher than they have been historically.

If you are not an alarmist, then you have something to celebrate. The S&P 500 has now officially ended its longest streak without a 3% drop in its history. It's an historic run not likely to be seen by any of us again. The truth about the markets is that short, sharp pullbacks are inevitable and routine—unless you were living in the past year and a half, when we seemed to be immune from normal market behavior.

Source:

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