Weekly Market Insights

December 31, 2018

A Wild Ride, Positive Economics and Continued Confusion - Oh and Happy New Year!

As we are all aware, U.S equity markets went on a wild ride this past week. Investors watched in wonderment, not at sugar plums, but at the violent gyrations of the market.

On Monday, the Dow lost 600 points in just a half a day's trading, only to see a record reversal and have a one day point gain of over 1,000 points on the next trading day, which of course was Wednesday, the markets being closed on Christmas. When the week finally ended, the DJIA gained 2.75%, the S&P 500 2.86% and the NASDAQ 3.97%. Why all the drama and volatility? Economic releases were certainly not bearish. The CPI is well within the Fed's comfort range, industrial production rose 0.6%, not earth shattering but certainly very respectable, while capacity utilization was 78.5%. That is below the U.S. long term average, but strong nonetheless, and two of the most important leading indicators, unemployment and wage growth, were quite positive indicating a strong jobs market and healthy consumer. One disappointing release was consumer confidence. Although it remains well above the long term average, it did fall a bit. This can easily be attributed to high volatility in the financial markets and political turmoil. Brexit and China are legitimate worries for investors, but, in our view, not enough to warrant recent market behavior.

What else, in the face of very reasonable economic reports, can account for this very erratic volatility and an equity market clearly going to end the year in negative territory?

Lots! As we wrote last week, confusion and turmoil in the government not only makes investors skittish, but also may go a long way in explaining the drop in consumer confidence. Investors and the general public face a confusing political 2019. We have a government shutdown, with the Administration saying it will not relent until Congress gives it the funds to build the "wall." No one, of course, knows how it will turn out, but with a dramatic change in Congress, it is unlikely to be resolved easily or quickly. This change in power will create a lot of confusion and turmoil. Investors looking for some type accommodation are likely to be sorely disappointed. There will be lots of unpleasant hearings on the Hill. So, there may be precious little legislative activity going on. We will also be getting the Mueller report. Depending on the seriousness of the charges, the country may go through another impeachment. Even if the charges don't appear to justify impeachment, there is so much ill will that Congress may try to enact impeachment anyway. These are all unanswerable questions that are very important for markets. There will have to be some conclusions to these questions before investors can feel comfortable.

Another interesting thought has to do with why there are such dramatic market swings.

We and others have suggested that algorithmic funds and other momentum driven trading strategies may be causing excessive volatility. These funds have the ability to sell huge numbers of shares and when they sell or buy, there is little or no selectivity, nor is there much subtlety about the trades. This can create chaos in the markets. No one really knows what the effects are on market behavior, but soon, many academic and regulatory studies will be done and we will have an answer. Why do we care so much about the effect of these funds on market behavior? We are in favor of free and open markets! There are many reasons for this. Markets are very efficient. They are the best known way to achieve price discovery, and they pass on vital information through the seeming uncoordinated behavior of millions of participants. For all of these reasons, and many others, markets are necessary for a smoothly run economy. Our question is, does this type of activity detract from the purpose and efficiency of the markets? At first blush, they seem not to be very helpful and may be detrimental. They create an excess of volatility and the trading they do doesn't seem to help market liquidity, nor efficient price discovery. No one knows the answer.

The answer is becoming more and more important to investors every year. It started sometime after 1978 when Congress passed legislation creating 401(k) programs. This of course was to replace corporate pension plans. This is fine, but when 401(k)'s and IRA's started to replace pension plans, it forced many unsophisticated investors into the markets. Everyone knows that equity markets can be volatile and all investors can and do make poor choices. If a rapidly growing portion of a country's population is becoming dependent on these markets, there is nothing wrong with ensuring the smooth and efficient operation of the market. It may very well be that the studies show these funds are a positive, but until they are done, we won't know.

In a pure economic sense, we don't foresee a serious economic problem for the United States. But the world is fraught with political mine fields so investors, as always, must remain vigilant.

All of us at 1919 wish all of you a very happy New Year.

Michael

- Michael Olin Clark
moclark@1919ic.com