Weekly Capital Market Comments

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Will Stocks Ever Go Down?

A few weeks back, we published a note entitled "End of the Beginning," where we suggested that weak underlying economic fundamentals simply do not support current market valuations. After all, isn't the value of any asset the sum of the discounted present value of future cash flows? ?And if the cash flows are under pressure, shouldn't valuations suffer? Well, even since that note, the S&P has rallied another 3.1%, practically erasing the 34% draw-down between February 19th and March 23rd. So the question remains, will stocks ever go down?

Since the end of July, economic data has been mixed, but on the margin – results have been better than expected. Still, at the same time, we would characterize the "bar" as being rather low. The JOLT survey for June bounced up to 5,899 but is still now back only to December '17 levels. The draw-down in wholesale inventories was better than expected, but the June reading was negative 1.4%, compared to the consensus expectation of negative 2.0%. The Unemployment Rate for June recovered and is now 10.2%, while this week's Initial Claims improved to only 963k, compared to the consensus forecast of 1.1 million. Financial media is celebrating the first week of below 1.0 million in unemployment claims – yes, the bar is set rather low. Then you have the continued bickering in DC, with Democrats and the POTUS continue to dig in over the next round of COVID stimulus. So, we pose the question again, will stocks ever go down?

Well – in a perverse way, everything we just highlighted (along with other dysfunctional economic data) has actually helped keep equities elevated. And the reason is simple, professional investors, trying to see around corners, are betting that the Fed will do "whatever it takes" to push inflation higher and keep rates lower for longer. And in doing so, the Fed has created an environment of "negative" real interest rates. Negative rates theoretically occur when borrowers are credited and interest rate, that after taking into inflation, is negative. A simple example; currently, let's say a money market interest rate is only 0.2% (or 20bps), but inflation is running at 1.5% (or 150bps). This means, your deposits are actually losing value in real terms (0.2% minus 1.5% = -1.3%), hence a "negative interest rate."

As a result, these negative implied interest rates support asset prices because since the real return on cash (the real interest you get by putting money in the bank) is negative, TINA (there is no alternative) kicks in. Investors then resort to the likes of Facebook, Apple, Amazon, Tesla, or Netflix. But just like a game of musical chairs, at some point, the music stops, and one chair (either stock A, B, or C) is removed because of either an inescapable fundamental or valuation concern. This happens until there are no chairs left.

We'd love to hear your thoughts.

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