Why Markets Move – Don't Look At Economic Logic

by David Walter July 25, 2022

As I've often mentioned in client meetings and these letters, don't look for economic logic in markets over the short term.

Long-term market trends (i.e., years), are a result of monetary policy that comes via central banks and fiscal policy from governments.

Intermediate-term trends (i.e., months or weeks) usually reverse from bearish to bullish as follows: Large speculators, generally hedge funds, decide markets have come down enough for the time being and there are trading opportunities to be had. They're followed by CTAs: Commodity Trading Advisors. Trend-following is their game. They reverse positions without regard to valuations. Their models are computer-based and all they want to do is to get the meat of the new trend. Next come passive index funds. They buy blindly. They neither care about trend nor valuation. Then, we get the retail crowd. They're the last ones to reverse and many buy high and sell low. Finally, active investment managers round out the strategies. They invest based on valuation. Buy low, sell high.

Economic trends are getting worse all the time. Retail, home, and auto sales have declined. Retail inventories are up (i.e., more supply). Mortgage interest rates have doubled resulting in reduced refinancings and home sales. Layoffs in the tech industry are rising dramatically. Companies like Apple, Amazon, etc., that never had such issues before, are now laying off employees by the thousands. At the same time, retail sellers can't find workers.

COVID resulted in economic changes that were never predicted. Central banks follow lagging indicators and are not forward-looking. They read the major media headlines like everyone else and then react. They're tightening monetary policy while the economy is screaming that a recession is coming if not already here. In this economy, soft landing or hard will depend on when the Federal Reserve reverses position. The economy may already be in a recession.

In the last couple of weeks, markets have reversed the intermediate-term trend. Hedge funds started it, followed by CTAs. Once the CTAs got involved, markets started really moving up even though economic logic said to go down. Active investment managers, for

the most part, are out of the markets except for pruning positions here and there. How far the recent rally can go is unknown. They could easily go up another 5-10% based on pure speculation. As I've mentioned many times, bear markets don't go straight down. There are usually significant rallies along the way down.

Monetary policy is tight and there's no letup in sight from central banks around the world to undo the damage they created from the extremely loose monetary policy that came after COVID-19 started in 2020. Valuations are much better than they were six months ago, but just the way they were overextended in the bull market, bear markets usually take them to extreme undervaluation. In a bear market, a different strategy is required from what is used in bull markets.

Buying intermediate-term reversals and selling rallies is the way to go in this environment. Even though there are decent valuations to be had, bear markets usually take good value and eventually go to extreme undervaluation. Long-term bonds offer good value for the longer term. It's the same for new era stocks; artificial intelligence, robotics, cloud computing etc.. We're heading into a recession, and that means longer-term rates coming down even while the Fed is raising short-term rates through the end of the year.

Safety comes first and trading opportunities come next in this kind of market. Do not underestimate what may happen. Peak to recent trough was 30-40% down. Bear market rallies of 50% or more of that decline are not unheard of. If that were to happen, that implies a 15-20% rally off the bottom or another 5-7% up from here. Robotic and algorithmic trading strategies can take the numbers further in either direction. Finally, we can't forget the lurking global and macro triggers under the surface (i.e., emerging markets debt and the Russia-Ukraine war).

We continue to recommend sizable cash positions in portfolios. We also recommend staying open to the idea of buying large blue chip Megacaps for short-term trades.

The Fed will eventually pivot in a reversal of their monetary policy. This will coincide with the major media screaming headlines about the deep recession we're in, along with "gurus" telling us why markets have much further to go down. *That* will be the time to buy stock with both hands. That is not yet.

One final note: The history of a new president's first term is a weak second year to be followed by a strong third year in markets. It's not a guarantee, but it gives us a high probability of favorable outcomes in late 2022 and 2023.