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2020 4th Quarter Stock Market Commentary

CASINO CAPITALISM

"An unsophisticated forecaster uses statistics as a drunken man
uses a lamp-post – for support rather than for illumination."
– Andrew Lang

Since time immemorial, people have been looking for signs that would reveal the future. During the first millennium B.C. the seafaring Phoenicians established an outpost in Carthage, a city on the Gulf of Tunis. Carthage, with a powerful navy, grew to become the dominant power in the Western Mediterranean, ruling over what became known as the Punic Empire When the Romans, who traditionally had a powerful army but a weak navy, sought to extend their reach from the mainland to the islands of Sicily, Corsica and Sardinia, the Carthaginians resisted, triggering the first of the three Punic Wars in 263 B.C.

The Romans placed a populist politician and street agitator named Publius Claudius Pulcher in charge of their navy. At the time the custom was to use birds to predict the future, studying their calls and flight patterns as omens. In particular, chickens were used to predict the outcomes of battles. Priests scattered grain in front of specially raised chickens, and the enthusiasm with which the birds ate was said to correspond to the degree of success that the Roman forces would enjoy that day.

Pulcher decided that one particular day was perfect to attack the Carthaginian fleet, and so he decided to consult the chickens. But the chickens were less than excited by his battle plan and refused to eat anything. Pulcher had the chickens thrown overboard, saying, "If they won't eat, let them drink!" He ordered his ships into battle and suffered a crushing defeat.

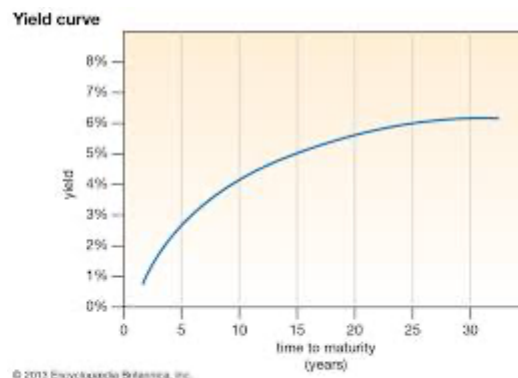
Pulcher was recalled to Rome and put on trial—not for losing the battle but for the sacrilege of killing the sacred chickens. He was sentenced to exile and died soon after. It is worth noting that, at least on this particular occasion, chickens proved to be an excellent leading indicator.

For investors and business executives, financial markets have generally proven to be a useful indicator of future economic activity. After all, stock, bond and commodity prices reveal

consensus expectations of economic conditions 6-18 months in the future. Financial markets are said to reflect, or "discount," what people believe will happen.

Consider, the bond market, where bond investors, as a group, are generally perceived as being smart money. They are temperamentally less prone to the wild bouts of fear and greed that typically plague the stock and commodity markets. This is not to say that the bond market is always right. However, bond investors—as a group—are generally seen as being "smart money" and less prone to the type of speculation seen in stocks or commodities. As a result, bonds actually do have a fairly strong track record as a predictor of economic conditions. For that reason, they are often used by economists as a leading indicator. If nothing else, the bond market can provide a gauge of the consensus expectation regarding the economy at any given point—even if that expectation sometimes proves incorrect.

The best way to use bonds to predict the economy is to look at the "yield curve." Yield is the return or income that an investor will get from buying and holding a bond. The yield curve is simply a graph with the x-axis representing the time to maturity, usually from three months to thirty years, and the y-axis being the yield to maturity. The yield curve typically slopes upward towards the right (as shown below), since investors demand higher yields for holding longer-term bonds. Longer dated bonds carry greater risk of default, and erosion of purchasing power due to future inflation.

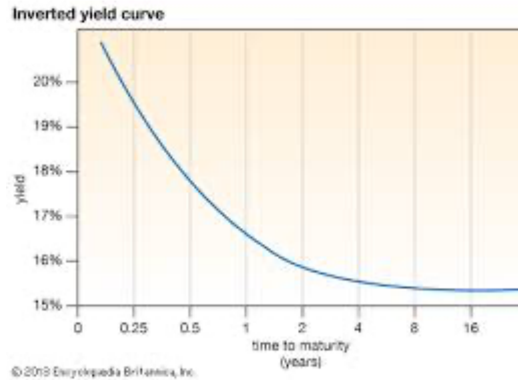


Since yields for bonds of all maturities change every day due to market fluctuations, the "shape" of the yield curve is always changing. It is these changes that provide insight into the economic outlook.

Historically, the performance of short-term bonds (those with maturities of two years or less) is determined by expectations regarding future Federal Reserve policy with regard to the federal funds rate. The performance of longer-term bonds, by contrast, is largely driven by the outlook for inflation and economic growth rather than Fed policy.

The important aspect of this relationship to understand is that while short-term yields are tied to the Fed's interest rate policy, longer-term bonds experience higher volatility based on shifts in the broader outlook. Expectations for the economy, therefore, tend to have a strong influence on the shape of the yield curve. The higher the expectations for future inflation and economic growth, the steeper the yield curve.

On rare occasions, the yield curve can become “inverted”—meaning that short-term bond yields are higher than long-term bond yields. When this is the case, it indicates that investors see a high likelihood of a recession ahead.

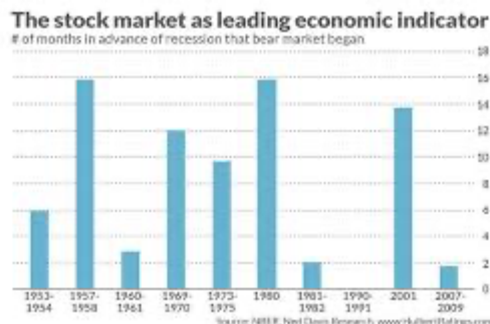


The yield curve has, in fact, forecast each of the last seven recessions, although it should be noted that there have been yield curve inversions when a recession did not follow.

The yield curves reputation as a predictor of the future is well deserved. In a 2006 paper titled “The Yield Curve as a Leading Indicator: Some Practical Issues,” written by Arturo Estrella and Mary R. Trubin of the Federal Reserve Bank of New York, the authors conclude: “Since the 1980s, an extensive literature has developed in support of the yield curve as a reliable predictor of recessions and future economic activity more generally. Indeed, studies have linked the slope of the yield curve to subsequent changes in GDP, consumption, industrial production, and investment.”

Currently, the yield curve is relatively flat, an historical harbinger of slowing economic growth.

The stock market has also historically served as an accurate “leading” indicator, meaning its price movement tends to foreshadow subsequent economic events. There have been ten post-World War II recessions, as defined by the National Bureau of Economic Research. The stock market experienced a bear market on nine of those occasions, preceding the declaration of a recession by an average of 7.9 months. The sole exception was 1990 when both the bear market and the recession began in July. Moreover, the accuracy of the stock market as a forecasting tool has increased sharply over the past 70 years.



Just as the yield curve has occasionally sent misleading signals, the stock market has also often plunged without a subsequent economic downturn. This gave rise to economist Paul Samuelson's sarcastic quip that "The yield curve has forecast nine of the last five recessions."

So what are the stock and bond markets currently predicting? We have already noted that the bond market's flat yield curve is signaling an economic slowdown. If a slowdown is imminent, investors should raise cash levels, and rotate their holdings towards defensive sectors like consumer staples, healthcare and utilities. On the other hand, the stock market's strength would suggest a robust economic recovery. In that case, investors should remain fully invested and focus on communications services, energy, industrials and technology. It is not just investors who have lost signposts. Policy makers are also hampered by the loss of information content in many signaling mechanisms. The appropriate duration and size of future stimulus programs should be highly dependent on the likely direction of the economy, ignoring politics.

The fact is, there is no easy way to resolve this dilemma, because the Federal Reserve's unprecedented near zero interest rate policy has wiped out the significance of traditional predictors and turned the financial markets into a giant casino. Place your bets.