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Market Turbulence

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We have once again entered a period of substantial market volatility. Using the Dow Jones Industrial Average as a measure of the market, large moves have been observed in recent months. As an example, consider the week ending October 4. On Tuesday of that week, the Dow fell 344 points, followed by a 494 point drop on Wednesday. These drops were followed by rebounds of 121 points on Thursday and 373 points on Friday. Given the level of the Dow is approximately 26000, these moves are not excessive in percentage terms, but nonetheless they certainly can be a source of concern.

What is the source of this heightened volatility? Often, these volatile periods can be explained by a primary factor – for example, a dramatic economic slowdown. However, in the current environment the volatility driver is multidimensional in nature. One dimension is the prospects for future economic growth. Another dimension is the role of political considerations elevated by the election next year.

Economists expect real economic growth to decline in 2019 relative to solid 3% growth in 2018. Indeed, many fear that a recession is imminent. However, as discussed by my colleague Keith Hardman in the August newsletter, predicting recessions is very difficult. Indeed, many of these economists predicting a recession in 2020 have wrongly predicted a major downturn over the past two years. A consensus forecast for GDP growth in the third quarter of this year is 1.8% and for the calendar year 2019 is 2.1%. Further, economic news is not uniformly bad. On the positive side, jobs growth has remained solid and the unemployment rate is at a fifty year low.

Outside of the U.S., the economic slowdown has been global in nature. For example, a slowdown has occurred in both China and most European countries. In aggregate, the combination of recent

data and economic forecasts do suggest that in the near future slower economic growth is likely. However, a recession is far from a sure thing.

Slower economic growth primarily feeds into the value of the stock market through reduced current and future corporate earnings growth. Consistent with the moderating economic growth, corporate earnings growth is also anticipated to decline. Aggregate earnings growth for the S&P 500 stock market index for calendar year 2018 was over 22%. In contrast, according to FactSet, the expected earnings growth for 2019 is 1.2% -- a dramatic decline. But an earnings growth rebound is expected in 2020 with a growth projection of 10.5%. While this estimate is lower than 2018, it does provide hope that the economic slowdown could be short lived.

Implications of the political environment must also be considered when assessing the value of the stock market. Uncertainty in this area comes from many directions. One factor is the potential impact of ongoing trade disputes with Europe and especially China. These disputes are clearly eroding market confidence and depressing market values. If these disputes can be resolved, it is likely a significant market rebound would occur.

Another factor that is dominating discussion in the market place is uncertainty created by the election next year. Many proposals are being aired by both sides of the aisle. The economic implications of most of these proposals are difficult to develop. In a sense there is double uncertainty here, since the election outcome is unknown and the proposals that will actually be implemented are unknown. The impact is high volatility since new news about either of these unknowns does move the market.

On the positive side, interest rates have stayed low. This year, the Federal Reserve has been cutting the fed funds rate to stimulate economic growth. Indeed, current market expectations are that further cuts could still be coming in 2019. This “dovish” Fed stance is always welcomed by market participants, and is believed to reduce downward pressure on the market.

How should one respond to the current environment if at all? First, it is important to keep in mind the unpredictable nature of the stock market. As previously noted, many economists have been forecasting a recession for the past two years. Eventually, they will be right. But it may not be next year that a recession occurs but rather five or more years down the road. Maintaining solid economic growth is a goal of both the Republican administration and the Federal Reserve. Given this, it is premature to sign on to a major economic slowdown.

However, from a risk control perspective, it is prudent not to increase equity exposure and to reduce the risk of one’s fixed income allocation. At PMA we have recently decided to lower the fixed income risk by reducing the allocation to high yield bonds. This is a topic that we will continue to discuss at our 3rd quarter investment committee meeting on October 16th.

There are many things happening in the market place that need to be considered when analyzing valuation and the risk of stocks and bonds. The investment process should reflect all these factors. At PMA, we include these factors in our analysis as we strive to control risk and to achieve high risk-adjusted performance.