Normalization: How A Rational Market Downturn Yields Irrational Fear

Since the market bottom of 2009, unbridled Federal Reserve policy urged investors to board the bandwagon of a multiyear market upswing. And for almost seven years following one of our history's worst financial crises, many investors left caution in the dust.

Still, others remained skeptical, fixating on the underlying influences of the rally. As the clock struck midnight of the New Year, markets snapped back to reality, proving the merit of long-term investing amid a new wave of short-term market fears. The former bulls have begun to flounder, moving to cash and locking in losses. Meanwhile, others will choose to ride above the noise and avoid the impulses that destroy long-term financial success.

Easy Money

In the run-up since 2009, some investors worried markets had detached from reality. Fundamental analysis of firms and of overall economic strength fell by the wayside as unprecedented policies from the Federal Reserve (Fed) urged equities higher. Ongoing rounds of quantitative easing (QE) suppressed interest rates, lowering yields on safer assets and driving investors into the stock market. If markets wavered, the Fed eased investor angst with veiled promises for continued stimulus.

Former Fed Chair Ben Bernanke even acknowledged that the rush to equity markets was an intentional effect of QE, as he believed strong financial markets would lead to economic growth:

> "...higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

To some investors, the Bernanke theory seemed a bit backward even as stocks began to soar. Rather than investors driving equity markets higher based on confidence in a growing economy, Mr. Bernanke was hoping for the reverse: For consumers to spend based on confidence in rising equity markets.

So the truth was right there all along: The Fed wanted to prop up equity markets. Risk-on investors took advantage, and greed overcame the logic that one day markets might refocus on true economic fundamentals rather than the coddling hand of central banks. Since the inception of the final round of QE, the Fed's hesitation to even slightly raise rates has exposed a lack of confidence in our economic growth. Indeed, those years in a raging bull market didn't fully restore the economy as Bernanke suggested.

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Despite minimal inflation and other economic weakness, the Fed finally began raising interest rates toward "normalization" for the first time since before the recession. Markets awoke from their New Year's hangovers to a haunting realization: Global economies may face a rough patch, and the central bankers have very little left to combat the problem. As a result, equities have endured the worst start to a year in the history of the stock market.

In a recent CNBC interview, Former Dallas Fed President Richard Fisher reiterated the Fed's initial reasoning for QE. "What The Fed did…was front-loaded an enormous market rally in order to create a wealth effect," Fisher said.

The start of 2016 suggests the wealth effect has worn off, and investors have finally stumbled upon the chasm between economics and valuations. Mr. Fisher stunningly acknowledged that markets could face volatility as they move back toward rational valuations following the Fed's artificial acceleration:

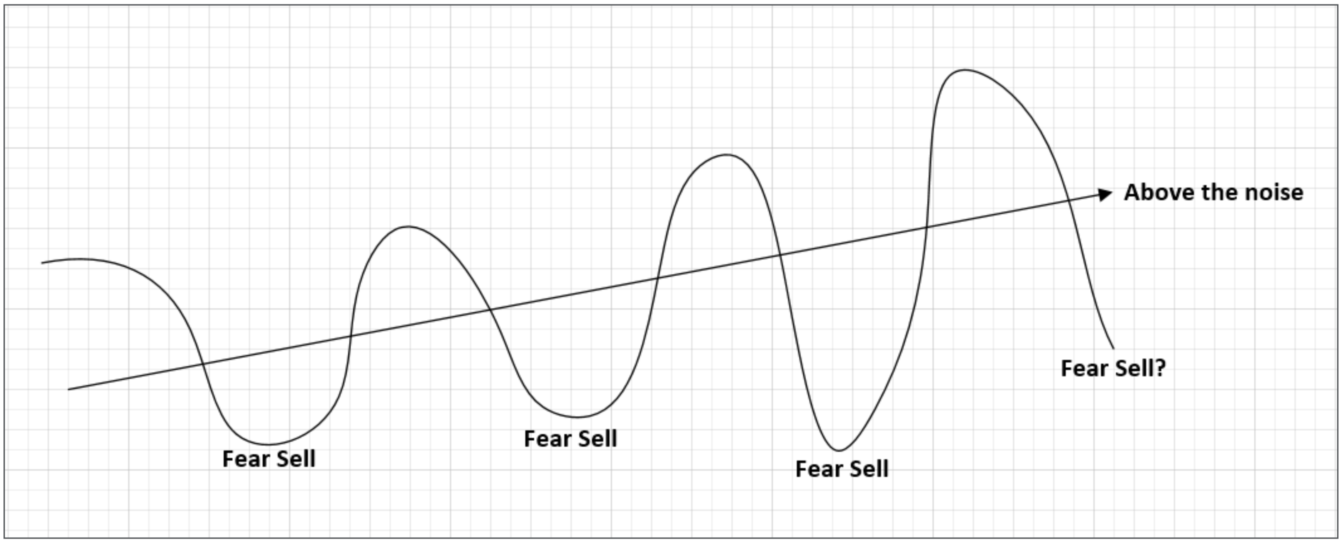
> "Now we go back to fundamental analysis, the kind of work that used to be done, analyzing whether or not a company—on its own—is going to grow its bottom line and grow its shareholder value and price accordingly, and not just expect the tide to lift all boats. Indeed, when the tide recedes, we're going to see who's wearing a bathing suit and who's not."

The move toward rate normalization has meant markets are no longer preoccupied with the timing and tone of Fed speeches. Suddenly, jobs reports matter again. China, oil, and corporate earnings matter again. Geopolitical crises matter again. In years past, the Fed might have calmed markets with a well-timed speech or interview about continued loose policy. Now, markets must relearn how to absorb the volatility of changing fundamentals and external forces. Meanwhile, markets have become aware of the Fed's self-inflicted lameness, and that a reversal of the plan for additional rate hikes—or the implementation of additional QE—could rile markets further if additional weakness arises.

Forces of Fear

In some sense, markets have chosen to become more rational, finally reacting to the valuation gap left behind from years of easy money policy. But rational downturns can bring about irrational fear, intensifying the impulsiveness of trading. And today, technology spreads fear unlike ever before, as computer algorithms trigger large-volume trades, often adding to the atmosphere of panic. Meanwhile, screens of our phones, TVs, and tablets light up with breaking news headlines as we watch "expert" talking heads explain the nuisances of every trade. Such exposure, coupled with ingrained human tendencies, can force the hand of an investor, manifesting as investment choices that destroy financial security.

In particular, the risk-on bulls that refused to miss any part of the upswing now can't handle short-term price declines. Instead, irrational fear compels investors to sell out of positions, locking in significant losses and missing positive day-to-day reversals. When the market heads higher, greed will force those same investors to buy back into markets too late. Those investors will have missed the upward correction, instead both locking a loss at the bottom and paying a premium at the top. Even investment manager "gurus" that attempt to harness fear by timing the market have continuously proven the failures of such practices.



The Power of Rationality

Meanwhile, rationality floats above fear and above the noise of short-term trends. Investors with a longer-term approach don't presume the inevitability of full-blown market crashes. Instead, they presume the inevitability of uncertainty from rational market changes like we've seen recently. Many of these investors even presumed that Fed policy to prop equities would ultimately fail. But the recent effect of Fed policy is merely the latest example of the importance of sticking to a plan. Whether or not an investor actually foretold the Fed effect is, ultimately, irrelevant, as long as that investor remains cautious, well-diversified, and within the original plan.

Investors build globally diversified portfolios because they never presume they can predict both the effect and timing of influences like Fed policy. Such portfolios will always face volatility, and some positions even vastly outperform others. But unlike market-timing or fear-based trading, diversification can suppress the impulses that lead to disastrous investment choices. Investors must learn to accept the reality that no one can consistently predict what's to come, or when, or how markets will decide to react at that moment. These are the moments when investors must make the choice to weather the storm or become part of the debris. As fear persists and markets absorb the move toward normalization, investors with properly diversified portfolios should focus on what's important: They've planned for this all along.

Sources

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