

# KANAWHA CAPITAL MANAGEMENT

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## ***IS WINTER COMING?***

**July, 2019**

At the end of June, America's economic expansion officially hit the 10-year milestone. It now stands as the nation's longest on record. Meanwhile, although occasionally interrupted by a violent reversal, the stock market has risen significantly over the same timeframe. But with all the financial and geopolitical cross currents these days, many observers are second-guessing the durability of both the expansion and bull market.

### **Befriend the trend**

Newton's *First Law of Motion* famously states in part that "...a body in motion will remain in motion unless it is acted upon by an external force." While the immutable laws of physics hardly apply to the *dismal* science — or to the fickle stock market — one can draw some parallels. For instance, the *First Law of Equity Markets* might be that the "trend is your friend".

That is, stock prices move in cycles, often extended ones; they gain momentum. So what external forces might derail the secular bull market? Typically, bear markets correspond with recessions. While the current economic expansion has been long-lived, no bell will automatically toll for its demise. The recovery from the Great Recession has been the most sluggish in the post-World War II era. Crisis-induced caution has tempered the behavior of households and businesses.

### **No bubble to pierce**

Recessions usually occur when rising rates expose serious imbalances. The two most recent contractions were primarily driven by the unwinding of financial market imbalances that coincided with asset price bubbles. In the late 1990s, over-investment in the technology sector proved the culprit and in the following decade, the housing sector. Today, the economy is not displaying the excesses or over exuberance that characterize the end stage of a business cycle. No asset bubbles or other major imbalances appear evident.

Every expansion has its own tone, but they tend to end the same general way: Imbalances form, the economy shows signs of overheating, inflation expectations rise, and the Federal Reserve steps in to pull away the punch bowl. As MIT economist Rudi

Dornbusch quipped in 1997, “None of the U.S. expansions of the past 40 years died in bed of old age; every one was murdered by the Federal Reserve.”

### **Lower for longer**

“Don’t fight the Fed” denotes a second law of equity markets. Accommodative policy benefits stocks while restrictive measures punish them. And rather than removing the bowl, Powell and company are now spiking the punch. The Federal Reserve has pivoted dramatically in that last six months — from hiking rates to signaling a rate cut as soon as July. Indeed, central banks around the world have modified their posture in favor of more easing.

Why the dovish shift? Policymakers have become increasingly concerned about an outlook for slowing global growth, in part due to the trade spat. Bond markets have embraced the same view. Worldwide, long-term rates have plummeted. The 10-year U.S. Treasury yield moved below 2% in early July. Yields on 10-year sovereign bonds issued by Germany, France, and Japan are actually *negative*, underscoring the deflationary pressures overseas.

In the years following the financial crisis, the Fed took extraordinary measures to jumpstart the economy and goose inflation. But inflation expectations have dropped back down. There now seems to be a renewed urgency to sustain the expansion. This environment suggests the Federal Reserve may adopt a policy stance that risks running too hot rather than too cold.

### **As goes China**

Lower policy rates should ease global financial conditions and act as a tailwind to help restore growth. However, Chinese activity remains a key swing factor. That nation’s growth rate had been slowing even before Trump began lobbying tariffs. Chinese authorities are taking increasingly aggressive steps to mitigate the effects of the trade spat on their domestic economy.

While the dispute may dampen worldwide growth, the greater the impact, the higher the odds that the Chinese will pull all available levers to recharge their economy — and bail out the world. Due to its size, the Chinese economy has a large multiplier effect, particularly for export-reliant regions such as Europe and the emerging markets. A reflatting China should boost global growth.

### **Mutually assured destruction (is MAD)**

Nevertheless, a full-blown trade war — one that moves beyond tit-for-tat tariffs — could have profoundly negative effects. Simply put, tariffs are taxes; although potentially costly, consumers and businesses will adjust. The greater risk is that the combatants select non-tariff barriers as the next

weapons of choice. For instance, cutting off companies' access to inputs and technologies needed in their global supply chains would threaten their ability to function. Taken to its logical end, capital investment, such as factories and equipment, could become stranded and worthless.

The Chinese telecommunications company, Huawei, has been targeted primarily (and legitimately) for U.S. national security reasons. But it offers a vivid example of how rapidly a business's fortunes can turn with the stroke of a pen.

A broad trade war would pressure equity markets. And the global economy may well seize up. Presumably, some voters would blame the administration, jeopardizing Trump's reelection chances. One would think this path's severe repercussions would dissuade its pursuit.

### **Speaking of the iron throne**

With national elections 16 months out and the political silly season gearing up, a warning for investors: Keep your politics out of investing. It is potentially lethal to allow personal views to influence one's expectations and outlook. Time and again, many have extrapolated the outcome of a presidential election through a partisan lens, and moved in or out of the market, accordingly.

Several academic studies over the last decade have documented a link between investors' political optimism and their propensity to hold stocks. When their preferred political party comes to power, investors tend to become much more sanguine about the economy and stock market. The reverse holds true when the opposing party takes office. Emotions can prompt investors to needlessly alter their asset allocation as well as the intensity of their trading. And empirically, trading activity has been shown to be negatively correlated with performance.

### **The cost of emotions**

For example, on the day President Obama was first elected in November 2008, the S&P 500 Index stood at 953. Those on the left were elated; those on the right lamented the outcome and an outlook for higher taxes and a more activist federal government, antithetical to business. The economy survived and buy-and-hold investors were rewarded. On Election Day eight years later, the S&P 500 Index stood at 2,149, an increase of 125%. However, those red investors whose pessimism translated into reduced stock exposure paid a heavy price.

Similarly, after President Trump was elected, those on the right celebrated while those on the left cringed at his nativist and nationalistic rhetoric. As with the ascension of Obama, there were widespread predictions that the stock market would tank. Yet once again — at least so far — the economy has expanded with the stock market following suit. From Election Day 2016 through the end of June,

the S&P 500 rose almost 40%, reaching a level of 2,942. Yet some blue investors have missed a portion of this rally as their political views led to self-destructive investment decisions.

This is not to suggest that elections are meaningless or that presidential administrations cannot significantly affect the direction of the country. But political biases should not drive investment decisions. Emotion represents the enemy of disciplined decision-making. From rabid sports fans to political partisans, those with an intense emotional interest in a subject often lose the ability to observe things objectively. Events are perceived selectively; facts that contradict one's viewpoint may be ignored. Behavioral economists term this faulty (but common) cognitive wiring, *confirmation bias*.

## Counterforces

We *can* confirm that the current investment backdrop is noisy, with a number of existential threats. But when has that not been the case? While global growth has hit a soft patch, a number of forces seem to be aligning to counteract the slowdown. Nevertheless, a favorable outcome will depend on a friendly Fed, a reflatting China, and the diminution of trade tensions.

Stock prices are inherently cyclical and at some point, the bull market must end. After all, the trend is your friend — until it isn't. But recessions rarely occur when monetary policy is supportive and bear markets almost never happen outside of recessionary periods. Moreover, history indicates that stock returns can be substantially higher towards the end of an expansion. So once again, the lesson is that it could be costly to attempt to time the market.

— *Christopher J. Singleton, CFA, Managing Director*

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