MV CAPITAL MANAGEMENT

Weekly Market Flash

Sometimes Bad News Is Actually Bad News

March 8, 2019

How do you tell whether someone is a novice investor or a seasoned observer of the ways of the capital markets? Simply pose a question like the following: “Growth data show a marked slowdown in economic activity in key economic regions like China and the European Union. Good or bad for global equities?”

“Bad!” says the novice. “Low growth means a poor outlook for companies’ sales and earnings, and that should be bad for the stock price, right?”

To which the seasoned pro chortles a bit and ruefully shakes his head. “Let me tell you how the world really works, kiddo. That low growth number? That’s good news! It means the central banks are going to prime the pump again and flood the world with cheap money. Interest rates will go down, stocks will go up. Easy as ABC!”

Down Is Up

The logic of “bad news is good news” has been a constant feature of the current economic growth cycle since it began in 2009 (and, barring any surprises, will become the longest on record come July of this year). The key economic variable of this period has not been any of the usual macro headline numbers: real GDP growth, inflation or unemployment. It has been the historically unprecedented low level of interest rates.

Short term rates in the US were next to zero for much of this cycle, with persistent negative rates (a phenomenon which itself flies in the face of conventional economic theory) in Europe and Japan. Central banks argued that their unconventional policies were necessary to restore confidence in risk assets and stimulate credit creation for the benefit of consumer spending and business investment. The evidence would seem to support the bankers’ view, as growth started to creep back towards historical trend rates while labor markets firmed up in most areas. The Fed has drawn its share of criticism for the easy money policies of quantitative easing (QE) from 2009 to 2015 -- but the Bernanke-Yellen-Powell triumvirate will forever be associated with the phrase “longest economic recovery on record” when that July milestone is reached.

Draghi Speaks, Markets Balk

But to return to that conversation between our novice investor and seasoned stock pro: Does “bad news is good news” always work? Is there a point at which the magical elixir of monetary stimulus fails to counter the negative effects of a slowing economy? That is a question of particular interest this week. On Thursday, the European Central Bank (ECB) backed away from its attempt to wean markets off easy money when it reopened the Targeted Longer-Term Refinancing Operations, a stimulus program to provide cheap loans to banks, for the first time in three years. ECB chief Mario Draghi made it clear that the catalyst for this return to stimulus was the steadily worsening outlook for EU economic growth.

This time, though, markets failed to follow the “bad is good” script and reacted more the way our novice investor would think makes sense: selling off in the face of a likely persistence of economic weakness. Italy is already in recession, Germany is only barely in growth territory, and demand in the major export markets for leading EU businesses is weakening, most notably in China. That economy, the world's second largest, has its own share of problems. A record drop in Chinese exports -- far worse than consensus expectations -- sent Chinese shares plunging overnight Thursday. Other Asian export powerhouses including South Korea and Japan are also experiencing persistent weakness in outbound activity.

Pivot to Fundamentals

In our annual outlook published back in January we noted that weakness in Europe and China was prominent among the X-factors that could throw a wrench into markets in 2019. For much of the time since then it has not seemed to be much of a factor. World equity markets bounced off their miserable December performance in a relief rally driven by the "bad is good" logic of a dovish pivot by central banks, underscored formally by the Fed in late January.

But the market's underwhelming response to the ECB on Thursday, amid a vortex of troubled headline data points that now includes a tepid US February jobs report, suggests that real economic activity may be starting to matter again. In just a few weeks we will start to see corporate sales & earnings numbers for the first quarter, which consensus expectations suggest could be negative for the first time since 2016. Shortly after that will come Q1 real GDP growth, which analysts are figuring could be in the range of one percent. All this could suggest more of that volatility we predicted would be a primary characteristic of 2019 risk asset markets.

Our novice investor of that earlier conversation may not be schooled in the ways of markets, but she made one salient point. Low growth should mean a poor outlook for company sales and earnings. Those sales and earnings, in the long run, are all that really matters, because a share price is fundamentally nothing more and nothing less than a net present value expression of all that company's future cash flows. Perhaps the time is at hand when this long-term truth will actually have an impact on the market's near-term directional trends.

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