MV CAPITAL MANAGEMENT

Weekly Market Flash

Will Politics Matter in 2020?

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It's Thanksgiving week, and most of you are hopefully going to put aside for a few days the contentious topics that dominate the news on any given day. We certainly plan to do just that. But before we fully immerse ourselves in the aromas of turkey and cornbread stuffing (yum), here are some thoughts about those contentious politics and what they might – or might not – mean for markets in 2020.

The Shrug Factor

First of all, the default mode for the stock market vis a vis politics is to ignore them. Since we happen to live in the Washington DC region where political chatter is a fact of daily life, we get a fair share of incredulity about this. "Doesn't the market worry about impeachment/Brexit/Syria/geopolitical topic of the day?" To which we typically reply: "Does it have a direct, measurable relationship to the trade war, or corporate earnings, or the next Fed monetary policy meeting? If not, then…no."

It's the Cash Flow, Silly

The market's insouciance to political events may seem odd, but there is a certain logic to it, which can take one of two forms. The first is one you may have heard us say with some frequency. A stock price, at the end of the day, is a time-discounted summation of a stream of expected future cash flows. Those cash flows, in turn, largely depend on a small number of key drivers: demand for whatever it is for the company sells, the price that aligns with projected demand, input costs for raw materials, labor, overhead etc., along with the prevailing rate of interest in the economy (since future cash flows are expressed in present value terms based in part on market interest rates). If there is not a clear case to make that a political development threatens a direct, quantifiable impact of some size on one or more of these variables, then it can be summarily ignored by the discounted cash flow models cranking out valuation estimates.

The Rarity of Paradigm Shifts

The second way one might go about ignoring geopolitics is to consider them as part of a contextual backdrop that largely stays in place year in and year out, and only changes when a paradigm shift in the socio-economic context occurs (which is extremely rarely).

For the past forty-odd years, political evolution around the world has generally moved in one direction. Free, self-regulating markets opening up more and more of the globe to private enterprise and consumerist societies has been the default paradigm. Sure – nations may veer a bit left here, a bit right there – but the globalism that took root early in the Thatcher-Reagan years plowed ahead through subsequent decades like a dreadnought. Monetary and fiscal choices during this period have revolved around keeping financial markets hale, healthy and mostly trending upwards. In this view, there is no need to pay attention to politics because the big questions have already been answered.

Slowly, Then Suddenly

We're going to have more to say about this second viewpoint in our annual market outlook that will come out in January. Here is a preview, though. When we think about the shifting of a paradigm from one set of circumstances to another, we call to mind a famous quote from the Ernest Hemingway novel "The Sun Also Rises." One character asks another character who is down on his luck just how he went bankrupt. The now-bankrupt character replies: "Two ways: first gradually, then suddenly." That description seems to work with paradigm shifts as well.

The last time we experienced a paradigm shift in the world economy, the "gradually" part of the transition started in the mid-1960s. There were some (mostly) minor seismic shocks in capital markets as the pressures of the Bretton Woods mechanism of a US dollar-backed gold exchange standard stretched under the realities of newly competitive economies in Europe and Asia and the inflation-building escalation of the Vietnam War in the US. The "suddenly" part happened in 1973 with a stock market crash, the US dollar in freefall after the end of the Bretton Woods exchange standard and a tripling of the price of crude oil. Suddenly, politics mattered.

The transition of the late 1960s and early 1970s led to a bear market that didn't fully work itself out until the early 1980s. Why this matters today is that we see a rather convincing case to make that we are in another one of those transitional moments similar to the end of the Bretton Woods economy. Now, for all intents and purposes we are still in the "gradually" stage – and may well be for some time to come. The single uniting purpose of all major central banks around the world is to make "gradually" last as long as possible, using any means conceivable to keep the easy money coursing through the veins of the world economy. It would be great to know when that "suddenly" moment will appear so as to be fully prepared for it. In the absence of a crystal ball, though, the best one can do is to acknowledge the uncertainty and build adequate defenses into a long-term portfolio. There is an entire list of things we have compiled under the heading "newsworthy, not market-worthy" – so as to be alert to any indications that markets are starting to become alert to developments they normally ignore.

We wish all of you a safe, happy and healthy Thanksgiving.

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