MV CAPITAL MANAGEMENT

Weekly Market Flash

The Importance of Doing Nothing

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Sometimes the hardest thing to do is to do nothing at all. Our brains are built for action, not inaction. Flee the approaching predator. Eat all the food we see today because tomorrow there may be none. Rearrange the furniture, because we crave something new and fun.

Doing nothing, by contrast, requires discipline. One of the core principles of the ancient Chinese philosophy of Taoism is called "wu wei," which (roughly translated) means bringing about positive outcomes by inaction – doing good by doing nothing. The very jumpy state of the current equity market brings to mind for us the virtue of practicing a bit of "wu wei."

Meet the New Fed…

Here's a thought experiment. Knowing as you do that stock prices generally tend to react negatively to the prospect of increasing interest rates, would you have doubled down on equities ahead of this week's Federal Open Market Committee meeting if you had known for a fact that the Fed would be signaling three rate hikes in 2022? Probably not, right? And yet the major US indexes all jumped by upwards of 1.5 percent on Wednesday immediately after the FOMC meeting. The fact that the Fed's outlook was more hawkish than expected meant, apparently, that the central bank had regained some credibility by finally taking inflation seriously. That positive take outweighed the normally negative impact of higher rates.

Well, for one day, anyway. On Thursday sentiment promptly turned on its head and the indexes all went south again. Go figure. Now, imagine that you had tried to play this two-day seesaw of a market with action – with an active trading strategy. Did somebody out there hit the jackpot by buying calls at 2:30 pm on Wednesday and then dumping those and loading up on puts on Thursday morning at 9:30? Probably, in the distribution curve of tens of thousands of punters there were a few out on that right-side long tail. Also, to be sure, they were there due to dumb luck, not to acute skill.

…Same as the Old Fed?

Now let's consider a different thought experiment, one that relates to a very popular outlook among traders looking ahead to next year. This outlook dismisses much of the substance coming out about interest rates in the next couple years, because (according to this view) the Fed will just do what it did in 2018, and reverse its monetary tightening policy (and maybe commit to buying some more assets) if things get dicey in marketland. This is the view that the Fed in 2022 and 2023 will be, the same as the Fed every year since 2010, which means that equity investors have nothing to worry about. Just go ahead and buy every 2 percent dip that comes along and all will be well.

Not everyone shares that view, of course. The bearish take is that the Fed will have no choice but to follow through with the rate hikes because inflation is likely to persist throughout the year, if not longer. Meanwhile, the fact that just a small number of stocks are propping up the S&P 500 and the Nasdaq means that conditions are fragile. Five stocks – Apple, Microsoft, Nvidia, Tesla and Alphabet (Google) have accounted for more than half of the total return of the S&P 500 since April. Over on the Nasdaq, more than 1,300 of the more than 3,000 stocks on the exchange are down by more than 50 percent from their 52-week highs.

If you think about it, those are both pretty compelling arguments. Per the bulls, the Fed really is very reactive when the stock market signals that something is extremely out of joint. On the other hand, there is no denying the fact that performance in the market is very narrow and thus vulnerable to a reversal.

The Tao of the Dow

So what do you do? To translate that question into the terminology we use as investment managers, we have to consider the competing objectives of growth and capital preservation that pertain to all the portfolios under our management. If we take strong action one way and build up a big defensive cushion against a possible market downturn then we cut off the opportunity for meaningful growth. On the other hand, if we double down on the "buy the dip" mantra we are exposing ourselves even more to the fragility of a thin market. We remember the mania that reached a crescendo in early 2000, just before stocks went into an extended three-year tailspin and lost almost 50 percent of their value.

In this environment we are inclined to keep doing what we've been doing for much of this year: channel our inner Tao through thoughtful, disciplined inaction. Not too far one way, not too far the other way. This approach kept us from getting too caught up in the "value trade" when that seemed to be all the rage at the beginning of 2021. It kept us from overreacting when markets pulled back in the period right after Labor Day. Like we said in the opening paragraph, it's not always easy to do nothing. But sometimes it really is, we think, the best way to do the right thing.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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