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Weekly Market Flash

The Trade Winds Theory of Markets

August 25, 2023

The financial news media likes nothing more than an easy story. Stocks (or bonds) were up (or down) today because of X, X being the single event of the day to describe why the market did what it did. Every so often, that approach works. On September 15, 2008 the S&P 500 fell by 4.7 percent, a giant move for a single day. September 15 was also the day that investment bank Lehman Brothers declared bankruptcy. It was pretty much on target that day to report that "stocks fell by almost five percent because a giant securities firm failed and all sorts of collateral damage is probably going to come to the surface."

Most days, though, come and go without the failure of systemically critical financial firms or other commensurately earth-shaking events. On most days, hundreds of potentially market-influencing events blow this way and that, like trade winds crisscrossing each other on the open sea. Like the waves created by the trade winds, these events more often cancel each other out than move collectively in a single direction. This is a particular problem for momentum trading strategies, which have had a rough time of things in 2023. An article in the Financial Times newspaper today noted that trend-following hedge funds this year have been sideswiped by a number of developments their high-powered algorithms didn't see coming in the markets for equities, fixed income and commodities alike.

We thought this week would be a good time to revisit our "trade winds theory" of markets, because we have some fresh material to provide as an illustration. Recall that one of the big trend themes of 2023 thus far – arguably the biggest single theme in US equity markets – has been AI mania. All things artificial intelligence has been the big story ever since financial journalists started playing around with ChatGPT last November and sharing their amazement on Twitter, as journalists always do. A very small number of companies are central to the AI story, and they have done phenomenally well this year. One of those companies, Nvidia – a designer and manufacturer of graphics processors – saw its shares rise nearly 25 percent in a single day back on May 25 when it reported quarterly sales and earnings that blew away analyst expectations, thanks to overwhelming demand for its considerable AI capabilities.

Nvidia reported quarterly earnings again on Wednesday this week, and once again the report was stellar from just about every conceivable standpoint – well ahead of analyst expectations for the quarter past, a significant raise in guidance for the quarter ahead, and even a $25 billion share buyback as icing on the cake. This report came out after Wednesday's market close, and shares in aftermarket trading popped immediately. In other words, the stage was set for a corker of a rally on Thursday favoring all the AI-adjacent asset classes and themes – semiconductors, growth stocks in general, the Nasdaq Composite.

For about fifteen minutes or so on Thursday, that expectation seemed to be playing out. On CNBC the talking heads were rehearsing what they fully expected would be their end-of-day wrap-up: "Stocks soared, with tech stocks leading the way on blowout earnings from Nvidia." But then those darned trade winds came in from other directions. Earnings reports from consumer retail companies have also been coming in this week, with some concerns about pricing power, margins and demand weakness. Tensions grew about what Jay Powell might say about interest rates at the Fed's Jackson Hole symposium on Friday. Durable orders were a bit worse than expected, Germany's manufacturing sector is in the doldrums – winds blowing in all sorts of different directions.

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At the end of the day, Nvidia shares were more or less flat, but the Nasdaq Composite was down nearly two percent and the S&P 500 lost more than a percent. There was momentum, in other words, but not the momentum that the algorithms or the financial reporters expected. As we write this on Friday mid-morning, shares generally seem to be under further pressure as the market digests a somewhat (though not unduly) hawkish speech from Powell in Wyoming, and a closely watched University of Michigan consumer sentiment report suggesting that one- and five-year inflationary expectations rose (despite a recent downtrend in both headline and core inflation).

Such is the unpredictable nature of the trade winds on any given day. Our message to our clients is always the same: you can't know what is going to happen in the short term (and even if you did know what was going to happen, you would not be able to predict how the market is going to react). Markets usually do not close up or down on any given day "because of X" – excepting those rare days when things like systemically critical financial firms go bankrupt, and thankfully those really are few and far between. Focus on your long-term financial goals, and stay disciplined and patient while the trade winds blow this way and that.

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