Crisis? What Crisis?

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Two weeks ago I published an article dissenting from the near-universal view among my Gavekal colleagues, and also probably among our clients, that the global equity markets had entered a severe bear market (see **Is Wall Street In A "Bear Market"?**). Since I expressed this relatively optimistic view on January 27, the S&P 500 has fallen another -2.7%, the world MSCI-ex US by -3% and the Nikkei by a whopping -8.5% in yen terms. It may therefore be time for a *mea culpa;* but I prefer to double-down. To see why, consider the following pattern.

Markets are seizing on any and all news as signals to sell

In the first few days of January, China seemed to be planning to devalue the renminbi. The markets duly went into meltdown. A few days later China stopped devaluing, but instead the oil price seemed to be plunging towards zero. The markets duly went into meltdown. A few days later, the oil price stopped plunging towards zero, but the US economy seemed to be sliding into recession. The markets duly went into meltdown. A few days later, the US economy stopped sliding into recession, but central banks around the world seemed to be out of ammunition. The markets duly went into meltdown. A few days later, central banks proved they were not out of ammunition, but commercial banks in Europe seemed to be collapsing. The markets duly went into meltdown. A few days later, banks in Europe stopped collapsing, but the Fed seemed on the point of easing and admitting a "policy mistake". The markets duly went into meltdown. Yesterday, the Fed showed it was not on the point of easing...

Is the sell-off a sign that something is fundamentally wrong with the world economy?

You see my point. These days, whatever happens, or doesn't happen, investor panic seems to be the default response. There are two contrasting interpretations of this behavior. The first is that it is evidence that something is profoundly wrong with the world economy—and maybe not just something, but almost everything. Charles, for example, has long believed that zero interest rates have caused misallocations of capital on an unprecedented scale around the world (see **The Typology Of A Deflationary Bust**). So nobody should be surprised that huge financial

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US mortgage apps for home purchases are up 25% YoY, as 30y mortgage rates fall to 4%	N/A; apps have been growing at ~25% YoY since last summer, the strongest growth since 2004	The strong US$ & weak mfg. raise recession risks, but robust home construction counters
France and Italy IP fell -0.7% YoY and -1% YoY in Dec vs 3% and 1.1% rise respectively in Nov	Below expected respective increases of 1.7% and 1.4%	EZ recovery on less than solid footing; weak euro unable to offset weak global demand
Japan PPI continued to fall -3.1% YoY in Jan, from -3.5% in Dec	Below expected -2.8%	Strengthening yen likely to undermine BoJ aim of ending deflation

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losses are finally materializing in markets ranging from China to US energy to European banking to Japanese robotics. The problem with this interpretation is that the problems materializing in these sectors are *not* turning out to be as fatal as bearish market predictions—at least thus far. As a result, the story about what is driving equity prices lower keeps shifting, sometimes by a full 180 degrees. A month ago, for example, perhaps the biggest systemic threat to the world economy was said to be a relentlessly strengthening US dollar. But then investors noticed that the dollar was actually weakening, not strengthening, this year. So the weakness of the dollar—and its mirror image, the stronger yen and euro—was suddenly identified as the new systemic threat.

The problems are not proving as fatal as the bears fear

Of course, there is no law requiring investors to be consistent or logical in their judgements; but the extent to which the bearish narrative keeps shifting—and the fact that the most important stock market index, the S&P 500, has stubbornly refused to follow most of the others into a free-fall—does give some credence to another possible interpretation of what is going on.

Perhaps causation is running in the other direction?

Maybe the panicky behavior should not be viewed as proof that the market "knows something" terrible about the world economy or financial system—a horror that is not yet visible in economic statistics, banking numbers or corporate results. Maybe instead, the causation in today's markets is the other way round: investors see stock prices falling and therefore believe that something must be terribly wrong with the world. But nobody can quite identify the precise nature of this horror. So the horror story keeps changing as long as the markets keep going down.

Even this complacent-sounding interpretation is not necessarily benign. There are times when the beliefs of financial markets, even if they start out being false, can change economic reality so much that they become true. This is, of course, the process of "reflexivity" which has caused boom-bust cycles since the beginning of time. If a financial panic gets bad enough, it can sometimes cause the economic or political calamities that markets appeared to anticipate. And the opposite is equally possible: "irrational exuberance" can sometimes become so powerful that it causes self-fulfilling booms in asset prices and credit that can last for years or even decades.

Investor irrationality can take hold on the downside too

There is, however, a curious asymmetry in the attitude to reflexivity among most investors. When markets go up for no adequate reason, as technology stocks did, for example, in the late 1990s, this behavior is invariably described as irrational and driven by herd instinct. But when markets collapse with no good reason, everybody assumes that investors must know what they are doing and that the collective wisdom of markets has discovered some hidden horror, even though nobody can work out what it is. In reality, however, markets are as likely to be driven by herd instinct on the downside as on the upside. After all, fear is an even stronger motivation than greed.

Suppose, then, that I am right in believing that all the "fundamental" fears behind this year's market panic are highly implausible at present. China will not be forced into a disruptive devaluation. Low oil prices will not damage the global economy or financial system. The US will not slide into recession or secular stagnation. The European and Japanese banks will not collapse because of negative interest rates... and so on. Even then, the bears could still be right to drive prices ever-lower because if markets fall far enough, the financial panic itself could make the prophecies of doom come true.

Low oil prices will not damage the global economy or the financial system

The possibility that expectations could create their own reality is always the risk in reflexive situations—and this seems to me the biggest reason for anxiety about market behavior since the beginning of this year. Why then do I refuse to turn bearish? Because extreme cases of self-justifying reflexivity like the mortgage-related boom and bust of 2006-09 are the exception in financial history, not the rule. When prices fall far enough, the momentum traders motivated by self-fulfilling reflexivity are usually outweighed by value oriented return-to-the-mean investors, who follow Warren Buffett's rule that when an asset gets cheaper you should buy more of it, not less. The circumstances when reflexivity beats value are usually ones when economic or political conditions are already quite unstable, when valuations are near extremes and when policymakers make crass mistakes. That is what happened on the upside in 1998-99 and on the downside in 2007-08. Today, I don't see much evidence of serious policy mistakes (this is where I disagree most seriously with Charles). Nor do I see evidence of extreme valuations, except in bonds. That is why I remain bullish—and why I become more bullish as the markets keep falling.

Value will trump momentum