Markets May Shake Off Bad News for Quite a While... Or Not

Things stabilized a bit in the financial markets in January, and both the Dow Jones Industrial Average and S&P 500 enjoyed increases of just over 7% (although all the major indexes are still down from their peak highs).* Overall, the month was certainly a welcome change from all the volatility of 2018, which ended as Wall Street's worst year since 2008. In January, big investors seemed to make an effort to shift their focus mainly to positive and hopeful financial news. But why, and how long will they be able to keep it up?

Granted, there *was* some hopeful economic data for investors to focus on in the first month of the New Year, including strong early fourth quarter earnings reports and the more dovish language coming from the Federal Reserve about interest rates. In its January meeting, the Fed said it would be "patient" with further interest rate hikes, and removed language about "further gradual increases" from its policy statement.** In addition, the U.S. added 304,000 jobs in January (more than anticipated) and the Labor Department reported that average hourly earnings over the last 12 months rose 3.2%.***

However, before you jump on the optimism bandwagon, keep two things in mind. Number one, there was also a lot of positive economic news throughout 2018, yet despite that, the year saw extreme volatility and some of the largest single-day point declines in market history; and number two, in order to focus on the positive headlines in January, investors had to also ignore a lot of negative news, including concerns about the economic impact of the longest government shutdown in US history.

Typical Trend

In truth, what we're seeing with the markets now is not uncommon from a historical perspective. Investors typically fall into a trend of shaking off bad news toward the end of a cyclical bull market period, and—as I explained in my 2019 market forecast last month—I believe we're at such a period. I'm forecasting a second straight year of losses for the stock market, and an economic slowdown that could lead to a new recession by 2020. Whether we're in the early stages of the third major sustained market correction of this secular bear market remains to be seen, but it's certainly possible.

As you may recall, I also forecast that the Fed is not going to be able to achieve its original goal of approving three additional short-term interest rate hikes this year and may not even end up approving one. The Fed amending its statement in January to remove the "further gradual increases" language suggests to me my forecast is accurate. I believe my forecast is also supported by the fact that long-term interest rates continued to exhibit a strong resistance level throughout January, with the yield on the 10-Year Treasury rate ending the month almost exactly where it started it, at around 2.7%.

As I explained last month, the bond market is often said to be "smarter" than the stock market when it comes to forecasting economic growth, and this resistance level is an example of that. When the Fed instituted its last rate hike in December, that's when the bond market said, "enough is enough," and this time bond yields didn't rise to make room for the Fed's increase.

As a result, the yield curve remains perilously close to being flat, with the Fed funds rate now at 2.5% and the 10-Year holding fast at around 2.7%. In fact, the yield curve almost did completely flatten on January 3rd when the 10-Year sunk to 2.56%—which could easily happen again. Remember, too, that the yield curve is already partially flat and has been since December 3rd when yields on the 2-Year Treasury rate rose higher than yields on 5-Year Treasuries. As I've also mentioned recently, a flat yield curve preceded both of the last two market crashes and is widely regarded as a huge red flag of a coming recession.

Emotional Attachment

So, with at least as much bad or potentially bad news underlying the good, how and why is it that big investors typically shrug off all the bad news near the end of a bull rally? Psychology is one answer. As I've mentioned before, many investors remain "mentally stuck in the 90s" because they first started investing in the 80s and 90s, during the best long-term bull market in US history, and enjoyed great success. Nearly 30 years and two major market crashes later, it's still the paradigm they're still used to. They remain committed to it either because it seems logical (even in the face of mounting evidence to the contrary) or because they have an emotional attachment; it's simply what they're comfortable with.

Keep in mind, too, that many big investors tend to be competitive by nature. They have an athlete's perspective and treat investing as a competitive sport. The trouble is, many get so focused on offense and trying to ring every last dime out of a bull market that they ignore or forget the importance of financial defense...until it's too late.

But how long can these investors continue shaking off bad news and ignoring warning signs near the end of a cyclical bull rally? The answer is: sometimes for quite a while. Remember in 2007, it was widely known in February and March that the subprime mortgage crisis was coming, but it wasn't until November that the markets started to drop.

The good news about this lag time is that it allows informed investors to make changes and decrease their risk in time to avoid getting caught in the next downdraft. Keep in mind that even after last year's turmoil and losses, the market overall is still only down about 10% from its peak highs since the Financial Crisis. So, ask yourself: if you were going to make a change, doesn't it make sense to do it at 10% rather than risk getting caught in a drop that history says could range between 40 and 70%? That, of course, is a rhetorical question.

**"Stocks Wrap Up Best January in 30 Years," CNN Business, Jan. 31, 2019*
***"Treasury Yields Fall Further After Fed Vows Patience," CNBC, Jan. 31, 2019*
****"Why the Fed's Shift into 'Superdoveland' Looks Shaky After the Jobs Report," MarketWatch, Feb. 1, 2019*

6550 North Federal Highway
Suite 510, Fort Lauderdale, FL 33308
Phone: (888) 492-0505
Fax: (954) 337-0621
www.soundincomestrategies.com
info@soundincomestrategies.com