How Markets Work

by Pitt

Like anyone else, I watch TV. However, I might be a tad more discriminating about the "facts" I allow to invade my cranium. Previously mentioned in my scribblings is a passion for how things work. It is not unusual for me to take things apart before using them. Markets are the same way; I have always wanted to know what was driving them.

Market volatility generally occurs when one or two of the fundamentals falls off the tracks. Let's look at how things are supposed to work in hopes that will help us understand why they are not working. All markets seek equilibrium, an equal amount of supply and demand, buyers and sellers. When machines don't work smoothly, they usually need oil (or WD40) and, as a substitute, markets use price, and price is defined as interest rates and market values. When demand exceeds supply, prices go up. When supply exceeds demand, prices drop.

Stock markets experience consistent demand from many sources: retirement accounts, dividend reinvestment plans, dollar-cost averaging, payroll savings plans, corporate stock buybacks, mergers and acquisitions, index rebalancing, etc. When added together, these are extremely large forces. The same markets are fed consistent supply from portfolios in distribution, rebalancing, performance rotation, retirement requirements, risk tolerance, etc. Once again, these are extremely large forces.

How big is large? There are 23 million sole proprietorships in the U.S., 7.4 million S-corps, 1.7 million C-corps, 89,004 local governments and 50 states. All these entities maintain their own financial resources and manage their own balance sheets. When they are in harmony, there is equilibrium, and when they are not… prices need to change. Collectively, a large group of investors are happy to take their financial advice from "THEY." THEY say that inflation will rise. THEY say that the markets will crash. THEY say there will be a recession. And THEY say, "I'm not so sure about that." To the best of my knowledge, no one has ever met "THEY," who tends to be consistently negative and virtually never positive.

The latest coronavirus has no known cure at the current time. Just the kind of fuel for the fire that THEY love. The advent of a handful of cases in the U.S. threw a broomstick in the bicycle spokes of financial equilibrium. Buyers that had the option of not buying didn't while supply continued. Picture Lucille Ball in the chocolate factory. Market makers dropped the bid side (price) and supply just kept coming. Market values dropped and the financial gunslingers seized an opportunity to make money by shorting stocks…and more shares flooded Wall Street. Within a couple of days, the market was "no bid" and prices formed a waterfall chart. Legions of analysts pulled their estimates and a cloudy future became cloudier. THEY were firmly in control.

We don't know if a bottom is in or near, but we didn't predict the demise of equilibrium either. The stocks we own are best of breed and benefit from deep management benches. The U.S. is at the forefront of healthcare innovation and our guess is the current malaise will eventually disappear as mysteriously as it arrived.

Last week, the Dow Jones Industrial Average dropped 12.4% while the S&P lost 11.5% in value. If you subtract holidays, there are 50 weeks in the year. Multiply last week's drop by 50 and you get -620% for the Dow and -570% for the S&P. Let's just call it -600% annually for investment grade stocks. This math would lead you to believe that once the market drops 100%, the market will pay current equity owners 500% of the market value they hold. Obviously, an unachievable event. Rather than looking for checks in our mailbox, we tend to look at this rate of change as unsustainable; investors should become buyers not sellers. Likewise, when the markets go up at annualized rates that exceed 100%, we brand those scenarios as unsustainable and encourage clients to spend money on wish list items and fulfill long term goals. Hopefully, this is ringing some familiar bells.

We do this in an orderly fashion and rarely hit market highs and lows. We do, however, identify opportunities. Markets have behaved this way throughout our careers, and we see little reason for them to change. If you fail to seize on one or more of these opportunities, fear not, there will be more. Prices will behave in herky-jerky fashion and THEY will push things beyond sustainable rates of change. For us, this has been a great ride. A bit chaotic at times, but one that we always seem to be able to take apart and put back together.

On Monday, March 2nd, between 1:30 CST and 3:00 CST, the Dow gained 827 points to finish 1,290 points higher on the day…clearly an unsustainable rate. This type of price action is called a "whipsaw" and needs to be viewed in the context of a longer-term market. For further proof, see Tuesday's Fed rate cut and the market's reaction. Liquidating positions in an environment like this can be very expensive.

It's ok to be nervous and it's ok to explore opportunities. All our portfolios are custom and managed to the risk tolerance of the owner. If you would like individual counsel from any of us, please call. It is impossible for us to know when THEY are gaining traction.