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Internal market forces rather than fundamentals are fueling volatility

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Investors are dumbfounded by the market's sudden turbulence – Pessimists are saying "I told you so"

Stock prices suddenly plunged in October. No investment professionals who believe in fundamentals expected this sharp downturn, the second this year after the February drop. Since the beginning of October, US stock prices are down 10% and Japanese stock prices are down 14%. These declines are still smaller than the big stock market drops in emerging countries and Europe.

When a downturn of this magnitude occurs, everyone quickly believes that the cause can be nothing else than a serious problem with economic fundamentals. Worries about fundamentals can be justified somewhat. A number of issues involving the real economy, politics and other matters are in the news. Examples include the shift in U.S. monetary policy (interest rate hikes and higher long-term interest rates), the US-China trade war, turmoil in the Middle East, worries about the higher cost of crude oil, and uncertainty about the outcome of the US midterm election and a possible impeachment of President Trump. But none of these problems could have an impact significant enough to stop US economic growth.

Very few economists are forecasting the start of a US recession in 2019. This is true both before and after the October stock market sell-off. Furthermore, US-China tension is very unlikely to become even more heated than it is now. According to the Wall Street Journal (October 26), China has not made any bookings for November imports of oil from Iran. Apparently China is beginning to comply with US sanctions against Iran. This may be an indication of progress with talks between the United States and China.

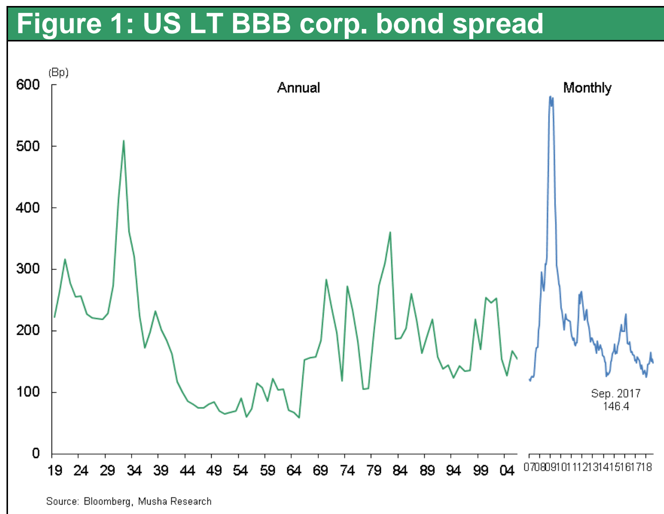
US stock prices have retreated about 10 to 15% many times since the global financial crisis. All of these downturns were triggered directly by uncertainty about the real economy or politics. For example, stock prices plummeted because of the euro crisis that started in Greece, the Bernanke shock, the China shock and Brexit. Whereas, both sharp stock market declines this year were not accompanied by increasing worries about the actual economic and political situation. We can find problems with fundamentals if we look hard enough. The semiconductor sector is unsettled, investments in China are sluggish (machine tool orders are down, for instance), automobile sales in China are falling, the declining price of crude oil may have a negative impact on energy stocks, and higher interest rates may cause a growth or high-PER stock correction. But not one of these problems is big enough to affect the overall economy. Assuming this is true, the only suspect as the cause of the October bear market is internal market forces.

Technical factors are most likely the cause of both 2018 market downturns

Reason 1 – No volatility in financial markets other than the stock market

Although stock prices have dropped, there were no indications that investors were completely shunning risk. For example, there was no sell-off of US junk bonds (the risk premium is still low) and the yen did not appreciate. As you can see in Figure 1, the BBB bond risk premium has increased significantly during every recession (when stock prices fell). After the global financial crisis as well, this risk premium increased during the 2011 Greece/euro crisis and the 2015-16 China shock. But this time the BBB bond risk premium did not move.

Figure 1: US LT BBB corp. bond spread



Reason 2 – The different nature of stock markets due to AI trading systems and the growth of index ETFs
AI has become the primary means of trading stocks. In the past, Goldman Sachs used 500 to 600 people to buy and sell stocks. Now, apparently only two or three people are needed. CTA, risk parity and most other types of investment funds rely on AI trading. Machines have taken over the world of stock investing. Computers that control massive amounts of investments by using virtually unlimited amounts of data and no vulnerability to human emotions will always beat human traders. People try to buy low and sell high but often end up doing precisely the opposite. When people made investment decisions, gut feelings, intuition about price movements and similar emotional factors were a natural part of trading. But now these emotions are no longer valid. As a result, the age of investing by using stock trading has probably come to an end.

Another big change is that index funds and exchange traded funds have become the primary means of channeling money into stocks. The bottom-up approach that requires studying various companies and picking individual stocks is no longer dominant. Funds instead use a top-down method that begins with macroeconomic data in order to place money in stocks that are in a targeted index. Index funds, which have no active managers, now account for more than one-fifth ($7 trillion) of the total market capitalization of US stocks. Moreover, index funds have increased from 19% in 2009 to 44% in 2018 as a share of all US equity funds. According to the Financial Times (October 24), this ratio will probably surpass 50% about three years from now. The growth of index funds has made stock prices more volatile and even distorted prices at times. Index funds tend to do most of their buying and selling in the last hour of trading, which can cause prices to move significantly. In 2012, the last hour accounted for 17% of total trading volume. But due to index funds, this percentage was 26% in 2017 and is probably even higher in 2018 (Wall Street Journal, October 18).

However, index trading is neutral from a long-term standpoint. Stocks that are sold will always be repurchased at some point.

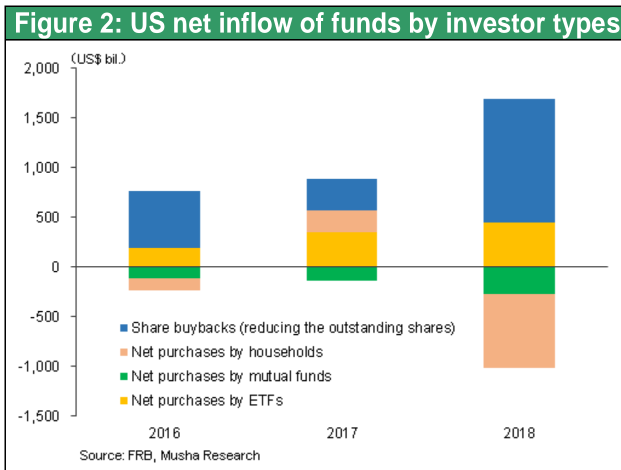
Reason 3 – Intensive speculative selling during blackout periods
Most companies and corporate insiders are prohibited from repurchasing their own stock during approximately one month before the release of quarterly results. This is called a "blackout" period. Speculative sales to beat down prices of stocks during this period are apparently becoming increasingly widespread. Companies welcome a lower stock price. One benefit is the ability to buy back stock at a lower cost. Another is a higher limit on repurchases due to the rapid increase in trading volume as the stock price falls. (The Securities and Exchange Commission limits daily stock repurchases to no more than 25% of the average trading volume over the past four weeks.) Consequently, companies are able to repurchase a large volume of stock at a reduced price. (Wall Street Journal, October 24)

During the past few years, stock buybacks have been by far the largest component of stock purchasing in the United States, as is shown in Figure 2. Individuals and mutual funds have consistently been the primary sellers. Due to this situation, the supply-demand balance tips extremely to the sell side during blackout periods. Speculative selling becomes much easier and more effective as a result. In fact, the stock sell-offs at the beginning of February and October this year both took place at the beginning of blackout periods.

For these reasons, investors can expect an enormous reversal in stock supply-demand dynamics when this blackout period ends.

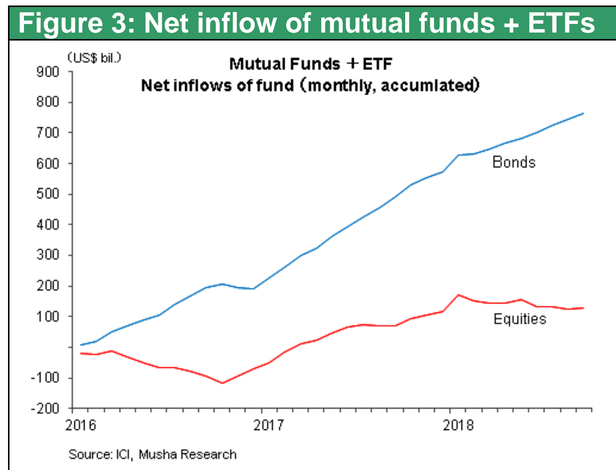
Musha Research Commentary

Figure 2: US net inflow of funds by investor types



Source: FRB, Musha Research

Figure 3: Net inflow of mutual funds + ETFs



Source: ICI, Musha Research

The forgotten lesson that the financial crisis taught us

As we reach the tenth anniversary of the global financial crisis, many publications have feature sections about lessons learned during this event. But one critical lesson is almost always overlooked. Few articles analyze internal market factors. Financial markets collapsed on their own to a large extent. Of course, there were other major causes. Financial institutions and investors took on too much risk and the defective countermeasures could not prevent this risk-taking. But one point is even more important. Capitalism and the market economy, which are both inherently sound, broke down almost to the point of a catastrophic collapse. Here, inherent soundness means that the value creation mechanism and the consumption of value backed by the proper allocation of value-added were functioning completely as they should.

Why did markets fail? The reason was the inability of markets to correct mispricing. In fact, markets incorporated systematic elements that caused mispricing to increase in a self-fulfilling manner. The amplification of mispricing is the point on which financial authorities as well as investors should focus their attention most of all.

My final subject is the Big Money Poll in Barron’s (October 22). The survey immediately prior to the October stock market drop is probably an accurate picture of the views of institutional investors.

1) 56% of investors were bullish and 8% bearish (but customers were 23% bullish and 19% bearish)

2) No worries at all about China (Biggest threats: 1) Rising interest rates 28% 2) Policy missteps 21% 3) Earnings disappointments 14% 4) Slowing economic growth 11% 5) Geopolitics 6%)

3) Bearish sentiment about Japan (Highest expected stock return over the next year: 1) US 42% 2) Emerging countries 29% 3) Europe 10%, China 10% 4) Japan 9%)

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