

RE: Interpreting the Market's Volatility

Last week was the stock market's most volatile week EVER! It's noteworthy anytime the stock market sets a new record, and the high volatility continues this week with the Dow Jones down over 400 points as I write this. So what are we as investors to make of this?

Key to understanding stock market behavior is realizing the importance of expectations. In the normal course, recessions are followed by economic recoveries that at this stage should be fairly robust. However, the recession we just experienced wasn't caused by normal business cycle events, but rather by a housing bubble that spawned a credit crisis. This created a major economic imbalance, and until the enormous housing inventory is reduced to more natural levels, strong economic growth can't occur and high unemployment will persist.

Compounding this problem are international austerity efforts which will further dampen economic growth. It can reasonably be argued this is necessary given the high levels of sovereign debt, but the fact remains, without additional fiscal stimulus, economic growth will slow. That doesn't mean a recession is imminent, but it does mean much slower growth than is normal at this stage of the economic cycle is to be expected. The major market gyrations of late suggest the above is somehow surprising to many market participants.

Made very happy by all this are the high-frequency traders, where the greater the volatility, the larger their profit opportunity. These market participants use both longs (buys) and shorts (sell) and heavily leverage their "bets," thus greatly influencing and destabilizing the market in the short run. They wait sometimes years for this sort of opportunity, and then all together join the trading frenzy. While there are always some long-term investors chased out of the market by these episodes, putting further downward pressure on the market, long-term investors collectively tend to have only a marginal impact during these periods.

Also impacted very little is corporate worth, which is driven by earnings. It's hard to understand how corporate profit performance could be so strong given the tepid economic growth of late and current stock prices, but the fact remains, corporate America has performed admirably in this regard. In 2007, the S&P 500 companies posted their highest level of collective earnings of \$91.47. In 2011, these companies are expected to post collective earnings of \$99, with further earnings growth expected in 2012 and beyond. Driven by these earnings, the underlying worth of the stock market is unquestionably greater today than ever before, though stock prices clearly don't reflect this.

Hence the final point. It is of utmost importance to realize that periods of heightened volatility will routinely trigger the market's emotional herd response. This happens repeatedly through time and we all waste a great deal of time and energy trying to make sense of what we observe, when in fact there is no reasonable justification other than extreme market sentiment (both too hyped and too dour). The truth is invariably somewhere in the middle, and it's just a matter of time before stock prices reflect that moderated reality. And when it does, we'll reap the reward of our continued focus on fundamentals and the market cycles during this turmoil.

Keep the faith!  
Lowell