Where Did the Bear Market Go?

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"Wall Street predicted nine out of the last five recessions." (Paul Samuelson, Nobel Laureate in Economics.)

It was truly remarkable how carried away market pundits became in response to the fourth quarter swoon, even as the economy continued to plow ahead. Yet predictions of recession were everywhere and hyped by the media. Now, we're simply getting back to business. Fourth quarter earnings currently being reported are reasonably solid and economic growth is continuing. There is no recession in sight. The Fed succumbed to the panic and stated publicly it intends to keep policy unchanged until the economy's policy needs become clearer. Unfortunately, too many investors also succumbed to panic and got out, only to watch stocks rebound without them. With no impending threat from the Fed and continued solid economic growth, chances are good that the stock market will return to its highs and possibly set new ones. The key lesson here is investors should remain committed to their long-term strategies.

Fears of a recession pushed stock market prices down very sharply rather quickly. But it clearly went much too far. Excluding the FANG stocks, the S&P 500 (less the 4 FANGs) traded below 13 times expected 2019 earnings to end the fourth quarter. At the lows in December, we were within a single percentage point of a "bear market" and many more than 100 companies traded below 8 times expected 2019 earnings. That's reasonable for the middle of a severe recession! 2019 earnings had been projected at around $178 per S&P 500 share, but "whisper" numbers as low as $160 were mentioned (without any basis other than assuming a recession.) Now we're already back to $173 and that may be too low. It is all proving to be a tempest in a teapot.

Oddly, a fear of recession may help prolong the expansion. The economy still lacks imbalances that could cause a recession, and if households and firms remain careful about their spending, it will take longer for imbalances to accumulate. So a moderate rate of economic growth can be sustained longer, because labor shortages will become acute more slowly. That's why the economy <u>needs</u> to grow more slowly, ideally 1-1/2% to 2%. If the strong growth of the second and third quarters were maintained, a rapidly falling unemployment rate would quickly become a serious bottleneck and labor scarcity would push up labor costs and inflation. This is still the most serious problem facing the economy and it is being exacerbated ever so slightly by legislation as more States adopt a $15 minimum wage. Yet most pundits seem to think a slower pace of growth is just a midpoint in the process towards negative growth, i.e. recession. This is precisely backwards. Rapid growth would cause bottlenecks to emerge more quickly, while slower growth allows the expansion to continue.

Evidence that the economy is not cratering has brought bargain hunters back into the market. It also brought corporate buybacks and insider buying, which surged in the quarter. Since Christmas, the market recouped very close to half the loss suffered in the fourth quarter. The bargain hunters will be followed by retail investors, especially once they become fearful they are missing out on the market rebound. It is doubtful the political scene will become less chaotic, and earnings outlooks are likely to be cautious. But, investors will learn that the performance of the economy is not as sensitive to the political news headlines as they are, so they need to differentiate between economics and politics. As Warren Buffett said, “be fearful when others are greedy and be greedy only when others are fearful.” The last several weeks are a textbook example of this investment philosophy.