Chicken Little Comes Out of the Woodwork

By Dr. Charles Lieberman, Chief Investment Officer

Anytime the market takes a tumble, the Chicken Littles of the world come out to predict the coming stock market collapse. Because market corrections are quite common, they get this forecast right roughly one out of ten times, if that often. Such forecasts suit the needs of the media, however, so they get plenty of visibility, which serves mostly to scare the individual investor. Nonetheless, the fundamentals supporting the market remain sound, so we expect last week's decline to prove to be yet another buying opportunity.

Stock prices are driven by three key factors: earnings, interest rates and market psychology. The last of the three dominates the market in the short run, while the other two dominate over time. That's why statements by politicians, trade battle developments, and other events can move markets sharply in the short run, but quickly fade in importance relative to trends in corporate profits and interest rates, which reflect true underlying economic fundamentals. So it is always important to discern the underlying signal from the ambient noise.

The economy is performing quite well and corporate profits are surging, reinforced by the decrease in corporate profit taxes. Rising interest rates are a fly in this ointment, but are less worrisome since stocks never rose in keeping with the lows in interest rates over the past few years. Investors fully appreciated that the record low level of yields was simply unsustainable. So they never priced in those low rates fully, despite the disparaging remarks of some Chicken Little pundits suggesting that stock prices were on a sugar high. Let's review market valuations.

David Lieberman noted in a recent commentary that if we merely exclude the five FAANG stocks, the market's price-to-earnings multiple was a mere 13.3 based on 2019 earnings. That is flat out cheap, even with prevailing higher interest rates. Yes, it is cheap for a reason: investors simply haven't had much faith in stock prices since 2007. They don't seem to appreciate that owning stocks means owning a piece of the U.S. economy. They may fluctuate, and stocks are even more volatile than economic growth, but the longer-term growth prospects of both remain stellar. If you want your nest egg to grow, you must hold stocks, even if it's a volatile ride. Yet investors have been unable to do this.

Since 2007, investors have pulled more than one quarter of one trillion dollars out of stocks and stock mutual and ETF funds. In contrast, $8.2 trillion has flowed into bond and money market funds of all types. Americans are fearful of stocks and seek the security of bonds, but nothing could be more detrimental to the long-term financial health of the typical household. The stock market has fully recovered and more since the darkest days of 2008 and set new highs, which have been missed by many investors. Bonds yielded little over the past decade and they have been sinking in value over the past two years, because growth is firm, inflation risks are rising and the Fed must normalize interest rates to contain those inflation pressures. Investors who listen to the Chicken Littles lost a great deal of their stock nest eggs selling in 2007 and subsequent years and have lost even more money in their increased holdings of bonds over the past two years with more losses ahead.

So, what's an investor to do? Most critically, investors should work with their advisors to establish a sound long term game plan that meets their needs and they should ignore short-term market fluctuations. Stocks are vastly more volatile than bonds, but provide much better long term returns. Investors must choose the right mix of stocks and bonds to give themselves the best returns consistent with their tolerance for market volatility and stick with this plan through market fluctuations. I'll readily acknowledge this isn't easy. Investors commonly think they have taken too much equity exposure when stocks go down and not enough when the market goes up. But they should stick to their long-term game plan. We have been preaching this approach for many years and, apparently, have been getting through to our clients, since our phones rang little over the past week. But the volatility in the market, decreases in holdings of stock funds, and additions to bond funds demonstrate quite definitively that most investors fail to appreciate this approach.   So they continue to harm themselves.

Stocks still look attractive to us and bonds remain at considerable risk. We're carefully positioned accordingly, with holdings of solid values in stocks and a very short average duration in bonds.

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