CFEE CANADIAN FOUNDATION FOR ECONOMIC EDUCATION
FONDATION CANADIENNE D'ÉDUCATION ÉCONOMIQUE

WHAT'S HAPPENING IN THE STOCK MARKETS

For those who have been investing for a while now, the reaction may be, "Oh no, here we go again." After a long period of increases, stock markets have been tumbling. Like a roller coaster, the ride up can be so much slower than the ride down. Climb, climb, climb … and then plunge. The question is, why now? There are a number of factors at work.

What is a "Market Correction"?

One factor for the decline is that markets always go through periods of adjustment and correction – and often the longer and higher the climb up, the further and faster the turndown may be. Stock markets have generally been trending upwards since the financial crisis calmed down in 2009. That is a long climb – about 10 years. Many were of the mind that the market was due for a "correction."

Why are "corrections" needed one may ask? Well, as may be the case at some parties you have attended, people can get a little carried away at times. Perhaps party a little too hard. Maybe go a little too far?

Well, markets can too. The good times can get people investing and buying stocks to the point where many stocks are at a higher value than they probably deserve. It may be that the value of a company, as reflected by its stock price, may be higher than what the company is actually worth. A "correction" – a decline in stock prices – can bring the value of such stocks back into line with companies' real value. So some correction was probably due in the over-heated stock markets.

The Psychology of Markets – and Expectations – Can Be a Factor

But that was probably not the cause for such a steep drop. It certainly contributed to the "psychology" of the markets. That is, many investors were of the impression that stocks had, indeed, risen too far too fast and that a correction might come. If you are an investor, and suspecting a correction might be coming, you are likely going to be quick to act if you think it has arrived. So when the markets started to turn, indicating that the anticipated sell-off had arrived, selling would have certainly accelerated as investors looked to get quickly out of stocks that had risen and provided a nice return. Best to sell if you can and lock in the return before it diminishes or disappears during a correction.

The Most Significant Likely Factor – The Tax Cuts in the U.S.

But what was the trigger that gave light to the prospect of a correction and potential for a significant sell-off? A major factor contributing to the mounting fear and concern was the tax cuts recently approved in the U.S.

U.S. Economy Appears Close to Full Employment

Statistics were showing that the U.S. economy was growing quite quickly, gathering more momentum – and, as a result, was nearing full-employment and its capacity to produce goods and services. When an economy is close to its capacity, and actions are taken that boost spending, the economy struggles to respond with output. Available resources are scarce and start to become more costly. Labour costs, for example, start to rise when an economy approaches full employment because, as the term implies, labour is close to being fully utilized. And, as employers look to compete for available labour, the cost of labour is bid up. The same is true of other resources.

More Spending at Full-Employment = Growing Inflationary Risk = Concern to Monetary Policymakers

As resources cost more, it is not hard to guess what happens to prices. Inflationary pressures start to build and the threat of higher inflation looms. That is of great concern to monetary policymakers – such as those at the Federal Reserve in the U.S. and at the Bank of Canada. Most central banks have inflationary targets that they have set – and which represent the level of inflation they believe is appropriate – and that they are willing to accept for the economy. The common target these days is 2% and policymakers like to keep inflation within a 1 ½ to 2 ½ range. But 2% is the target.

If it looks like inflationary pressures may put their target at risk, monetary policymakers will act – and they act by raising interest rates.

Outlook: Growing Inflationary Pressures and Higher Interest Rates

So, with an economy at close to full employment, and with the tax cuts in the U.S. providing a big boost to spending, many could foresee the risk of inflationary pressures starting to build – and, as a result, the risk of higher interest rates was also looming.

Then, on Friday, statistics showed an increase in wages in the U.S. This, to many, was a sure sign of higher costs, higher prices, and, most concerning, mounting inflationary risk. That brings with it the greater risk that the Federal Reserve would start to move interest rates higher – and more quickly – to try and dampen borrowing and spending – and increase saving – and reduce the risk of inflation moving outside the target range.

Stock Markets Don't Like the Prospect of Higher Interest Rates

Stock markets tend to react negatively to the prospect of higher interest rates. Higher rates reduce consumer spending and business investment. That usually leads to lower corporate profits. Depending on the impact, it can also lead to some companies struggling. That, in turn, can lead to layoffs, lower incomes, less spending, etc. In short, the economy could take a turn and impact companies leading to further stock price declines. Higher interest rates also provide other possible options to buying stocks – e.g., saving options and instrument and buying other investment such as bonds.

Quick Summary of the Scenario

So the stage was set for the kind of market reaction we have seen:

- There has been a very long "bull" market – that is, rising stock prices;
- Stock prices rose to levels that probably were higher than they should have been – that is, some assigned a higher value to companies than the companies were actually worth;
- Many investors were expecting, and watching for signs of, a market correction;
- The U.S. economy was operating at close to full employment and momentum was building – and the Federal Reserve has already started to move interest rates higher;
- The tax cut legislation represented a potentially big boost to spending in an already heated economy;
- Statistics, such as wage rates, were starting to show signs of growing inflationary pressures;
- The greater risk of higher spending and higher inflation prompted investors to believe the "Fed" would increase interest rates even more – and more quickly;
- Therefore, investors, suspicious of a looming correction, and seeing the risks mounting for such a correction, acted when things started to turn, fearing that things could turn down quickly for the market after such a long "bull" run and as the "Fed" acted to moderate inflationary pressures;
- The result – lots of selling and rapidly declining prices.

There are two other points to note in this brief discussion of the stock market turmoil.

Institutional Buyers – and Sellers – Can Affect Stock Markets

First, be aware that there are large institutional investors – such as pension funds – that invest very large quantities of funds. When they buy and sell, they can influence markets. And, after likely making some very healthy gains in the market, their selling programs can kick in to lock in the gains they have made before stock prices fall very far. This can lead to large volumes of selling that can accelerate a sell-off in stock markets. Some selling is programmed and automatic when stock prices hit a certain point. That is why you can get some very large quick drops in the market – and then a fairly quick moderation as the programmed selling eases off.

This is Different from the Financial Crisis

Second, this is different from 2008 when, during the financial crisis, there were very real factors triggering the declines in the market – e.g. the collapse of Lehman Brothers along with the risk of a collapse of the global financial system – as well as risks to some European economies (remember that?).

The markets are not declining because of such real economic challenges. They are declining based on the great run they have had – the fear of a correction, and the forecast for higher interest rates based upon recent events – that scare stock markets.

How Far Will Things Fall? Hmmmm….

Consequently, since the fundamentals in the global economies are much stronger than they were back in the time of the financial crisis, our belief is that markets will stabilize soon – after a healthy correction to normalize stock values and bring them into line with real value. Then, most investors will look for the opportunities to buy that have been created by the downturn. After all, in the same way that some stocks get over-valued on the way up, some stocks will be over-sold during the downturn to the point where the stock price is below the real value of the company. Those prices represent buying opportunities. New buying will stabilize the market and likely start to recoup some of the losses experienced during the downturn. If history is any indication – and that is not always the case with markets and investing – the markets will eventually recover from the losses as the economy, and companies, continue to grow – and consequently higher stock values are justified.

Buying Will Return – But When, and to What Extent? Hmmmm….

How high the markets will then go after the downturn, and how much will be recovered, and how fast any recovery will be, is anyone's guess. The uncertainty of the stock market is something all investors have to live with.

So What is One to Do?

The best move for most investors now, after such a downturn has happened, is likely to hold on, ride out the downturn – hope it is not far and long – and hope that the market will soon start to turn positive again. After all, if your stock values have fallen, you don't actually realize the loss until you sell your stocks. Selling now would realize the loss. If there is a recovery – and there has always been an eventual recovery – you may not actually incur those losses. But that is, of course, your call, and you should be aware that capital losses can often lead to tax write-offs. That can be the happier side of a loss. (Although capital losses are not realized for investments in RRSPs – just an FYI).

So, as we have noted, every investor is different. Situations are different. Life circumstances are different. Tolerance of risk is different. In the end, you will have to do what is best for you – and hopefully lets you sleep well at night. We wish you and your investments, if you have them, all the best.

Gary Rabbior, President
Canadian Foundation for Economic Education

February 2018