What Makes Stocks/Market Go Up/Down? Part 2

I worked for a major discount brokerage firm, and I traveled to many of their branches presenting investment seminars for their affluent, active investors in the North East of the U.S. down to Puerto Rico.

I would ask the investors/attendees to the seminars on what they thought drove the markets; the most common answers were market manipulators and the stock market is gambling (the big boys manipulate the markets), sentiment, news, earnings…

Last week I wrote the first of a three part series on what are the three most important variables that move the markets/stocks up/down. Click here to read the first article.

Variable #2

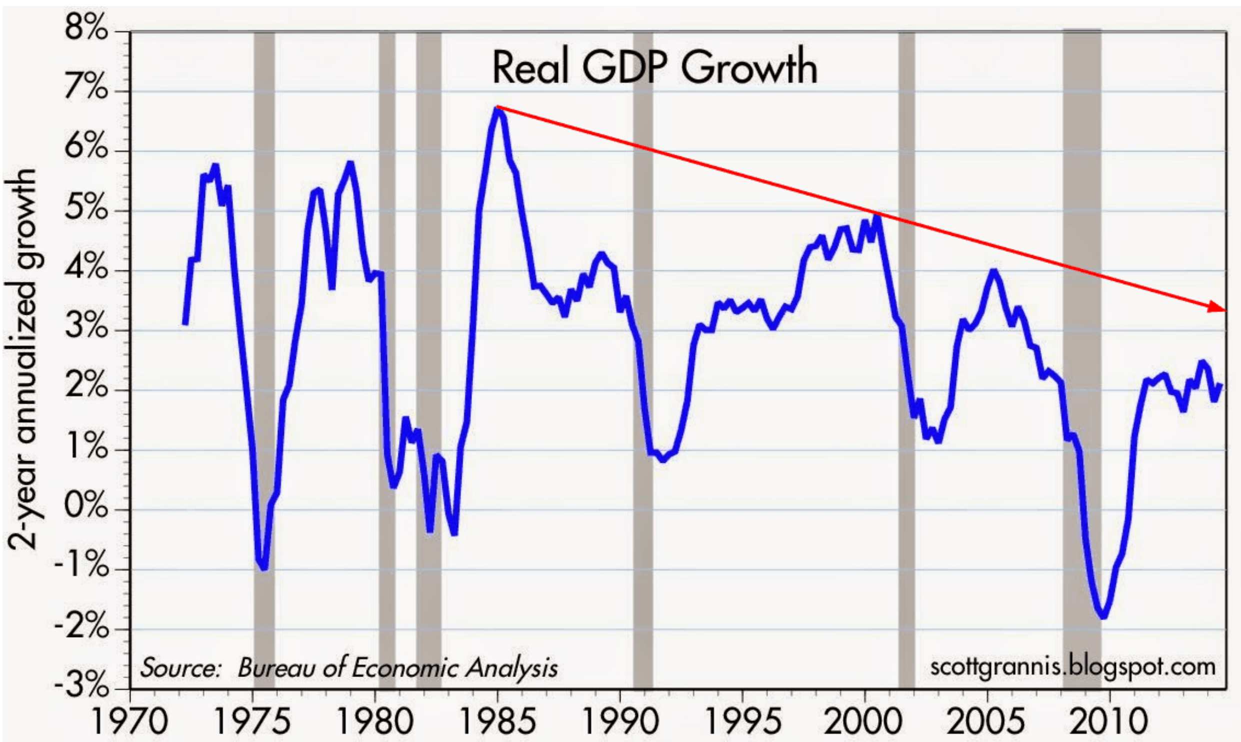
Last week I wrote about how important inflation and interest rates were to stocks and markets.

Low interest rates and inflation normally create the conditions for growth in the economy.

Growth in the economy is essential for appreciation of stocks and the markets. Growth allows for more hiring, earnings and free cash flow growth, capital spending, dividend increases, buyback programs of company stock, and this leads to a positive feedback loop and the potential for higher stock and market prices.

A contracting economy causes the opposite: layoffs, lower earnings, cuts in capital spending, cuts in dividends and a negative feedback loop that causes selling that eventually leads to emotional, irrational selling.

The best way to determine growth is to start with the U.S. economy. Below is a long-term chart for GDP growth:



The grey highlighted area are periods of recession; fortunately they are few. The average U.S. recession lasts about 10 months.

There were two recession in the 1980s (double dip recession 1980, 1981) and the first decade of the 2000s.

There was only one recession in the 1970s, and 1990s.

Below is a long-term chart for the market for the same time period as the GDP chart:

I circled the periods in the market when there was a recession. We do get a bear market each time the economy goes into a recession.

The market has gone into bear markets without going into a recession. I will explain why in the 3rd part of this series of articles.

Most growth periods last about 5 ¼ years. Our current recovery started in 2009 and is in its 6th year, one of the longest in U.S. economic history.

Notice in the GDP chart, normally at the beginning of a recovery, the growth rate is faster, as the economy enters its topping, mature phase investors need to be more cautious. Economists and analysts are not very good in forecasting important inflection points in the economy and markets.

Also notice that the growth rate in the 1970s and 1980s were over 5% and peaked in the middle of the 1980s. There are lots of reasons why the economic growth rate has slowed since the peak in the 1980s.

One of the main reasons why the growth rates has slowed is the “new normal”. Click here to read my update on the new normal. The “new normal” in the 3rd section of the article.

Most economic and stock market cycles end because the economy heats up and the Fed needs to raise rates to slow the economy. The economy slows and the sins of the cycle (bad underwriting, too much leverage, too much speculation….) cause more economic problems that normally leads to a recession.

What is good about this cycle, is the economy is not strong enough, and inflation is low enough where the Fed does not have to raise rates to slow the economy and inflation.

Because we can expect slower growth in future economic cycles, perhaps we can expect longer economic and market cycles, a good thing.

Conclusion

There are several take aways from this article:

- The market and stocks need growth in the economy to do well. If the economy is in recession, expect a bear market.
- Fortunately the U.S. economy spends much more time growing versus being in a recession.
- Because of the “new normal” we can expect the average growth rate of the U.S. economy to continue to slow.

There are many actions that an investor can take with a slowing, mature U.S. economy:

- Invest in industries and companies that are growing faster than the economy, but pay attention to valuations.
- Invest in companies that pay dividends to enhance your total returns.
- Write options at appropriate times to enhance the total return of your positions.
- Be aggressive and think long-term at the beginning of an economic and market cycle.
- Be more cautious as the economic and market cycle matures.

I do a monthly economic outlook for our subscribers. The main reason for the monthly economic outlook is to provide our subscribers the direction, temperature of the economy: I’m taking the temperature of the economy for its health, and to determine the conditions for investing. This helps us be on the right side of the market, and to adjust to changing economic conditions.