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What's behind falling stock prices?

Quickening economic growth and sliding interest rates are ideal conditions for stock prices. Decelerating growth and tightening monetary settings – where we are now – are among the worst.

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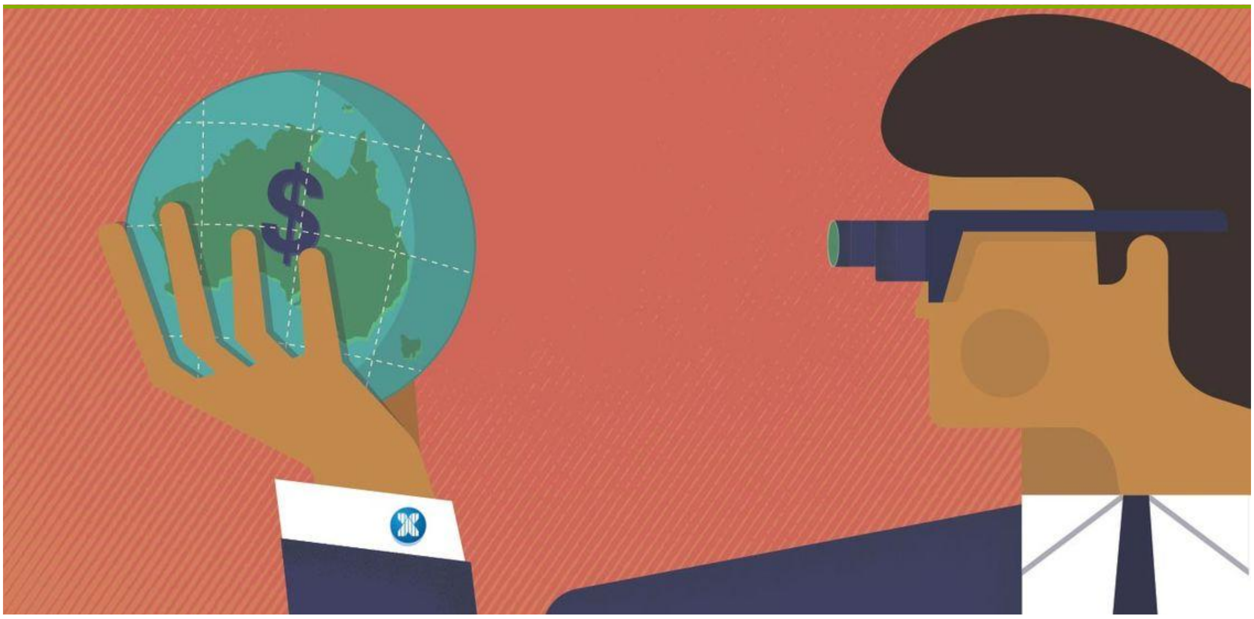

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Global equity markets had started to wobble in the early weeks of 2018 with a nine-day drop of 9% after a nine-year gain of 227%. Despite the gloomy overtones, many equity investors were happy to take a 10% drop in the S&P 500 as another cue to buy, as they had on numerous occasions since 2009 whenever prices had faltered.

As 2018 nears an end, the benefit of the doubt has swung in the opposite direction as, one by one, the principal drivers of the 2009-2017 market performance have lost their impact. The macro outlook now suggests sluggish markets, at best, with a heavy reliance on central bank policy for future market gains.

In the US, economic growth had been subdued by historical standards but the expansion had been sufficiently long to get unemployment down from 10% to under 4%, in an outcome economists had once labelled an unlikely possibility.

Into this benign US economic mix has been injected a fiscal stimulus, including a dramatic cut in statutory corporate tax rates, which helped push S&P 500 corporate earnings growth to an unrepeatable 33% over the year to September 2018, dooming 2019 to a series of unfavourable comparisons.

Worryingly, US market gains had become centred around a handful of well-known names including Apple, Amazon, Facebook, Google parent Alphabet and Netflix - popularly known as 'the FAANG stocks'.

Longer established companies more broadly connected to the domestic US economy had been finding the going tougher. A stronger US dollar was not helping. Nor was stubbornly low wages growth. The more domestically focussed Russell 2000 lagged other US market indicators.

Helped by the onset of rising interest rates and the prospect of a lightened regulatory regime, US banks made dramatic share price gains in 2016 and 2017 but, there too, momentum sagged as narrowing bond yield spreads frightened investors. The important S&P 500 financial services index has made no net gain over the past year.

> **Peak growth for the cycle appears to have occurred in late 2017**

Progressively, even the technology high flyers faced stronger headwinds as investors' ready embrace of plans for aggressive market penetration gave way to questioning about future threats and challenges.

The five FAANG stocks on which the market had relied for a disproportionate part of its ascent have now lost over US$900 billion in market capitalisation. Hopes for a business model immune to the growth and liquidity forces shaping market outcomes in other sectors are being dashed.

Daily market noise levels have also contributed adversely to sentiment. Sino-US trade policy frictions, interminable Brexit negotiations, oil price gyrations, Russian interference in foreign elections, European government debt overload and developing country political ructions have added market volatility.

Some of these events might have proven little more than temporary distractions, if more profound changes in monetary conditions were not already underway.

Critically, after a near four-decade downtrend, US government bond yields have begun moving higher with adverse implications for valuation and equity market stability. At the same time, markets have become rightly preoccupied with what the US Federal Reserve will do despite, or perhaps because of, a well flagged determination to get interest rates back to something called ‘neutral'.

With good reason, investors are sceptical about the Fed achieving its policy goals without hurting growth. In the past, the world's most important central bank has been unable to tune its decisions finely enough to guide economic activity onto a smooth landing trajectory.

When policy rates were near zero, the direction of a neutral setting was self-evident. The gap was so large that the risk of moving too far or too quickly was negligible. Now, as the central bank edges closer to still ill-defined neutral settings and economic conditions become harder to discern accurately, the risks of accidentally precipitating a recession grow.

On the other side of the balance, even an overly cautious central bank is a worry if near-term reticence to act is taken to mean the onset of worsening growth or if delays in taking action necessitate larger, and more damaging, adjustments later.

Even if the Fed surpasses expectations about its monetary management prowess, the ‘will it, wont it' guessing will be an ever-present market performance barrier in 2019 - unless the Fed emphatically backtracks on its stated plans.

Tightening US monetary conditions have added to the domestic policy pressures confronting a large number of developing economies whose currencies have dropped by as much as 50% over the past year and whose growth prospects have been dimmed by a flight of capital.

It had taken the best part of a decade for economists to cast off their pessimism about the risks to the global economy. During the latter part of 2017, the International Monetary Fund (IMF) had finally started to talk about the balance of risks improving. Market commentators began talking excitedly about synchronised growth.

The improved outlook proved fleeting. The anticipated self-reinforcing cycle of synchronised growth was struggling barely a few weeks into 2018. Within a year, the IMF was recanting its optimism.

Peak growth for the cycle appears to have occurred in late 2017. US, European and Chinese governments will be pleased to simply hold the line. Nothing better is expected. Worse is easily possible.

US stimulus is subsiding. A Europe preoccupied with institutional arrangements is giving little thought to much-needed productivity enhancing policies. And, in China, the transition to a more decentralised, consumer-oriented economy means permanently lowered growth potential.

Ominously, too, OECD money supply growth has already decelerated from higher than 10% (M1 inflation adjusted) over the year to March 2017 to 6% over the year to August 2018 in a trend pointing to further unpleasant cyclical adjustment in the year ahead.

The direction is set.

Next week's 'From the Capital' column will discuss what this change in growth patterns and evolving monetary conditions mean for the mining industry.

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