Zero-Sum Market

In the wake of nearly a year and a half of exceptionally stable and strong stock market activity, the beginning of February saw an unleashing of daily price movements not unlike what you would have expected from the awakening of a sleeping giant. Three-quarters of the trading days since then have seen triple-digit changes and there were two days when the closing difference ended up needing four digits.

Given this dramatic upsurge in volatility, one might be tempted to think that we have moved into an end-of-the-world scenario, but the reality is that it has been similar to an essentially zero-sum game. A zero-sum game is one in which the gains on one side are exactly balanced by the losses on the other side.

At the end of March, the Dow Jones Industrial Average found itself just slightly below where it stood at the end of 2017. The net result of all the recent daily fluctuations is a little changed market.

These gyrations suggest that short-term swings in psychology, not economic fundamentals, are what's driving investors' actions. Domestic political problems are one thing. And then there are geopolitical concerns such as the prospective summit meeting with the North Korean leader and the continuing carnage in Syria. So one day the media sows the seeds of increased tensions in some area or another. The next day new information suggests that maybe everything's going to be just fine. The hitch is that there is no consistency, which leads to the continuation of wild swings in stock prices.

What drives stock prices over the long term in a reasonably dependable fashion is improving corporate fundamentals. What drives investors crazy in the short term is the uncertainty of what's going on.

One would be remiss in thinking that this volatility will taper off anytime soon. But one would be correct in appreciating that the overall economic environment remains quite favorable. Corporate earnings, at least partially due to an easing in tax rates, are likely to climb almost 20% this year and a further 10% in 2019. Those bottom-line increases together with this year's marking time of stock prices have brought valuations down to significantly more reasonable levels.

The current price-earnings ratio of the Standard & Poor's 500 is in the range of 16 to 17 times, which is in line with traditional levels. Against the backdrop of continuing low interest rates, there is a decent argument for suggesting that today's prices are attractive.

The longer view is encouraging, though there certainly are concerns. For one thing, with the unemployment rate hovering near a decades-long bottom of about 4.0%, there are increasing constraints on the labor supply. The number of jobs has risen without a proportionate increase in the population of folks who would be able to fill those jobs. If this continues, there may well be upward pressure on wages. Whether this will be accompanied by a similar path of inflation is another story.

Although there has been some upticking in prices, the current level as well as the prospective inflation rate seems likely to remain relatively close to the Fed's target of 2.0%.

The central bank appears committed to a series of rate hikes over the quarters ahead, but that action probably will be at a measured pace, not one that would disrupt economic progress. At the current juncture, it would be reasonable to look ahead to annual GDP gains of about 2%, not exactly torrid, but enough to support a productive investment opportunity.

Aside from the daily intrusions of media regurgitation, one could certainly call this a Goldilocks time. Not too hot, not too cool, just right. Even so, it has been almost a decade since the Great Recession and the ongoing recovery, compared to those of the past, is growing long in the tooth.

No doubt, the more moderate gains likely in 2019 may be seen by some as a darkening of prospects. The bigger issue, however, is the continuing increase in the federal debt burden. During the past decade, when interest rates were at historical lows, Washington's obligation to service that debt was relatively light. With interest rates rising and government debt ballooning as a result of huge annual budget deficits, this will become an increasingly difficult situation. Unless and until Congress gets going with a concerted effort to reign in its top-heavy fiscal situation, we will be faced with the growing specter of something akin to an 800-pound gorilla in the room.

Things look okay today, but a lot of work will be needed to keep them okay tomorrow.