MARKET COMMENTARY

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Wildermuth WEALTH

Market Experiencing Odd Trading Patterns as Growth Slows in Face of Trade Wars

June has treated investors very well with most of the major market indices notching new all-time highs. Despite some mild pullbacks late in the month, markets remain sharply up on anticipation that U.S. President Trump and Chinese President Xi will reach a trade truce similar to the one struck in Argentina.

The same trade-war cycle keeps repeating – threat of new tariffs, talks break down, delay of tariffs, hints of compromise, a meeting is scheduled, etc. Through the process, markets react predictably, but mostly lurch forward more than backward.

Trade-war potential has provided the primary storyline to an otherwise relatively stable but deteriorating global economy. Overall, the U.S. economy keeps churning forward, but it's steadily slowing. First quarter growth was revised down to 3.1% with much of the expansion coming from inventory build-ups in anticipation of trade problems. Second quarter estimates project growth less than 2%. Manufacturing and housing are slowing, and consumer spending increased last quarter less than previously estimated. Growth in business spending is also slowing after a strong 2018 spurred by tax relief.

Headlines concerning economic growth are harder to find because the story is somewhat dull – not much good news, mostly declining trends, but no terrible news either.

Internationally, the story is similar but less positive. Nearly all economic indicators are weakening, but not disastrously. Eurozone confidence has fallen to its lowest level since 2016 in response to trade tensions and the increasingly somber global growth outlook. China growth is sluggish, but fairly stable.

Even though markets are setting records, economic data could be interpreted to

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suggest that the market may be topping out soon or minimally slowing. Beyond the economic indicators, the market trading data and valuations could be suggesting this too.

Trading and prices for different stocks over the past year are departing from historical norms in multiple areas. Small company stocks which earn more of their revenue domestically usually benefit from turmoil outside the U.S. as investors buy them to minimize international exposure. Instead, over the past year, investors have largely avoided them. The Russell 2000, a notable small capitalization benchmark, has trailed the S&P 500 over the past several weeks while the trade war rages. For example, on Monday June 24th, the S&P 500 slipped by 0.2% on trade fears, while the Russell 2000 lost 1.3%. This is the reverse of normal trends. Through June 24, the S&P 500 was up 7% while the Russell 2000 trailed it, up 4.4%.

Even the recent strengthening of the dollar, which typically boosts small-company stocks because they do not convert as much overseas revenue back to the U.S. dollar, has seemingly not helped.

Looking back longer term, over the past 12 months through June 24 the Russell 2000 has lost 9.2%, compared with the S&P 500's 6.9% rise according to Factset. Microcap stocks, which often benefit from international instability even more than small cap stocks, are faring even worse with the iShares Micro-Cap exchange-traded fund down 17% in the past 12 months. If the same performance were generated by the larger indices, headlines would be shouting about the impending bear market and other associated doom and gloom.

Much of the difference in performance results from the ongoing flood of money into growth stocks, frequently represented by the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix and Google). Through late June Facebook was up 47% on the year, Netflix was up 39% and Amazon was up over 27%. Their gains have propelled the S&P 500 forward, but have had no impact on the Russell 2000 because they are not in the index.

The growth versus value performance differences continue even within small stocks. Without the FAANG stocks, the Russell 2000 Growth Index has fallen 6.2% in the past 12 months, but the

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Russell 2000 Value index is down twice as much.

Over this time period, typical drivers of valuations such as underlying fundamentals have become less important. Instead, momentum and sentiment appear to be taking much larger roles in stock prices. General sentiment is also souring. The percentage of individuals reporting expectations for U.S. stocks to rise over the next six months has remained below 30% for six consecutive weeks, according to the American Association of Individual Investors. That marks the longest streak since the leadup to the tumultuous 2016 elections. Professional investors are also growing more pessimistic with half of fund managers projecting a slowing global economy over the next 12 months. The decline from only 5% in May marks the largest single-month drop since Bank of America began their polling in the mid-1990s. In another sign of pessimism, in recent weeks gold has rallied to over $1400 a troy ounce, its highest level in nearly six years.

Finally, compared to a decade ago, a vastly larger percentage of stocks are held by passive investment vehicles such as Exchange Traded Funds (ETFs) that buy and sell positions solely based on their percentage of an index. For many companies, more than 50% of their shares are held by a handful of ETFs. During good times when investors outside of an index are buying a stock, a rising price forces funds to buy shares to keep their ownership percentage the same as it is in the base index. The two buying groups can push a stock price up for reasons that may have little to do with underlying fundamentals. Markets with heavy exposure to big companies popular with small investors can move more sharply as passive investment vehicles must buy and sell to keep their holding percentages in line with the indices.

Still, all these atypical market and valuation trends could mean little, and a future reversion to normal could minimally impact investors. Yet, the increasingly odd trading patterns and larger deviations from multiple past norms also suggest that the recording-setting U.S. equity market may be less stable than it seems. In addition, if the market reverses and various valuations and trading patterns revert to norms, many indices and trading approaches that have benefitted from the unusual past few years could suffer disproportionately. Simply, while there is no recession in sight and slowing growth remains reasonably solid, caution may be warranted even if the trade dispute is settled and markets follow their familiar pattern of charging higher in the short-term.

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