The Outlook: Jan. 15, 2019

The state of the market.

Let's ask a very basic question. "What is the state of the market these days?" In one form or another, this question is asked and answered, all day and every day, by countless people whose expertise ranges from "a lot" to "none."

The only good answer to that question begins by defining "the market." If we don't agree about what "the market" actually is, any discussion of "the state of the market" will become a hopeless muddle in no time . . . which happens to a lot of conversations about "the market."

The market is where ownership shares of real, operating businesses are bought and sold every second by a very large crowd of people. This crowd is much bigger than most investors imagine. As vast as it is, though, it holds only two kinds of people: investors, whose basic plan is to make money from their businesses for a reasonably long time; and speculators, whose basic plan is to make money from each other by guessing how most other speculators will act in response to the impressions created by the daily flow of news—generally in the next few seconds, minutes, hours, days or weeks.

Investors look at the businesses they own. Speculators look at each other. The difference is night and day.

We don't know how many people belong to each camp. We do know, however, that the speculators' camp completely dominates daily trading activity. The investing camp's trades are something near a drop in the bucket compared to the speculating camp's trades. What this means about "the state of the market" is unmistakable. It means the often-false impressions absorbed by a vast crowd of very anxious people will regularly make a big part of that crowd feel the same way, and buy or sell in the same direction—because that's what crowds of anxious people feel and do. In other words, the lack of judgment of a big crowd of anxious people will regularly push market values to levels which make no sense to investors who actually try to make good judgments, using all the real-world facts concerning their operating businesses.

The last thing we know is that false impressions held by anxious people don't live forever. They are killed, eventually, by the same never-ending stream of news which so easily created them—because the news does carry facts, regardless of how often they're distorted or ignored by the headlines. And the most powerful of all, among such facts, are those which report on today's valuation of real operating businesses, by the market crowd. That anxious crowd aims to make money every day, and when valuations either become cheaper and cheaper, or more and more expensive, the speculating camp finally can't ignore the chance to profit.

So we investors own real, operating businesses whose share values will regularly plunge in a senseless way—and sometimes soar in the same way—because of the nature of the market's speculating crowd.

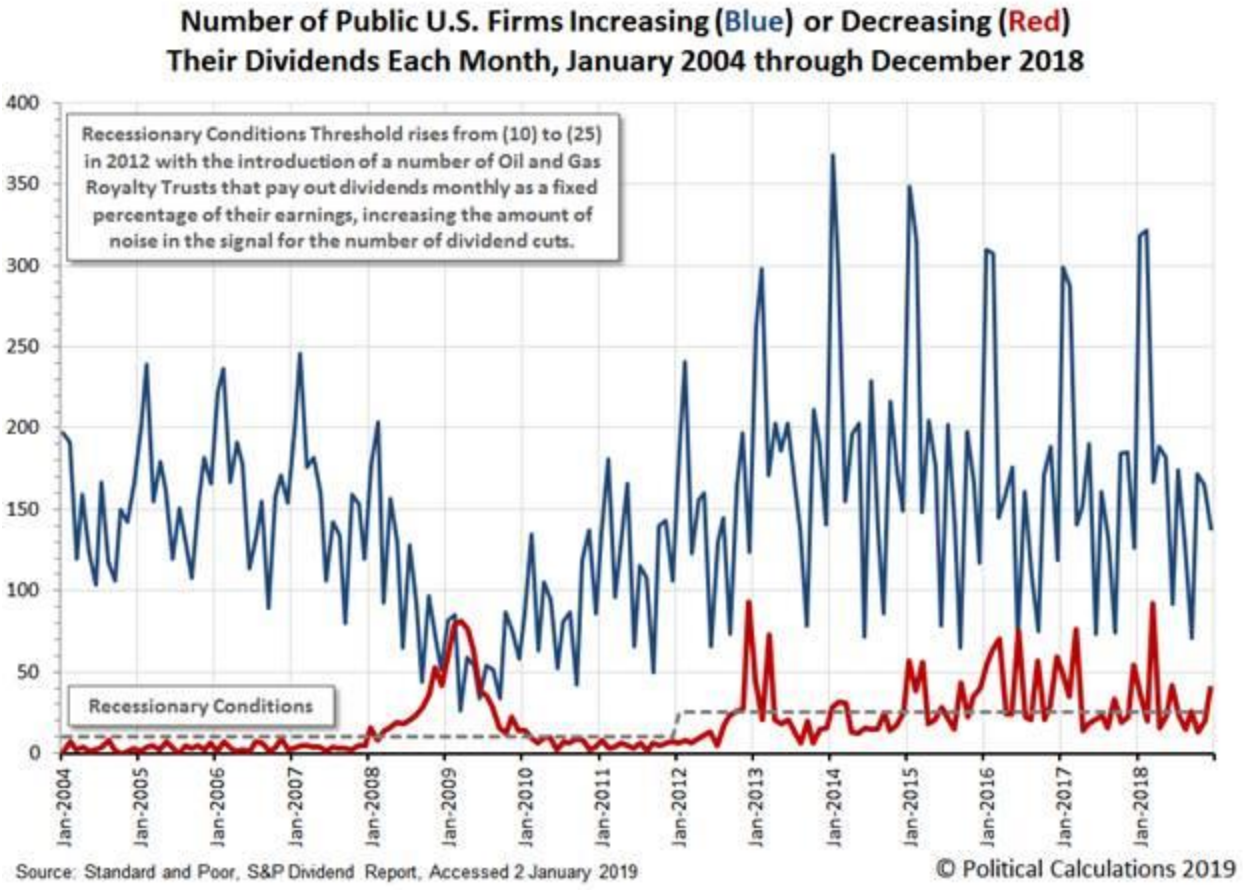
The market spent September, October and December in exactly that kind of plunge. The anxious crowd is always especially open to false impressions when the market has done well for a good while; and 10 years of general bull market, plus the last 2 years of unusually good gains (in 2016 and 2017), left the crowd readier than usual to be fearful. Economist Scott Grannis, the other day, wrote down the entire list of the market's fearful impressions:

- Trade war with China.
- Chinese and European recession.
- Falling profit forecasts (led by Apple.)
- The government shutdown.
- Trillion-dollar U.S. deficits.
- Rising interest rates.
- Plunging oil prices.
- Rising credit spreads (meaning more fear of default by lower-ranked corporate bonds.)

That's an impressive list, isn't it? As Outlook has noted, some of its items are especially fearful because they're poorly understood: trade war, China's economy, and the government shutdown, which is now unusual enough to earn the fear-laden label of "unknown." As a whole, the list carries some facts . . . but its essence is "the unknown:" the possibility that each of these general trends and events <u>might</u> end up making real trouble for the U.S. and world economies.

Next Mr. Grannis made another list: of hard, cold facts about the health of the U.S. economy. He is very good at such lists, and Outlook has often looked at them. We won't now . . . but we'll sum them up this way: the U.S. economy is extraordinarily strong at this moment, by a broad list of measurements. It is so strong, and the list is so compelling, that the most determined pessimists struggle to persuade people otherwise. (They've never stopped trying these past 10 years; but they're having an exceptionally hard time of it at the moment.)

Instead of looking at Mr. Grannis' list of positives, let's look at something completely different.



Here is 15 years of U.S. dividend history. (This particular chart "only" gives us 15 years . . . but we'd see exactly the same thing if we looked at 50 years.) The jagged blue line is the number of corporations which hiked their dividends each month. The red line is the number which cut their dividends. (The annual December spikes are because so many companies choose that month for their annual hikes.)

Over time, about 175 companies hike their dividends each month, compared to about 35 which cut them. Except for the Calamity of 2008—2009, when cuts just about equaled hikes for 6 months, dividend increases are very far above dividend cuts. This has been going on for decades and decades. It's been going on through all the booms and busts; through times when Mr. Grannis' list of market fears would have seemed 5 or 10 times as frightful (and likely) as his list today.

It tells us one profound thing: "The real economic world—the world of our operating businesses—continually and routinely shrugs off fears and impressions which continually and routinely paralyze the market with fright—for a while."

The state of today's market is this. The speculating crowd's belief in the staying power of fear was sharply weakened by 2 recent facts: first, the fact of ridiculously cheap valuations as of Christmas Eve, which had its predictable effect on a speculating crowd which wants to make money in both directions; and second, the fact of January's really spectacular U.S. jobs report—which strongly suggested that Main Street has not been frightened, yet, into slowing down its methodical growth due to Wall Street's fourth-quarter nightmare.

Fear is always more powerful than greed, in the speculating crowd (and any other crowd.) It hasn't vanished because of those 2 facts, but lingers on, hoping for real-world facts to revive it. At Outlook we doubt it will get those facts from this upcoming Earnings Season; but we're certain it won't get those facts in the long run. The chart above tells us what will keep happening in the long run: rising cash rewards to investors who own operating businesses, whose people look at their products and customers, rather than at Wall Street's anxious crowd.

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