THE WALL STREET JOURNAL.
WSJ.com

August 24, 2015, 7:15 PM ET

Two Potential Roadmaps for Where Stocks Are Headed Next

ByE.S. Browning

Justin Lane/European Pressphoto Agency

The past few days of market turmoil have been frightening for investors, even though this is what many money managers have warned of for more than a year.

Sooner or later, these money managers have cautioned, the Federal Reserve's decision to end cash injections into financial markets and to raise interest rates, together with a shaky world economy and nosebleed stock prices, would create a market crunch. As of Monday's close, the Dow Jones Industrial Average was down 13% from its May record.

E.S. Browning
COMMENTARY

A question some people are asking is whether this will turn out like 1987, when stocks eventually crashed before resuming their longer-term rise, or 1997, when an Asian financial crisis caused a shallower disruption that barely interrupted the U.S. bull market. Both of those events occurred without a U.S.

recession, similar to today, when most economists see no sign of recession lurking.

The big problem today is that stocks are struggling to wean themselves from Fed support. After injecting trillions of dollars into financial markets in an effort to help right the economy, the Fed is trying to move things gradually back toward normal. It is little wonder that the stock market has finally stumbled.

Initially, markets seemed to shrug off the Fed's moves. In October 2014 the Fed ended a program that had injected more than $4 trillion into the bond market, much of which had found its way into stocks, helping sustain the market recovery. Stocks moved little in reaction to the end of bond-buying.

When the Fed gave strong indications that it planned to raise its target overnight interest rate from its near-zero level this year, stocks also initially kept rising, although slowly. After all, a Fed rate increase would leave overnight lending rates below 0.5%, still highly stimulative to the economy. Fed Chairwoman Janet Yellen complained about the "potential dangers" of "quite high" stock prices, and stocks reacted little. But two other problems emerged to damage this market confidence.

First, the world's second-largest economy, China, found its maturing economy couldn't sustain its breakneck growth. It also discovered its own real-estate and financial bubbles. Its appetite for industrial commodities such as oil and copper slowed. Suppliers suffered from the softening demand and from their own financial excesses. World economic growth slowed.

These foreign problems pushed the U.S. dollar higher and that, with the soft global economy, sent U.S. corporate profit growth to its lowest levels since 2009. Some multinational companies, especially in the energy sector, announced significant profit declines. Weak profit growth is inherently bad for stocks. Recently, with China's domestic stock market falling hard and reports showing manufacturing activity stagnating, fears spread that things there are getting worse.

The third problem is that, amid all the euphoria generated by the Fed cash injections, stocks have become expensive. Even with the recent price declines, the S&P 500 trades at more than 20 times its companies' net profits for the past 12 months, compared to a historical average of 15.5, according to Birinyi Associates. Investors could look the other way at high-priced stocks when it seemed the market was moving only upward. When Fed support began to wane and profit growth turned sour, high-priced stocks were harder to justify.

The question now is now low they can go.

Money managers widely believe that the market's woes are a temporary and possibly even healthy correction of these problems, which will squeeze excess out of stock prices and permit stocks to rebound and continue their longer-term gains. They point out that it is rare to have a long, brutal bear market, meaning a drop of 20% or more, without an economic recession. And with the Fed and other central banks determined to keep their economies out of recession, economists widely consider a U.S. recession unlikely. Investors expect the Fed to put aside rate-increase thoughts and even inject money into markets again if it is needed to prevent recession. That helps explain why some people were buying Monday, pulling stocks off their lows.

This thesis could be right. But there are problems with it. Money managers are notoriously poor at predicting bear markets, and economists are notoriously poor at predicting recessions.

And, although bear markets outside a recession tend to be shorter and shallower, they can on rare occasion be brutal.

On Oct. 19, 1987, the Dow fell 22.6%, its largest one-day percentage decline ever, at a time when the economy was growing and would continue doing so. Historians blame overpriced stocks and over-confident investors, as well as a currency crisis. There are big differences between then and now. In 1987, the Fed was raising rates before the crash in an effort to cool the economy. Today, the Fed has no desire to cool the economy. Even if it raises rates, they will remain so low that they are stimulative. And on the currency side, the problem today is a strong dollar, not a weak one as in 1987.

Another parallel some people draw is with 1997, when high-priced U.S. markets initially sank due to the Asian crisis, but soon rebounded because the U.S. appeared more stable, even a refuge.

Whether either of these parallels is useful remains to be seen. For the past six years, however, a resilient hope and confidence have propelled stocks to levels that many investors now consider inflated. Fear has overtaken greed as the driving market force, and the big unanswered question is how long fear will stay in the driver’s seat.

Copyright 2015 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com