

# Are Markets Stressed Out?

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If the financial markets had an “official band” the way many things have an “official soft drink,” “official spokesperson,” or “official online mortgage provider”—you get the idea—right now it would no doubt be the group Twenty One Pilots, whose music has been called “schizophrenic pop.” The official song could be their current single “Stressed Out,” which has been sitting at the number two spot on the U.S. music charts. Anecdotal, a few recent stories support the idea that markets might be a little stressed. Traders for all asset classes increasingly have been sending emails to their subscribers full of signs warning of global stress. For the first time since 2011—and before that it was 2008 and 2009—we are now regularly receiving emails detailing bank credit default swap (CDS) spreads and providing gloomy commentary on risk of default. Market-based models indicate a high probability of recession, while at the same time other measures indicate a trough in U.S. growth probably happened in the December/January timeframe. Economic data supports the idea that growth remains steady, but the skeptics point out that these are coincident indicators, not leading indicators. Certainly, sentiment is negative. A colleague noted that people call to ask why the markets are better on certain days. Yet, no one calls to ask “why?” on days when the markets are worse. Investors expect bad news is the new “normal.” Stressed out, indeed.

Part of the problem is likely recency bias. The most recent U.S. recession is the financial crisis, or the Great Recession of 2008. According to the U.S. Bureau of Labor Statistics, this recession began in December 2007 and lasted until June 2009, although some experts put the unofficial end in 2014 while others say some statistics have yet to return to their pre-crisis levels. Anyone who entered the industry in just under the last 15 years only has that as their model for what a downturn looks like. The problem is that was not a typical recession, and valuing assets off of that kind of downturn is likely to lead to irrational prices. However, we believe unfounded valuations can lead to excellent opportunities. Great opportunities come from stressed markets, so the question is: how stressed are we, really?

One assumption investors make is that “markets” are good forecasters. They simply aren’t. There are excellent indicators that confirm when the economy is already in recession—inverted yield curves, for example. However, there is no one leading indicator that works on a predictive basis. On one hand, the ISM Manufacturing series, which is based on surveys of manufacturing firms by the Institute for Supply Management, indicates a 95% chance of recession right now. Meanwhile, the ISM Non-Manufacturing series indicates close to a 0% chance of recession. We have never had a recession with falling oil prices, although we have had profit recessions. Sending another mixed signal, high yield markets are at levels consistent with prior recessions. The conflicting data explains the investor confusion, and thus the fear.

Here is one way of gauging what might be priced into the markets in terms of stress. Currently, there are major U.S. banks trading well below tangible book value, implying that earnings will disappear and balance sheet assets will be written down substantially. Given that capital levels are much higher and leverage is therefore much lower than 2008, current valuations and underlying assumptions suggest an economic environment worse than the financial crisis. You may judge for yourself whether the data supports that view and whether the next recession will be like 2008-2009 or more like the recessions of 1990-1991, 2000-2001—or indeed most of the recessions since the 1930s. We will continue to filter out the noise and look for mispricings that we feel are unjustified. Often the market gets stressed out unnecessarily. Anyone remember the expected recession of 2012 that was predicted to follow the market stress in 2011? It is our expectation that current, overly discounted valuations will revert back to the mean, providing opportunities as the markets switch to a new soundtrack.

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