The Bullwhip Effect of the Economy on Stocks

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"Financial Advising is a prescriptive activity whose main objective should be to guide investors to make decisions that serve their best interests." **Daniel Kahnemann**

Executive Summary

This regular update is intended to be used as talking points with clients.

- Since the early 1990s, the major economies of the world have become far more globalized. This makes them highly interdependent.
- Small changes in end demand result in big changes in stock prices or more cyclical/ economic-sensitive stocks especially.
- Based on our reading of the business cycle tea leaves from ECRI, it is very likely the S&P 500 will fall below 1290 and stay below it for some period until the economic growth rate turns up again. We will talk about this more in a future letter.

Global Economies are More Synchronized

Cycles in industrial growth for global economies have become more and more synchronized. Since the early 1990s, exports as a percentage of GDP have doubled or tripled in Asian economies including Japan and in other export-oriented economies including Germany and Mexico. Even in the US, UK, France, and Italy, exports as a percentage of GDP are about one and a half times more than they were in the early 1990s.

Trade is an increasingly important mechanism for transmission of the business cycle and weakness (or strength) in one region quickly moves around the world. For this reason, investors are (rightly) worried that problems in Europe or Asia could spread to the US.

The Bull Whip Effect

A small change in end demand at the consumer level (as one would expect to occur during consumer deleveraging) is amplified in the supply chain and becomes most pronounced at its end. This is called the bullwhip effect because a small flick of the wrist produces a big arc at the end of the whip.

The sectors furthest from end consumers are those that are most discretionary in nature, i.e. those that either have a higher cost or that can be substituted for slack labor or existing assets. The prices of stocks in these sectors are generally the most impacted, especially in the early stages.

How Can We Use This Information

The point is that we have to be pragmatic. We cannot allow ourselves to be unduly influenced by those who are overly pessimistic or those who are overly optimistic. The reality that is, most ot the time, the economy muddles through and the approach we take to investing , Margin of Safety Investing, is highly successful. Our latest information suggests the business cycle slowdown which began recently will continue through the end of the year; however, there it is much too early to call a recession. Nonetheless, if you are buying individual stocks, in general now is a time to avoid cyclical stocks and to be more defensive.

When clear inflection points in the economy occur, as signaled by ECRI long leading indicators, we take a different stance to risk. During downward inflection points, we generally take less risk. During upward inflection points, we take more risk. At the moment a downward inflection point has already occurred and our portfolios are set up to withstand this as long as this does not turn into a recession. The next inflection point will be either more sharply downward (signaling a likely recession) or upward (signaling a renewed period of stronger economic growth).

ECRI's forecast for the economy leads us to believe the S&P 500 will move down in a pronounced, pervasive, and persistent fashion between now and the end of the year. If we assume that pronounced means 5% and that the peak of the S&P 500 was 1360, then we can assume the market will move below 1290 and stay below that for some period. If a recession should occur, it is not unlikely that the market will drop to around 1100 (20% drop) or even much lower depending on the severity of the recession. No-one can predict the future, but a good forecast can improve our odds and hopefully help us reduce downside risk should a recession occur again.

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