Context matters:

In the week immediately prior to my beginning to write this communication, there was the earth shattering (actually earth stretching) report that gravitational waves were detected. The existence of gravitational waves was predicted by Albert Einstein’s General Theory of Relativity. Now, you may be wondering how does this discovery relate to my life, and more importantly, my portfolio, and my financial life? That is a great question, please read on. In physics, there has been an attempt for many years to unite the four fundamental forces that exist in the universe (Strong Force, Weak Force, Electromagnetic Force, and Gravity) into one Grand Unification Theory (GUTS) that describes all of the forces. General Relativity brought new understanding to the force of gravity beyond the thinking described in Newtonian physics. In economics, Sir John Maynard Keynes published a book called the General Theory of Employment, Interest, and Money right after the Great Depression in an attempt to put that episode of history into proper context. A prior book that was published was by Ludwig von Mises and was called; The Theory of Money and Credit (1912) attempted to explain the economic realities of the late 19th century. All of these theories have one thing in common- they are attempts to explain the phenomena that occur in the world they are studying with the information and data that existed at the time. Like many of us, these men were curious about the how, and the why, as well as the what, as they, and we, move through our lives.

So, returning to the more mundane matter promised last month: What moves financial markets? Well, this is a subject for much debate, but for the sake of this communication, we will limit it to 2 variables: growth and inflation. These two variables are discussed at length in both Keynesian economics and the Austrian (von Mises) School of economics. What appears to be more important than the level of growth and inflation is whether the rates of both growth and inflation exceeded expectations. The following four scenarios in an economy can occur:

1- Growth and inflation are both higher than expected;
2- Growth is higher than expected, inflation is lower than expected;
3- Growth is lower than expected, inflation is higher than expected;
4- Growth and inflation are both lower than expected.
So, what does it mean for financial assets if both growth and inflation are higher than expected? Well, often times equities, hard assets, and inflation protected bonds will tend to outperform. Fixed income and cash alternatives are likely to underperform.

For the second scenario: Growth exceeds expectations and inflation is lower than expectations: Equities, Corporate bonds, and some treasury securities may outperform. Cash alternatives will likely underperform.

In the late 70s, there was a situation where growth was lower than expected and inflation was higher than expected, it was called Stagflation. This period had stagnant growth with high inflation. In this scenario, the inflation part of the statement tends to win out and some equities can move higher, but what tends to work here is real assets. Fixed income and many equities tend to underperform in this scenario.

When growth and inflation are lower than expected (please note I did not say non-existent, just lower than expected), fixed income (primarily government) tends to outperform and all others tend to underperform.

While the above is about the entire economy and broad market sectors, corporations have an analog. For corporations, the following is a possible scenario for them:

1- Revenue and expenses are both higher than expected-possible outcome: earnings above or the same as expected;  
2- Revenue is higher than expected, costs are lower than expected-possible outcome: earnings above expectations;  
3- Revenue is lower than expected, costs are higher than expected- possible outcome, earnings are below expectation;  
4- Revenue and costs are both lower than expected-possible outcome: earnings meet, or are lower than, expectations.

At this point, and this is where this communication needs to extend its length, as we should begin exploring who creates the expectations and what is being discussed with respect to expectations. One way of measuring the overall economy is by Gross Domestic Product (GDP). A very loose definition of GDP is that it is the sum of all goods and services produced within the US. If you look at an economy, it is based on transactions. One person is exchanging money (cash or credit) for the goods and services of another person. One person’s spending is another person’s income. This is a key concept. So, if the absolute level of the total spending is growing, that is considered a good thing. Meanwhile, there are hundreds, if not thousands, of people involved in calculating the expected levels of the total economy, and where the growth is likely to arise. These forecasters are the ones who create the expectations. Some of them are better than others, but by summing up all of their forecasting numbers and taking an average, that is where the expectation level often lies. So, if the average of the forecasters’ predictions creates an expectation of growth at a certain percentage, and the economy (as measured by the GDP growth) either exceeds or falls short, this creates the surprises. This then gets coupled with the concept of prices paid (costs). If prices rise more or less than the forecasters’ predictions, this also creates a surprise.
This level of forecasting is also done on the company level by securities analysts. For many of the larger companies, there are tens of analysts following them. For some of the less well-known companies, the numbers may be in the single digits. Each of these analysts do on the company level what is done by economists for the total economy. Also remember, these are estimates. Revenue for a company is often the sum of all transactions for their goods and services. Expenses for a company included personnel, raw materials, rent, equipment, etc. On the company level, their expenses are someone else’s income. In this case, when revenues are different than the forecasts predict and when expenses differ than the forecasts predict, that is when surprises occur.

If you turn on any of the financial news outlets that run 24/7, there are a few forecasters that show up after extreme market moves, usually down, and these same people often appear on every one of the outlets. Often times they are publicized as the ones that “predicted” the extreme market dislocation. Unfortunately, it appears to be challenging to find out the accuracy of their past predictions.

To sum up, in the areas of physics, chemistry, economics, and security analysis, a great deal of time and effort is expended in trying to understand the systems that are being studied. Models are created to explain and predict results. Expectations are then created. Results that differ from the expectations create surprises. Depending on the field, surprises are either welcome, or not welcome. I suspect that this is also true for individuals in their lives as well, so why should it be any different in the financial markets?

Opinions and comments expressed are those of the author and do not necessarily represent the views of Wells Fargo Advisors, LLC.

Wells Fargo Advisors, LLC, Member SIPC, is a registered broker-dealer and a separate non-bank affiliate of Wells Fargo & Company. CAR 0316-00000

CAR# 0316-01914


Gary N. Kwawer, CFA®
First Vice President – Investment Officer
10369 Clayton Road
St. Louis, MO 63131
314.991.7853 phone
800.999.4448 toll-free
314.991.7879 fax
gary.kwawer@wellsfargoadvisors.com
www.garykwawer.wfadv.com

My mission
I assist my clients in all stages and aspects of their financial lives. By providing independent, objective, and unbiased advice, I separate fact from opinion, allowing them to make informed and suitable financial decisions.

Past performance cannot guarantee future results

Investment and Insurance Products: NOT FDIC Insured NO Bank Guarantee MAY Lose Value

Wells Fargo Advisors, LLC, Member SIPC, is a registered broker-dealer and a separate non-bank affiliate of Wells Fargo & Company