Mitch on the Markets

Investor Pessimism Could be a Plus for the Market

By Mitch Zacks
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Investor sentiment has made a notable shift over the last two years or so, and the pendulum swing may actually help explain why 2018 was such a disappointing year for stocks.

Flashback to 2017 – the buzzword when describing the global economy was "synchronized global recovery," referring to the widely-held expectation that all developed economies were (finally) expected to grow convincingly and in unison. After several agonizing years of slow to negative growth in Europe and Japan, and "muddle-through" growth in the U.S., the global economy had finally hit stride.

Investor sentiment followed suit, with optimism about economic growth and market returns running high. Around this time last year – at the Davos economic conference – one of the longest-running gauges of investor sentiment created by Investors Intelligence showed bearishness at an *all-time low* among investment prognosticators. According to the data, the proportion of bulls versus bears was at its highest since 2010 in the weeks leading up to Davos.[1]

Perhaps this optimism should have been a clearer indicator of the difficult road stocks faced in 2018. In my view, here's how it works: Investors become overly optimistic about prospects for the global economy, then they become complacent and pile on risk, then they apply selling pressure when the economic data and news is not as positive as everyone hoped. In 2018, the not-so-positive news seemingly came in droves. The trade war, Fed tightening, political uncertainty, the government shutdown, and weaker earnings outlooks set the stage for disappointment and made it difficult for stocks to do well.

The upshot for 2019, however, is that the pendulum appears to have swung back in the other direction, with the mood in the global economy notably more negative/pessimistic today.

Market declines tend to affect sentiment, but I sense that there is also growing concern that the next recession is closer than many expect. In other words, investors see that the global economy is in sync again, but this time it's *slowing* in unison – not the other way around. The U.S. is coming off a ~3% GDP growth year in 2018, and 2019 looks poised to deliver at least a full percentage point lower in growth. The global economy bears a similar story – China expecting notably slower growth, and the U.K. and the European plagued by Brexit and the rise of populist politics. World trade volumes, coming off 5.4% growth in 2017 and 3.8% growth in 2018, are expected to grow at less than 3.6% in 2019.[2]

The current makeup of the global economy simply does not possess the same or even similar exuberance-warranting characteristics, and in my view, that's a good thing. If the global economic outlook in 2019 is uninspiring and has investors increasingly 'worried' about the outcome, then to me that just means there's a greater potential for a positive surprise. And stocks like positive surprises.

In my view, for the year ahead, these positive surprises can come in three forms:

1) A Federal Reserve interest rate "pause" mid-year or sooner;
2) A formidable deal with China over trade and structural economic issues regarding subsidies, patents, technology transfers, and openness to foreign investors; and,
3) A lifting of political uncertainty with the completion and delivery of the Mueller report.

These are three pretty big "ifs," but I tend to be in the camp of believing resolution is within closer reach than conflict.

Bottom Line for Investors

Sentiment has shifted fairly strongly to the negative, and investors seem increasingly inclined to hedge and shift to defensive positions even as the U.S. and global economy continue to grow. Yet the unemployment rate in the U.S. remains near 50-year lows with wages rising, and corporate earnings are still set to grow in the high single digits for 2019. It's as though investors are posturing for a recession that does not actually fundamentally appear imminent.

Warren Buffet once said that it's wise to be "fearful when others are greedy and greedy when others are fearful."[3] If investment sentiment is to be measured today, I would venture to say that investors are far more fearful than they are greedy or optimistic about the outlook for the economy and stocks. Assuming we get growth and positive results with a backdrop of pessimism, I think that could mean a good outcome for stocks.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, January 21, 2019. https://www.wsj.com/articles/investors-go-from-overoptimistic-to-sort-of-pessimistic-11548084000?mod=article_inline.
[2] The Wall Street Journal, January 21, 2019. https://www.wsj.com/articles/the-world-braces-for-slower-growth-11548116422?mod=djem10poin
[3] Investopedia, October 11, 2018. https://www.investopedia.com/articles/investing/012116/warren-buffett-be-fearful-when-others-are-greedy.asp

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