Pain is good, and the beatings to the markets will continue until the FOMO stops

KEVIN FOLEY
CONTRIBUTED TO THE **GLOBE AND MAIL**
PUBLISHED OCTOBER 19, 2022

Kevin Foley is a managing director of institutional accounts at YTM Capital and a former head of credit trading at a major Canadian bank. He sits on three Canadian foundation boards and investment committees.

Investing certainly isn't easy, but if we take a step back for a moment, it is easy to see how cheap money has fuelled excess, how prudent valuations got extended and how return expectations swelled. It's also easy to see how the can got kicked down the road. Now, some of those excesses need to be allowed to return to fundamental valuation levels, reflecting the current social and economic environment.

This is not a Harry Hindsight missive. This difficult market environment may be unfortunate, but it is natural, overdue, and healthy. The good news is that while this is a continuing repricing, it is not necessarily a crippling recession.

Investors abandoned fundamental valuations, which are not unquestionable rules but are excellent guides, by expecting emergency-level interest rates to fuel valuations for some time to come. Ask the equity analysts how they learned to support stock prices that had fully decoupled from traditional valuation. Ask home buyers about their experience. Sure, allow for the effects of momentum and sentiment and new models, but we need to be wary of true distortion. Current market behaviour continues to reflect more of a fear of missing out (FOMO) on the upside than a fear of the more likely downside.

As an example, look at the shocking market response to the COVID-19 pandemic from April, 2020. The onset of the pandemic was a largely unprecedented global human and economic event, yet after an initial slump, markets bounced back on cheap funding and went on to set massive new highs over the ensuing 21 months. That kind of behaviour wasn't normal, yet that and other market events in the past several years have conditioned investors to expect it.

Another example is the Dow rallying 500 points before this month's U.S. inflation report, followed by the 500-point drop when the very unlikely Fed pivot got even more unlikely, and then a massive same-day rebound, which further demonstrates the point.

The continuing hope that too many investors hold out for old, higher, asset prices in lieu of a sober application of reasonable multiples, a fair discounted-cash-flow analysis, and a consideration of the overall economic outlook is simply misguided.

These investors should consider their own pivot: toward patience for stocks and other assets to represent reasonable fair value.

The market can't go up until this learned bad behaviour and the FOMO stop. For the market to bottom and reflect fair value, thereby becoming attractive again, it has become apparent that it is going to take quite a shock.

Investors have been conditioned to not sell – and in fact to buy – the dip, after being saved or supported by cheap money so many times in the past 14 years. It is understandable why it may be natural to rely upon that same approach again this time, but we need to consider if this time is different.

Central bankers certainly have made arguably well-intentioned mistakes, but it is different this time and they can't be the saviour for asset prices. They have a very important inflation fight to fight, and it's one they can't lose.

Imagine for a moment that central bankers relent on raising rates in order to lend a hand to the stock market and the economy, and fully lose control of inflation and the disastrous consequences that could bring. In fact, the potential disastrous effects of runaway inflation, added to so many other worrisome current events such as war, other geopolitical conflict, falling earnings, slower growth, the rise of the U.S. dollar and civil unrest – not to mention the continuing, albeit subdued pandemic – should be reason enough to pause hopes for a rebound in equities and other growth asset valuations.

So where do we go from here?

Odds are that we may enter a technical recession but are not likely to face the worst fears of a full-blown recession because of strong earnings, healthy corporate balance sheets and strong employment. This period might be better dubbed a repricing rather than a nasty recession, as some would define it. The period may prove painful for many, but this repricing is arguably quite healthy in the grand scheme of things.

Most companies and individuals are actually well prepared to survive this downturn. Employment is strong and good companies prudently used the period of low interest rates to reset the cost and term of their debt, and used strong equity markets to manage their capital structure.

The coming effects of a higher cost of capital and a higher discount rate, of debt-laden companies going bankrupt and the end for some unfunded companies, the reality of lower growth owing to higher rates and associated economic factors, along with global considerations, should prioritize the demand for high-quality assets and high risk-adjusted-return investments – a notion that got lost in the cheap-money shuffle.