

What's Next, the “Ebola Sinkhole” Indicator?

“I am not a gloomy man by nature, nor am I easily depressed. I always say that, no matter how much it looks as if the sun were never going to stop shining and no matter how long the birds carry on their seemingly incessant chatter, there is always a good sleet storm just around the corner and a sniffly head cold in store for those who will only look for it. You can't keep Old Stepmother Nature down for long.”

~ Robert Benchley, *The Sunday Menace*

If he were still alive, Mr. Benchley could be making big money these days as a stock market analyst. Since the U.S. market peaked in late April, market commentators and economists have inundated investors with dire pronouncements. Investor sentiment has switched from bubbly to grim.

First was the handwringing over the “flash crash” in May. In early July came a widely publicized prediction by a well-known market technician that the Dow Jones Industrial Average would decline more than 90 percent over the next five or six years. Later that month, news services quoted various market seers worrying about an ominous chart pattern they labeled the “death cross.” In August, something market technicians call the “Hindenburg Omen” occurred, and the Chicken Little faction among the market's chattering class once again raised the alarm. (Where do they get these names? If only we could harness this remarkable creativity to fight market malfeasance.) As summer was ending, vexed experts began to fret anew about September being the really, really most very awful month of the year for stock market returns. Of course, there also are various economists telling us we are headed into another depression and that we have reached a tipping point in the federal budget leading to default and an inevitable national bankruptcy.

What does this search for a sleet storm amidst relatively sunny market weather tell us? The question is not the state of the economy (and most of the recent actual news admittedly is bad), but the degree to which that condition is priced into the market. Stock prices only reflect reality indirectly through the prism of the actions of a mass of investors. If everyone already knows something, it is not worth knowing because the market has already reflected it in prevailing prices.

“Never theorize before you have data. Invariably, you end up twisting facts to suit theories, instead of theories to suit facts.”

-- *Sherlock Holmes (2009)*, screenplay by Michael Robert Johnson, Anthony Peckham and Simon Kinberg

Psychologists might term the recent investor depression as “confirmation bias.” Against the warning of Sherlock Holmes in the quote box, most people *begin* with a pre-existing view, rather than simply assessing the evidence with no preconceived notions. Our brains are wonderful things, but sometimes they are so helpful that they keep us from seeing what we ought to see. For example, if you believe everything is rosy, you tend to notice all the news

stories that confirm that belief, while your brain filters out all bad-news stories to protect your theory. This may make it easier to relax at the end of a long day, but it is not a recipe for investing success. If you begin by looking for something in your market analysis, it is almost inevitable that you will find it. The media makes overcoming confirmation bias even more difficult, because the way to attract readers or viewers is to present stories that accord with already existing beliefs. The recent spate of negative market outlooks just tells us that investors, shell shocked by the events of the past few years, are inclined to be negative.

In other words, we humans tend not to see things as they are, but as we are. The market analyst predicting a 90 percent market decline generally has been bearish on the stock market since 1987 – a journalist could have interviewed him virtually any time during the past 23 years and written the same story that ran in *The New York Times* and other newspapers in July. The “death cross” and “Hindenburg Omen” make great copy, but both have very questionable records in predicting market declines. We reserve the right to return to a bearish stance in the future, but it will be the result of our careful analysis of evidence, not alarming stories in the media.

A key to successful investing is to admit that you do not know everything, that you cannot predict everything, and that you cannot control everything. Last month’s newsletter (available at www.sigmainvestment.com) was about Norman Borlaug, the virtually unknown creator of the “Green Revolution” who saved what *The Atlantic Monthly* estimated to be one billion lives. At the beginning of his career, he studied forestry and worked briefly for the U.S. Forest Service. Borlaug lost that job due to budget cuts, however, and this setback led him to return to school to study plant pathology. A billion people, therefore, may owe their lives to a failure, an unplanned detour in the career of a forester. Borlaug did not control his forestry career, but he was able to adapt to changing conditions, overcoming his inability to predict or control the future. If only market pundits and investors had the humility to accept that lesson. What is to come is uncertain; obstacles will arise that we did not expect. We just need to play the hand we are dealt as well as possible, both in the financial markets and in our lives, even if others insist on applying scary names to what may occur.