How to Deal With Market-Moving News

It's now been a year since the presidential election. While many were predicting the end of the world, U.S. stocks are up 24%, foreign developed stocks are up 23%, and emerging market stocks are up 23%. Allowing political beliefs to guide your investment ideas is not a useful strategy but people also get caught up looking for signals from potentially market-moving news or events where none exist. This piece I wrote for Bloomberg looks at how investors should approach the binary outcome nature of market predictions.

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A few weeks before the U.S. presidential election, two economists set out to quantify the impact the winner would have on the stock market. Justin Wolfers and Eric Zitzewitz looked at the market's reaction to the presidential debates to determine what would happen if Donald Trump were to beat Hillary Clinton.

They concluded stocks would fall sharply after a surprise Trump victory, with losses in the 8 percent to 10 percent range. While stocks briefly fell in after-hours trading the night of the election in the futures markets, they rallied more than 1 percent the day after the election from the previous day's close. And since Trump became president, U.S. stocks are up double digits with little-to-no volatility to speak of. Wolfers wrote a follow-up to his research paper to discuss where his prediction may have gone off the tracks:

What should I make of our forecast that stocks would fall if Mr. Trump were elected? One answer is that we were right, and that -- at least until midnight -- markets did fall sharply. A more humble answer is that we got this call totally wrong. It's not that we mis-measured what markets were telling us -- I'm confident we got that part right. It's that markets can change their minds, and we still lack a method for predicting that.

What most people failed to grasp is that the markets don't really care who the president is. The markets are rarely "telling us" something. Most of the time what's going on is completely random noise. But we want to believe that everything that goes on in the markets can be explained.

The stock market is a complex adaptive system where trying to understand how one event will impact the outcomes is often useless. Forecasting the future of any single event or variable is difficult. We saw this with the Brexit outcome in the U.K. in addition to Trump's victory. Forecasting the future for a number of different variables that interact with one another is even more difficult. And even if you have the ability to do that you still have to figure out how other investors, all with competing goals, time horizons and opinions, will interpret these variables.

It's hard enough being right once. Being right about both an event, its impact, the magnitude of the move and other investors' reaction is almost impossible, because the markets are based on

expectations more than anything in the short- to intermediate term. To make money, you don't just have to be right about what occurs; you have to understand what's priced into the markets and what the underlying expectations are.

In early August of 2011, Standard & Poors downgraded the U.S. credit rating from AAA to AA+ following the political circus surrounding the debt ceiling that year. While this was an unexpected event, the initial reaction from investors was that this unprecedented move could have huge ramifications for U.S. debt and rising interest rates. Before the downgrade, the 10-year Treasury yield stood at 2.6 percent. Rates are actually lower now, at 2.1 percent. The markets simply didn't care.

The September calendar is overflowing with potentially market-moving events. The European Central Bank meets this week. The Federal Reserve meets in two weeks. Tax reform is also on the table, not to mention the drama surrounding another debt ceiling.

Obviously, the markets don't always ignore everything that's going on, so investors have to come up with a framework to deal with both the expected and the unexpected. Here's how you can deal with the never-ending flood of potentially market-moving events:

- **Avoid binary thinking.** The markets don't operate like physics. There are no "if X, then Y" formulas to explain precisely what will happen.
- **Avoid single-variable analysis.** Relationships come and go in the markets. Correlations are constantly changing. Investors update their priors based on new information and data accessibility. Placing too much emphasis on any single variable, ratio, statistic or data point makes it difficult to understand what's really going on.
- **Avoid extreme positioning.** All-in or all-out can make you a hero if you're right, but that's no way to stay solvent over the long-term. Planning for various market scenarios is intelligent behavior when you're dealing with an uncertain future. You don't get to hit as many home runs this way but you also avoid striking out. The thing that makes an extreme stance so untenable is that it's psychologically challenging. You could try to sidestep every single potential landmine that exists on the calendar or you could try to create a portfolio of investments that is durable enough to handle a wide range of outcomes.
- **Pay attention to psychology.** Speaking of psychology, it's important to not only understand your own behaviors but those of all market participants, too. Fear and greed cause the pendulum to swing between pessimism and optimism. You can be the most rational investor in the world, but if you don't understand that everyone else can become wildly irrational at times, you'll have a hard time succeeding in the markets. Looking at market sentiment, expectations, trends and investor positioning are all paramount to gaining an understanding of the make-up of the markets.

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