Reversion of Expectations Theorem

The US stock market launched itself upon a massive rally after the election results last fall. It was starkly dramatic as short sellers had to buy to cover their shorted shares before they could go long, so the "booster rockets" kicked on fully and gave investors a one week gain of over 1000 DOW points!

What changed? Common wisdom holds that the rally on Wall Street was sparked by an outsider winning the election. From that perspective it was not a vote for Don Trump, but a vote against the consummate Washington insider. Why? Again, nothing to do with the personalities involved, although that occupied much talking space. No, not at all. It has to do with the feeling on Wall Street that the groupthink of Washington has been hampering this Nation for years. This isn't an ideological position, of left versus right, or free markets versus social responsibility. It's an operational position, namely, that Washington has ceased to function with any effectiveness, and that effect has been putting a drag on our Nation' s GDP for at least twenty, if not more, years. It had become acutely magnified as we entered the Great Recession.

We think it very important to view this along a proper time line, it is NOT about Clinton V Trump or D v R or last year's election specifically. It is about all of it. "IT" being the permanent malfeasance that drags all of us down with it, akin to an endless partisan civil war where we are collateral only.

In the past, we've been very careful to not mention "politics" in our investment missives, even though we have subscribed to the belief that we can quantify the drag Washington has put on our economy. We were validated by a Harvard Business School study , among others, that took our intuition and proved it with data. It is less about government spending as it is about effectiveness and efficiency.

If we hold this to be part of the truth, that the market has staged a rally from DOW 17,890 the day before the election, to over 22,000 now partly based on expectation of breaking the logjam, what may happen if it becomes common knowledge that the logjam is as dense as ever and nothing has really changed? We believe that is the question we must ask.

Using old rules of advances and retracements, folks have often reckoned on 40% retracements of forward advances by individual shares. The market being a "pool" of those shares should behave similarly, although the market will always have sectors that overshoot or undershoot the mean.

The old school wisdom would say that it would be "expected" to have a 40% retracement of the gain, especially if the basis of the gain has been put into question. Some simple math would should the gain of 4547 DOW points (recent high of 22,397 minus the beginning of 17,850) and if we took

40% of that gain off the high peak of 22,397, we establish a "what if" target of 20,579 on the DOW. (An earlier calculation showed DOW 19,933.) Either way, this is the ten percent correction many markets observers speak of. Our over simple math actually shows potential of an 11% drop.

Are we predicting it? Only conditionally upon the "reversion of expectations" theorem. If Wall Street wakes up one morning, and sees that nothing has really changed in Washington over the last year and realizes that the "accelerant" of breaking the logjam never really materialized, you can bank on it.

To re-emphasize , this is not about President Trump. It reflects a systemic issue that some clearly thought President Trump could tackle, an issue that has been around since at least the 1990s. Maybe his administration still can. That is beyond our expertise. Yet, if not the last paragraph will hold true.

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