Investors Have Become Brain Dead

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DUBLIN – Oil fell below $43 yesterday. Brick-and-mortar retailers are being emptied. The auto industry – including $1.2
auto debt – is stalling.

Meanwhile, restaurants are having trouble filling their tables. Consumers aren't buying, perhaps because their incomes
approximately nowhere for decades.

House ownership is at its lowest level in half a century… along with employment participation. And consumer price infla
measured by the Bureau of Labor Statistics, is falling. So are Treasury yields.

All of these things – and more – point in the same direction: toward a recession.

Blinded by the Fed

Meanwhile, in a parallel universe ed in Lower Manhattan, prices for stocks still sell near record prices.

The stock market is supposed to look a. It is supposed to see more than any one person. It is supposed to detect signs
long before they appear to the naked eye.

But it seems to see nothing at all. The subject of today's *Diary*: What is the cause of this blindness? Who's to blame?

Wasting no time on the evidence, we collar the culprit and get out a rope.

Why can't the stock market see what is going on in the real economy?

Because the Fed poked out its eyes. It did this, we charge, by cutting the optic nerve that connects the equity prices to
profits.

A stock represents a share in an operating business. Investors have many different businesses to choose from. Until re
spent some time getting to know them and then made a decision about which was most likely to do best.

If he anticipated a cold winter, for example, an investor might buy a company that delivered heating oil. If he saw a new
flying off the shelves, he might want to own the company that made it.

A more sophisticated investor might even take out a subion to Value Line and check the numbers.

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Rise of the Quants

Today, the market is dominated by quantitative (or “quant”) hedge funds (those that use complex computer algorithms t
and out of stocks) and passive ETFs (stock-like funds that simply buy and hold indexes such as the S%26P 500).

From a report by independent research firm 13D Research:

> The rise of passive investing has been well-reported, yet the statistics remain staggering. According to Bloomberg,
> [the world’s biggest provider of passive ETFs] saw net inflows of $2 billion per day during the first quarter of this yea
>
> According to *The Wall Street Journal*, quantitative hedge funds are now responsible for 27% of all U.S. stock trades
> investors, up from 14% in 2013. Based on a recent Bernstein Research prediction, 50% of all assets under manage
> the U.S. will be passively managed by early 2018.

Passive ETFs do no traditional stock research. Instead, they rely on rudimentary algorithms, or sets of rules, when it co
which stocks they buy and sell.

No algorithm ever went to a company meeting nor took the measure of the people running the firm. Nor do they care ab
industry the company is in… nor its products. Nor do they attempt to make any connection between the real world of bu
commerce and the stock price.

Missing Connection

Investor Steven Bregman, speaking at the *Grant’s Interest Rate Observer* conference, used the example of Exxon Mob

Suppose an investor, five years ago, was given advance notice of the future. He saw that the oil price would be cut in h
that Exxon’s revenue, too, would be almost halved, with earnings down 75% and the dividend payout ratio at almost thr
earnings.

What would he think? What would he do?

Surely, investors wouldn’t miss such a big swing in Exxon’s fortunes. The market would take in this new information and
the right price for the stock, wouldn’t it?

But no. A share of Exxon sold for $82 five years ago. It sold for $82 yesterday.

What happened to price discovery?

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How could a stock in a mature industry remain unchanged even as the price of its product (and its operating margins) h
halved? 13D Research again:

> At the heart of passive "dysfunction" are two key algorithmic biases: the marginalization of price discovery and the h
> Because shares are not bought individually, ETFs neglect company-by-company due diligence.
>
> This is not a problem when active managers can serve as a counterbalance. However, the more capital that floods
> the less power active managers possess to force algorithmic realignments. In fact, active managers are incentivized
> the herd – they underperform if they challenge ETF movements based on price discovery. This allows the herd to c
> assets and escalate their power without accountability to fundamentals.

The missing connection to the real economy has implications for the next stock market downturn. As they bought, so sh
As prices fall, the quants, robos, algos, and passive ETFs will not trouble themselves to discover the value thus reveale

They will simply sell.

How? When?

We don't know. But we wouldn't want to be standing in their way when the robots decide to run for the exits.

Regards,