

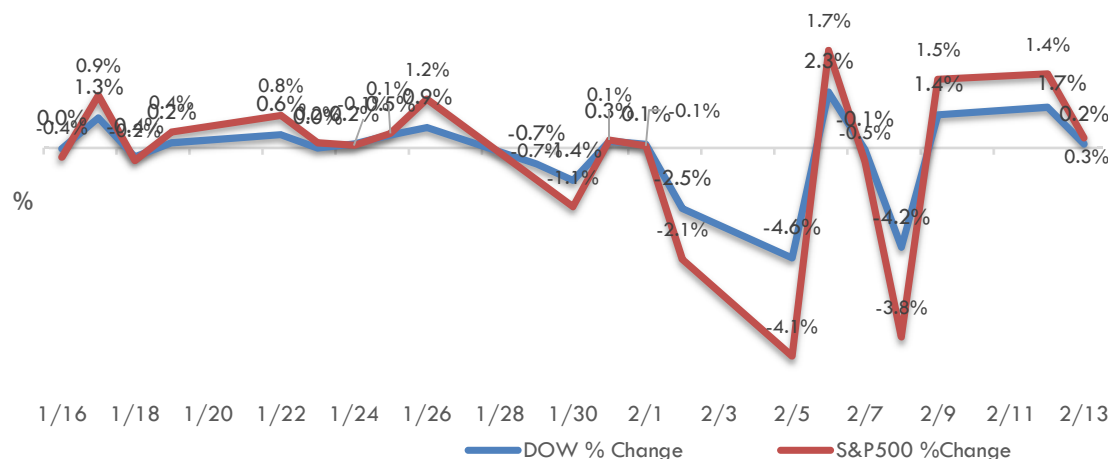
Of US Tax Cuts, Panic and Market Correction

The Red Flags

January 26, 2018 marked the beginning of what was to become a global stock market correction. For a good period, the market rode on a bullish tide which to many analysts seemed too good to be true. Consequently, analysts warned investors and maintained a look-out posture for red flags which pervaded their predictive judgements. However, consistent with the speculation, global equity market opened to a retreat in the first week of February; a panic reaction at the possibility of monetary tightening in the United States. Since perceptions typically precede same outcome, stock prices eventually dropped consistently for several days.

The climax became apparent on the 5th of February with S&P 500 and DJIA shedding 8% and 4% respectively. See figure 1. The Dow dropped 3% of its value in a feverish

Figure 1: Percentage change in S&P500 and the Dow



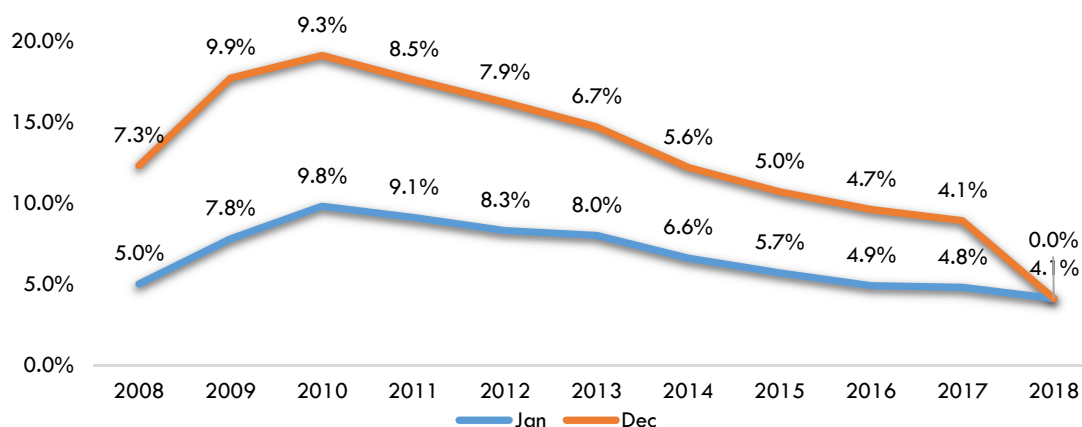
period of 10 minutes and regained it in few minutes. Almost all the S&P 500 stocks closed in the red at the start of that week. Wall Street was at this point jolted to the reality of a market correction. The effect rippled to Asian and the European markets with the latter being hit the least. The Nigerian stock market was not left out. She suffered about 6% loss within 7-trading sessions.

Puzzled by the Retreat

American business men had generous relief in December. Thanks to the passed tax-cut bill and the eventual 14% corporate cut aimed at stimulating domestic investments. The sudden positive impact was palpable with major boost recorded in the employment rate and the hourly wage rate among others. See figure 3.

What would have gone wrong? Is there a connect with the outcomes of the tax cut and the stock market? Analysts worried about how increased wages, higher dividend, lower unemployment rate, booming stock prices and a promising future will suddenly result in the observed market trend. An analyst¹ felt that the US government gave “expensive medicine to a healthy child” which would metaphorically-speaking cause the economy, as well as the stock market to “overheat”. The consequence is a boom-bust cycle of impressive growth followed by a sudden plunge. The argument is that the resulting economic performance might have slightly nudged inflation thus creating concerns that led to

Figure 2: US Unemployment Rate (+16 years)



Source: US Statistical Bureau

the U.S. Federal Reserve (Fed) tightening monetary policy more aggressively than initially planned with attendant increases in bond yields and corresponding decline in the equity market. The increase in inflation from December 2017 to January 2018 added salt to the injury. These speculations equally gained more ground sequel to the 3-time increases in the interest rate in the past year.

Counter-arguments

Another school of thought² holds a different view on the possible source chain. The counter-argument is that these conclusions are not in agreement with economic theory since the lagged effect of a tax-cut on any economy is typically longer than the period considered. Following this line of reasoning, the opinion is that the tax-cut has no

relationship with the inflation rate that rose higher than the expected level between last year and this year. It is arguable that large organizations such as Apple Inc. will move their investments abroad back home because of the impact of the tax-cut. Apple

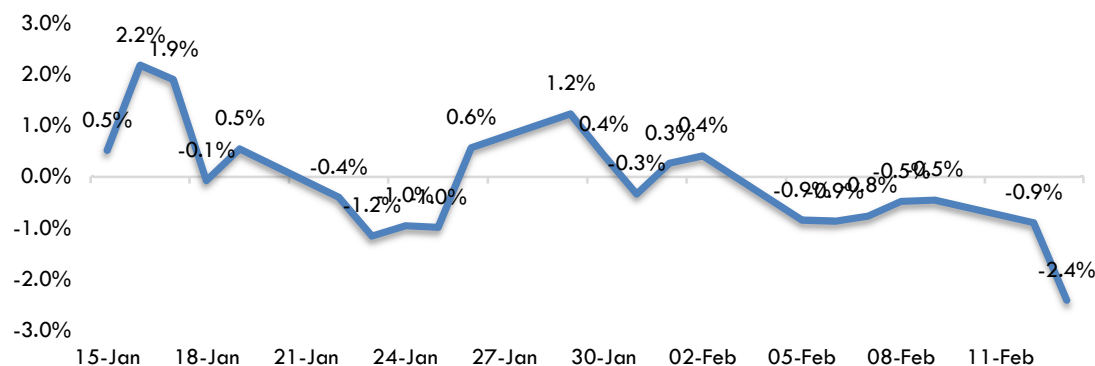
Inc. for instance declared an increase in workers' wages almost immediately after the tax-cut was approved; a coincidental spontaneity that cannot reasonably be tied to the tax-cut.

However, where do we locate the source of the increase in inflation from December 2017 till January 2018? It is apparent that more economists still attribute it to the tax-cut.

Nigerian Stock Market: 7-day Shock

Nigeria's equity market appeared to have equally responded to the tumult across US and other markets. The storm finally hit the prices of stocks on the 2nd of February. And for 7-consecutive days, Nigerian investors were asking themselves if that was truly an end to the months-long upward trend in the equity market space. The speculations of an

Figure 3: Change in ASI in the NSE (%)



Source: NSE, 2018

increase in the interest rates in the U.S was causing Foreign Portfolio Investors to pull out with local investors following suit. The theory that as the equity market thrives, the bond market slumps and vice versa apparently played out in the supposed flight.

Nigeria might have been spared if she had

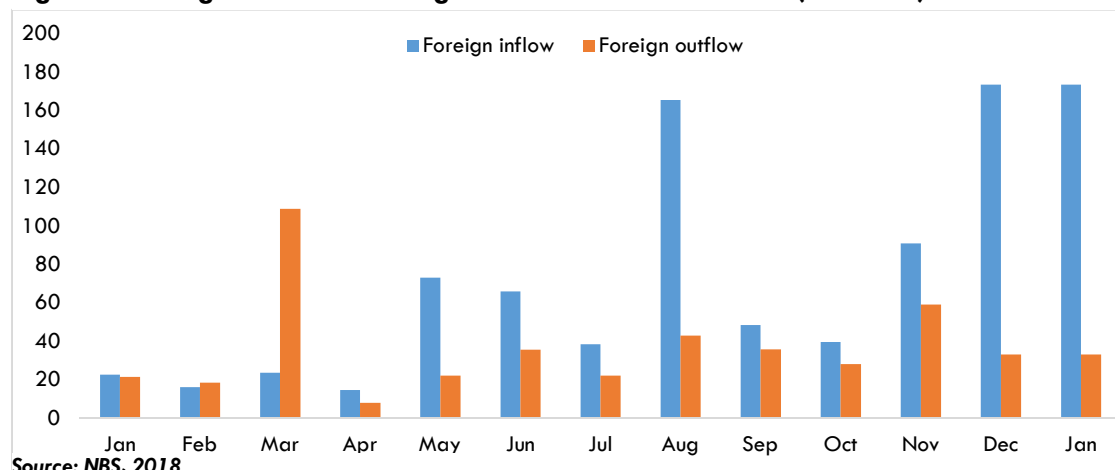
November 2017 was 53.90%. Compare the performance with that of December 2017 which was 42.95% (Figure 3)

Impacts Beyond Stock Market

For years, the Federal Reserve had kept the interest rate down as they believed it would give rise to a growth in stock prices

the ASI had a growth of +29.79%. If correlation and causation are same perhaps the dip in the stock prices might have had same effect on the economy; a loss. But as a precaution, the Federal government recently injected \$210 million in foreign exchange which substantially serve as a buffer for the exit of the FPIs and further neutralize any negative effect.

Figure 4: Foreign Inflow vs Foreign Outflow of Transactions (N'Billion)



a low ratio of foreign portfolio investments (FPIs) to Local investments. But in the last few years, there had been a fair upsurge of foreign portfolio investments which expectedly facilitates economic growth and development. Between October and December 2017, there was a gradual decline in the percentage of the FPI investments in the Nigeria economy. Statistics from The Nigerian Stock Exchange presented that FPI percentage as at

which will in turn grow the economy. The soundness of this supposition is debatable; stock market does not comprehensively affect the economy being only one of its many component drivers and parts. Nevertheless, the evident direct correlation cannot be denied.

In Q1 2017, both the GDP and the ASI recorded negative growths of - 0.73% and -5.05% respectively. In Q2 2017, GDP recorded a positive growth of 0.52% while

Failing forward

Many saw the correction as a beginning of the fall of the stock market, thus, a time to be wary. Others saw it as a necessary evil with the opinion that the “heated” market was overdue and was an opportunity for investments.

Panic sales in the equity market that accompanied the market correction offered a good time to purchase stocks of companies with good fundamentals at lower prices. The hope that the equity market will start gaining remains strong nevertheless; so is the expectations that the Market correction will normalize in a short time. To know which stock to invest in, the intrinsic value of the stock must be considered as opposed to the market value. This gives a better reflection of its value at that point.

Endnotes

- 1 Jethro Mullen, CNN Money
- 2 Dr Veronique de Rugy, CATO Institute.

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