Catching a Falling Knife

"Buy when there’s blood in the streets, even if the blood is your own."

- Baron Rothschild

“Buy when there’s blood in the streets...” is a piece of advice often repeated by those seeking to purchase undervalued stocks after a major market downturn. On the other side, there are those who warn, “don’t try to catch a falling knife” – avoid stocks and other assets that are in a free-fall.

Bargain-hunting for assets in a free-fall can seem like a good opportunity and they sometimes are. But they come with significant risks that investors often fail to consider. We will discuss some of these risks in this letter. We will also take a look at one of the “falling knives” of the past few months: oil.

Oil: An Anatomy of a Collapse

In June 2014, oil was trading for just over $100 per barrel. By the start of 2015, it was just $50 per barrel. Few could have predicted the intertwined economic and political factors that led to such a dramatic collapse in price. Wall Street analysts missed the severity of the oil price decline. In November 2013, a Reuters survey of oil analysts found an average price forecast of $97 per barrel in 2014.

By mid-2014, the U.S. oil industry was booming. Technological advancements in drilling and fracking had led to an oil boom and US oil production nearly doubled between 2010 and 2014. Americans were increasingly getting their oil from American oil producers and by 2013 we were domestically producing 67% of the oil we consumed. Led by American innovation, world oil production hit record levels.
With this boom in American oil production, oil prices were no longer captive to political strife in the rest of the world. Last summer, even as Russian troops entered the Ukraine and radical Islamists captured much of the oil-rich regions of Iraq and Syria, oil prices remained mostly unchanged.

But even as oil production spiked, growth in demand for oil was starting to slow. By 2013, U.S. oil consumption had fallen below where it was in 1998. Oil consumption growth was also slowing in China, the world’s second largest consumer of oil.

By October 2014, forecasts of slumping oil demand had permeated the financial markets and the price of oil dipped from $100 to $88 per barrel. Investors poured money into oil funds betting that oil had bottomed out and thinking they had purchased oil at a great value. Few expected the further decline that was yet to come.

By November, it was clear that a cut in oil production from OPEC was necessary to stem the bleeding in oil prices. Yet OPEC, led by Saudi Arabia, failed to cut production in their November 27th meeting. Some speculate that this was an intentional play to force US oil producers into sustained unprofitability, which could lead to the shutdown of some U.S. oil producers. Regardless of the reason, oil plunged another 10% on the OPEC news. By December 1st, oil traded at just $69 per barrel, another 20% below its July price.

Yet some individual investors still placed large bets in oil stocks hoping that they were “buying the dip”. But a bounce failed to materialize and oil proceeded to decline another 27% in December. More buyers abandoned the market and a sustained upward movement failed again. As we write this letter today, oil trades at $46 per barrel.

From this story and others, we can find a few common threads of knowledge related to the saying, “don’t try to catch a falling knife”.

1. Markets can stay irrational longer than you can stay solvent

Sometimes, a stock or other investment can become genuinely oversold and may seem attractive. However, before it re-enters a phase of sustained price appreciation it may first fall beyond a price that you can financially tolerate.

Some investors experienced this in the financial crash of 2008. By September 2008, Lehman Brothers had declared bankruptcy and fears of a broader economic collapse ran rampant. Even in what was perceived as a perilous situation, some investors felt that other bank stocks might offer an opportunity. Bank stocks like Bank of America, Citigroup, and Wells Fargo were down over 30% from their 2007 levels. Seeing those major declines, some investors thought they were getting a bargain at those prices and purchased more bank stocks.

Yet by the end of the year, panic had overtaken the stock market. Fear was once again in control. Financial stocks, even those of good companies with sound businesses, sold off across the board.

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Banking stocks collapsed further, falling as much as another 80% or more until bottoming in March 2009. Many investors who thought they were getting “bargain” prices realized huge losses in their bank stocks, and they sold their stocks out of fear for their financial security.

Some of those stocks never recovered. AIG still trades at just 4% of its 2007 price. Others stocks did recover eventually, but many former investors had already sold their positions and missed the gains.

That is the major risk of trying to “catch a falling knife”. Stocks that are in a free-fall may continue to go lower as other investors panic and markets become even more irrational. Trying to predict a bottom is rarely successful in these environments. Even stocks that seem “cheap” relative to their fundamental value can fall much further before they turn around.

2. Resistance is created on the way up

Humans have a natural psychological bias to avoid losses. When a stock price falls, they think, “If I can just back to even…”. These investors have mental break-even points in which they plan to sell their shares.

Therefore, as the stock price begins to rebound, those investors who manage to break even at these higher prices will sell the stock. This makes it difficult for a stock to sustain its upward momentum after a large fall.

3. Prices do not move in isolation

When a stock or another asset is falling rapidly, there may be major effects on the rest of the market, some unforeseen. When the price of oil crashed in 2014, there were some obvious results. For example, airliners profiting from cheaper oil prices saw their stock prices increase. And with cheaper prices at the gas pump, consumers had more money to spend and retail stocks rose as well.

But some of the negative changes were not immediately obvious. As oil plunged, the economies of major oil-exporting countries started to suffer. Their currencies fell against the U.S. dollar. For example, the Russian ruble fell 40% against the dollar, increasing the strength of the dollar against other currencies. A strong dollar then puts downward price pressure on other commodities, such as gold and silver.

This illustrates the complexity of the effects that can occur when the price of an asset, like oil, is falling rapidly. If you are attempting to “catch a falling knife”, it may be wise to consider the other ramifications in the investment markets.

Please feel free to call us with any questions regarding the issues we discussed in this letter or any other financial matters on your mind.

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[1] The spot price of Cushing, Oklahoma WTI Crude will be used as the price of oil throughout this article. All price and return data for oil in this article are taken from the Federal Reserve Bank of St. Louis. Retrieved from http://research.stlouisfed.org/fred2/series/DCOILWTICO.


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