Quarterly Newsletter

MV FINANCIAL

First Quarter Review: Upside, Downside

Large cap US equities dominated the capital markets through last year's 4th quarter. For the three years ending 12/31/14, the S&P 500 enjoyed a cumulative price appreciation of more than 60%. That is a bit more than three times the rate at which average earnings per share (EPS) grew for the companies making up the benchmark large cap index. In the first quarter of 2015, though, investors seemed unexcited about further prospects. The S&P 500 finished the quarter up 0.95% on a total return basis, almost all of which may be attributed to dividends and practically none to capital gains. Stocks did rally throughout most of February, reaching a year-to-date gain (and record high) of 3.2% by the beginning of March. But the headwinds proved to be too stiff to sustain the rally.

But while headwinds – slowing earnings growth and the strong US dollar prominent among them – have been holding back an upside breakout, there continues to be firmness on the downside as well. Stock indexes tested and found support around their 50 and 100 day moving averages on a handful of occasions over the quarter. As we often say on these pages, there is nothing inherently special about moving averages except that they tend to be trigger points for active trading strategies. So while equities struggled to gain traction in an upside breakout, they benefitted from a continuing inclination among investors to discount any signs of potential for a severe drawdown.

As the quarter approached its end we began to see signs of stabilization in energy prices and exchange rates. Brent crude oil, an international benchmark, staged an impressive price recovery in February. US crude benchmarks followed suit, though record inventory levels and modest demand suggest we're probably some way from regaining last summer's peak prices. Observers continue to wait for lower prices at the pump to translate into any real uptick in discretionary spending among US consumers. Meanwhile, many businesses are hoping that the current pause in the dollar's rise will show up one or two quarters down the road in the form of stronger earnings. Average S&P 500 EPS for 1Q2015 are expected to be negative for the first time since 2012.

Second Quarter Outlook: Navigating Wonderland

One recent trend that shows no signs of reversing anytime soon is the surreal realm of European bond yields. Negative interest rates became a thing last year; they are now going viral and currently account for about 25% of all outstanding European sovereign debt. On April 8, Switzerland became the first government in history (as in, ever in the seven hundred-plus year history of organized bond markets) to sell ten-year debt to the public at a negative rate of interest. Think about that trade for a moment. An investor buys a Swiss sovereign bond, in effect lending money to the government, and *pays the government* for the dubious privilege of lending to it. For ten years. If you think that sounds like something right out of a Lewis Carroll story, you are right. But it is no fantasy.

For the time being, though, there is a corollary benefit in the US to those *bizarro* rates across the pond. Yield-seeking investment flows from European institutional investors are likely to continue pouring into the comparatively attractive yields of US Treasuries. That, in turn, makes it less likely to expect sharp interest rate spikes here. Eurozone pension plans, banks and insurance companies need to stack their balance sheets with high quality assets. Rather than pushing these institutions down the risk frontier into dicier assets, then, Euro QE will more likely steer their funds into intermediate-long government and investment grade US debt. Even a Fed move to raise the Fed funds rate, should that happen before the end of the year, would probably impact the yield curve more by flattening its shape (i.e. reducing the spread between shorter and longer yields) than by transforming the entire curve higher.

Whether that rate hike happens this year, though, is still anybody's guess. A much weaker than expected March jobs report punctured a hole in the strong growth & recovery narrative and shifted rate expectations out further. The earliest potential date for a Fed funds increase will be the FOMC"s June meeting. We'll have some further headline data – jobs, wages, GDP and consumer prices – to consider between now and then. Any continued signs of a general slowing will be likely to stay the Fed's hand. We expect Fed meeting minutes, press conferences and the like to continue having an outsize impact on asset price trends.

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