Quarterly Newsletter

MV FINANCIAL

Third Quarter Review: Uninspiring Gives Way to Unsettling

Late summer is often called the "dog days" of the calendar cycle. That is not always true in financial markets – the mayhem of August 2011 comes to mind – but this year the moniker was apt indeed. After a torrid second quarter in which the S&P 500 gained more than 5% and rallies took place across a wide swath of asset classes, July and August were a time of low volatility, low volume and varied returns. Many areas of the market – from small cap stocks to emerging markets – did do well in August, but price movements were exaggerated by thin trading volume. The S&P 500 broke 2,000 for the first time ever but – as is often the case – found this round number to be a formidable resistance level. With little changed in the fundamental picture of the global economy, and with geopolitical unrest more or less baked into price levels, investors found little inspiration to let out the animal spirits.

The listless pace continued through the first half of September, but as the month rolled on we were treated to a reminder that this time of year can be full of tricks or treats. By the time the month closed, the S&P 500 had pulled back 2% from the all-time high reached on September 18, and the pullback would continue into early October. Other asset classes fared worse. Emerging markets gave up all their July – August gains, and small caps tested 52-week lows. A broad-based plunge in commodities prices ensued, led by crude oil. Interest rates plummeted as investors sought refuge in the traditional safe haven assets; the yield on the 10-year Treasury fell from 2.6% mid-month to 2.3% as October opened.

It is hard to pinpoint what exactly has driven asset prices lower. Concerns about Europe's economic future have resurfaced with some lower than expected manufacturing and export numbers from Germany. Concerns about the Ebola outbreak are gathering speed. But there really is not much new under the sun. U.S. economic growth continues its solid trajectory across most key areas: employment, GDP and consumer confidence remain strong, inflation remains mild and corporate earnings are expected to gain 7% or so for the full calendar year. The Fed has been careful in its forward guidance messaging, and appears to still have a reasonable amount of leeway to determine when and how it will begin raising rates in 2015, as most observers expect will happen.

Fourth Quarter Outlook: Volatility Returns…Will It Last?

As of this writing the S&P 500 is right on the edge of breaking through its 200 day moving average support level for the first time in nearly two years. Wall Street pullbacks are like California earthquakes: you can't time them, and when they come you don't know whether they will turn out to be just a minor tremor or the overdue Big One. As of the October 10th close the magnitude of the pullback was 5.2% from the 9/18 high point. That's more or less in line with the other two events of more than 5% since the beginning of 2013 – there were 5.7% pullbacks in June 2013 and again in February 2014. But it is also a reminder that the market has not pulled back by more than 10% - a technical correction, since the 18% peak-to-trough reversal from August – October 2011.

But the context in 2011 was very different. The European single currency zone was on the edge of falling apart. In the U.S. we came within a hair of defaulting on our debt obligations, and U.S. government debt lost its triple-A rating from Standard & Poor's. Investors had very good reasons to see those events as fundamental risks – and things would very likely had been a lot worse if the debt default or a Eurozone break-up had occurred.

It is not true to say that there are no risks in the market today that could upend the prevailing growth-and-stability narrative. But we are not staring them in the face the way we were in 2011 – to say nothing of the much more extreme conditions of 2008. Investors who have been waiting for valuation levels on high quality stocks to become more attractive – and that is a universe that includes us – will be looking out for buying opportunities in the days ahead. At the same time we cannot be complacent. We listen to the data, and today the data are telling us that conditions are volatile. We do not believe that a secular bear market is right around the corner, but we must be vigilant and prepared to deal with whatever outcomes do occur.

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