MVCM Quarterly Newsletter

Third Quarter Ended September 30, 2011

3Q 2011 In A Word: Dysfunction

3Q 2011 is likely to earn a place in the annals of financial history. Not because of the magnitude of difference between the market close of June 30 and that of September 30 – the S&P 500 lost 13.9% for that period, bad but not record-beating. No, the quarter earns its place in a Stock Market Rogue's Gallery for the reason that markets simply became dysfunctional. Maybe they will function again one day, but for now they are broken. Say what you will about what stock indexes represent on any given day – but what they do **not** represent is anything like a fair value of the actual financial condition of the companies that make up the index.

The most visible reflection of this dysfunction is day-to-day volatility. In July the unseemly US debt ceiling debacle proved to be a catalyst for a rash of selling with US equities markets losing over 15% in less than two weeks. That condensed period was where indexes lost most of their value. The rest of the time they simply gyrated – up 2% one day, down 3% the next. Up 4%, down 4%, seemingly every day. It was a rare day when indexes closed within 1% of where they opened. Just a few years ago you could count the number of 1%-plus days in a calendar year on the fingers of one hand.

US political gridlock is not the cause of market dysfunction, nor for that matter is the economically more meaningful crisis in the Eurozone. The problem is a new investing paradigm that views the world through utterly binary lenses of black and white. Either the world is about to end or it's a sweet rose-scented morning in the global economy. There is no in-between to this risk on / risk off mentality, no shade of gray. Either stocks go up or the US dollar and Treasury bonds go up. Headlines move high-frequency capital in and out of these assets, but there is no apparent logic between the headlines and the buy or sell orders. Rallies are junk rallies and sell-offs are indiscriminate, treating Apple and third-rate microcaps with equal disdain. It is truly a world of postmodern finance, a quantum wonderland of X-factors popping into and out of existence.

2H Outlook: More Absence of Clarity

As we write this third quarter outlook we already have intelligence on performance in the early part of Q4. This can be described as a junk rally – if you like, as the mirror opposite of the mindless meltdown of early August. The S&P 500 has gained about 11% in the past six trading days from the intraday (and 52-week) low it hit on October 4. Now, October is a tricky month – 1929, 1987 and 2008 all bear witness to that. With sentiment as fragile as it is now we believe anything could happen between now and October 31 – the junk rally could well continue and recoup a substantial portion of the August-September losses, or it could fall back and test new lows. Or it simply repeat the tendency of the past two months and gyrate pointlessly every day to come out flat for the month. Any of these scenarios are plausible.

The two contextual forces that may ultimately impact any sustained directional movement are the Eurozone crisis and US corporate earnings . With regard to the Eurozone, the headlines that are being attributed to the market's recent optimism are fairly meaningless, amounting to little more than joint declarations of commitment to do something, sometime, somehow. The preferred approach of putting a Band-Aid on a serious wound and hoping it holds for awhile continues to hold sway.

US corporate earnings season is underway and observers will look to these results as an indicator of how likely we are to avoid falling back into a recession (for many US households, of course, the first one never ended). Healthy earnings reports may shift attention away from the Eurozone and perhaps give a tenor to the market.

As for our approach, we are firmly committed to the belief that our paramount responsibility is to manage risk and preserve capital. We are not interested in the futility of market timing gambits in the hope that the ball lands on red or black. Our posture will continue to be defensive until we see signs of markets starting to function again.

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DOFU: October 2011

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