MV Capital Management Thought Leadership

All Over Again?

February 16, 2012

In the fourth quarter of 2010 equity markets began a rally that carried into and beyond the first quarter of 2011. The primary catalyst for that rally had been the implementation by the Fed of a new quantitative easing program in November – actually the rumors for QE2 began in August and had become conventional wisdom by September, so the rally was well under way when the Fed finally put the program in place. QE2 signaled that the Fed, as always, stood ready to flood the markets with money and thus mitigate the potential near-term liquidity impact of ongoing meltdown in European markets.

As the first quarter of 2012 moves past the midpoint it is reasonable to ask if the same thing is playing out all over again. The rally began a bit later last year compared to the year before – it started right at the beginning of the 4th quarter in early October – but the tune seems to be the same. The S&P 500 has gained over 7% in price appreciation since mid-December. The daily headlines of imminent collapse in the Eurozone have subsided. In their place are a series of data points indicating that the US economy may be on firmer ground than had been thought several months ago. Notwithstanding the upbeat prospects in areas ranging from employment to the housing market, the Fed continues to make sure everyone knows it will rain money on the markets if and when need be. Is history really repeating itself?

We always caution against the temptation to read larger meaning into short-term data points. But here is what we do know – the problems in Europe have not gone away despite their seeming to have not much impact on daily market moves these days. The Greek bailout-for-austerity-measures debate that has been playing out over the last several weeks has not offered much to cheer about. Indeed it is hard to see how the proposed austerity measures can reconcile with a viable path to prosperity for the country and its beleaguered citizens. With Europe itself in a mild downturn based on 4th quarter 2011 GDP estimates, there will be little opportunity for Greece or the other troubled countries to find a real growth trajectory. Investors, however, are likely to see this as a “down the road” problem and not an immediate market threat as long as something is cobbled together that keeps the bailout money coming. In fact this in itself would seem to be an optimistic scenario versus the outright default that many had been predicting last summer. Oddly enough Greece’s stock market is booming – the MSCI Greece index is up over 19% for the year to date, far outpacing core Eurozone markets like Germany and France (8% and 5% respectively), as well as other peripheral laggards like Portugal (in negative territory at -2.2% year to date). We have to remember the primary lesson of 2011 – markets are famously skittish these days, and today’s budding euphoria can evaporate overnight.

Nor is Europe the only potential threat bubbling perniciously in the mire. Brent crude oil prices have regained the $120/bbl mark they hit last summer, with the result that households are again keeping nervous eyes on the changing price signs at their local gas stations. This development also calls to mind an “All Over Again” moment, as we witnessed a similar rise in oil prices a year ago. At that time the concerns, rooted in the context of the “Arab Spring” and in particular the incipient revolution in Libya that would ultimately overthrow the Qaddafi regime, were that higher oil prices would throw a wet blanket over the gingerly recovering spending habits of US households. The recovery does appear to be a bit firmer this year, but not to the extent where those extra dollars spent at the pump won’t matter – they will matter. The latest Consumer Confidence Index report for January showed a slight, and unexpected, downtick from its previous level. Confidence is not as robust as we would like.

With regard to oil prices the stakes are even higher this year. The flashpoint of tension currently is Iran, the world’s third-largest oil exporter after Saudi Arabia and Russia, and the geopolitical wild card is a potential military strike by Israel, which many fear could become a reality later this spring, as an attempt to shut down Iran’s capability to develop nuclear weapons. There is a high level of rhetoric and saber-rattling all around and it is hard to separate the theatrics from the reality. But such a conflict could have the effect of shutting off the Straits of Hormuz and thus putting a major supply-related squeeze on oil. There are already other regional supply concerns – notably in South Sudan and Yemen, while Syrian oil exports are currently under sanction from the US and Europe. In fact if it were not for the fact that the demand side of the oil equation has been weak for some time now, in no small part due to Europe's slowdown, then prices at the pump today would likely be even higher than they are. If demand does start to rise in concert with raised economic growth estimates by major oil consumers like the US and China, then the effect of a Hormuz shutdown on downstream prices would be magnified even more, and the recovery really could be in serious jeopardy.

Looking at asset market performance so far this year we see conflicting signs of confidence and reticence. The confidence is seen in emerging markets equities, which have resumed their characteristic role as market leaders during rallies. It is worth noting that a year ago, as the US and most European markets were doing quite well, emerging markets were in negative territory and stayed there for the better part of the year. This year the usual suspects like India, China and Brazil are in double digits for the year to date. US small caps, another typical outperformer in growth times, are also doing well. So that would appear encouraging. On the other hand, bond yields remain low – below 2% for the bellwether 10-year Treasury note. Last year we got used to seeing bond yields rise and fall in tandem with the S&P 500 – but this year yields have stayed relatively flat while the market has soared. So that would tell us that investors are keeping their bets hedged with positions in cash or government bonds.

So what are we doing? Given the fact that last year's threats haven't gone away, and some new threats have a higher probability factor for playing out in the near term, our general position continues to be cautious and oriented towards managing the risk component of the portfolios under our management. Our most significant underweight position is in non-US developed markets, where we think the potential for volatility is still higher with lower opportunity for risk-based reward. On the fixed income side we have shifted weightings towards corporate investment grade and high yield bonds and away from Treasuries. We continue to closely monitor exposures across the board and will take tactical action as and when we see opportunities or threats.

With warm regards,

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MVCM 2012 0007
DOFU: February 2012

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