MV Capital Management Thought Leadership

200 Days of Tea Leaves

June 6th, 2012

As of the writing of this post the major markets are all in 2%-plus territory for no particularly solid reason – in other words, business as usual for the tea leaves readers who are back in the saddle as the world of risk on / risk off solidifies its return to front and center of daily market forces. The rumor of the day has it that something of a plan may be forming around a bailout for the Spanish financial system that would forego some of the bitter-pill austerity the Continent's policymakers have tried to feed down the throats of other ailing economies in the Eurozone crisis. As usual the details, such as they exist, are foggy and nothing is fundamentally different in terms of solving the root problems plaguing the troubled sovereigns. But no matter – we are back in the world of risk on / risk off that dominated for most of the second half of last year, and it is reasonable to take the view that this paradigm may continue to play itself out. Meanwhile noises have been wafting out of top US Fed members to the effect that a new round of quantitative easing is by no means off the table for ongoing central bank policy formation.

The willingness of investors to trade solely on the basis of speculative rumors that may or may not become actual news headlines, let alone clear and constructive policy decisions, may have something to do with a measure that has become more a talisman than a barometer. The S&P 500 is hovering a bit above its 200-day moving average, having briefly dipped below that average during the sell-off last week. Now there is nothing particularly special about the 200-day average – it is a simple rolling average calculation, nothing more. In normal times it can serve a role as one more useful data point for market observers who hold stock in momentum theories. But looking at the performance charts over the past twelve months it is kind of easy to see what may be driving investors to play a careful 200-day average game. During this time there have only been two decisive moves through the average. One was at the end of July last year when the markets plunged in the wake of the debt ceiling debacle. The other was right at the end of the year when the ECB began the first phase of its €1 trillion restructuring program to relieve banks of short term obligations coming due by deferring maturity for three years. That action confirmed the (response to policy-driven) uptrend that had started at the beginning of October.

When the S&P 500 dipped below the 200-day average last week you could almost hear the brakes squealing as investors paused to take stock of what might or might not precipitate another sustained fall through that support level. Much of the buying we have seen since then, particularly today's strong moves, are probably attributable to short covering in fear of "announcement risk". This would take the form of the latest incarnation of platitudes and paeans to unity and solidarity along with some broad-brush outlines of a plan – just enough to kick the can down the road one more time. You don't want to be doubling down on your bet against the market if the policymakers successfully pull that one off one more time.

The big question we continue to monitor is when the specter of announcement risk ceases to cause fear and trembling. Remember, this has been going on for two solid years now. Everything starts to go pear-shaped, investors panic, the central banks come to the rescue with a mix of soothing platitudes and occasional policy actions – just enough to provide the reassurances that they will always be there as a buyer of last resort. The Greenspan Put of old is the Universal Central Bank Put of new. The problem is that apart from goosing up risk asset markets for awhile until the next bad thing comes along, these policy tools appear to have had a very minimal effect on the actual economy. With 10-year US Treasury notes yielding 1.5% and German Bunds at historical lows, exactly what kind of central bank stimulus can provide the incentive for companies to aggressively move to extend more credit? With Europe enduring what seems more and more like a repeat of its painful withdrawal from the gold standard in the first half of the 20th century, how much can piecemeal platitudes accomplish if not supported by realistic plans that get at the fundamental core of the region's problems?

Investors are crowded around the S&P's 200-day moving average wondering the same things, hesitant to be on the wrong side but ready to place their bets when they have enough directional confirmation. We can't imagine this play can pull off too many more acts without something substantial changing that confirms whether today's valuation levels are screaming "buy" or screaming "run for the hills".

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2012 0045
DOFU: June 2012