MV Capital Management E-Update

Sideways Markets and the V-Word

February 27, 2008

In our 2008 Market Outlook back in January we opined that the defining word of the year was likely to be volatility. Not Bull, not Bear, but Volatility. Well, so far this year the level of volatility is truly eye-popping. On 20 of the 36 trading days from January 2 through February 22 the S&P 500 has closed more than 1% higher or lower than its previous close – with eight of those being up and twelve being negative.

If you are a lover of dry, analytical statistics then proceed to the next paragraph. If not, skip the next paragraph and move on, simply knowing that when the market moves more than 1% in one day, for many days, it's a volatile market.

To put 2008's performance to date in perspective, consider that in 2005 we had only 30 1%-plus volatility days for the *entire year* (that's 252 trading days) and in 2006 only 29 out of the 251 trading days saw this kind of roller-coaster ride. 2007 was really a tale of two years. The first half of the year looked very much like the preceding two years, with 16 out of 124 trading days being high-volatility through June 30. The second half of 2007 set the trend in which we now find ourselves, with 1%-plus volatility in 49 out of 127 trading days. For 2008 year-to-date the average *intraday range* through the close on February 22 was 2.18% (that represents the percent spread between the intraday high and low). That's over 2.5 times higher than the 2006 average of 0.86%.

Now, in the investment management profession we use the words "volatility" and "risk" pretty interchangeably, to mean large deviations up or down. For the world outside our profession, "risk" mainly connotes something bad that we don't want to see happen, like a free-fall in stock prices. But we aren't seeing a free-fall out there, at least for the past month. From January 23 through February 22 the S&P 500 rose 1.1% from 1338 to 1353. So, all those 1%-plus volatility days are more or less cancelling each other out. Market goes up by a lot, then comes down by a lot and so it goes. The arrival is uneventful but our nerves are frazzled from the ride. That's what is going on now – the market is essentially directionless but very, very bumpy.

Several things provide a clue as to why this is. On the macroeconomic front the market has already priced in the negative sentiment that greeted us in the New Year – the slippery slope towards recession with higher unemployment threatening consumer spending and inflation staying persistently above the Fed's comfort zone. That means there's not a whole lot more selling to take place in response to the current economic data points.

The big wild card is the state of the credit markets, which show signs of continuing dysfunction. The Fed has cut the Fed funds target rate by 2.25% since September last year, and is chomping at the bit to do it again, but quality spreads between safe harbors like Treasury bonds and the rest of the credit markets continue to widen and in seemingly safe destinations like the municipal bond-backed auction rate securities market, demand has at times been so poor that auctions have been cancelled and investors left holding illiquid assets with uncertain valuations.

This seems to be translating into market trading patterns as follows. On the one hand a handful of smart investors, including no less than Warren Buffett, are combing the markets looking for good value opportunities. That is setting a firmer undertone to the market that did not exist earlier this year. The presence of smart money also brightens the outlook for the savviest stock pickers among the money managers and mutual funds, as they may be able to translate their bottom-up valuation smarts into adding names to their portfolios that have a better than average chance of doing very well. That would be a welcome change from January, when it was practically impossible to find anything doing well, anywhere, a state of affairs which tends to do more harm to the stock pickers (even the really good ones) with their concentrated holdings than to the broader markets.

The financial sector, though, is still adrift and that is what is causing most of the volatility. One day the bond insurance market is primed for collapse and the Dow falls 200 points. The next day someone hears a rumor that the government might bail out the bond insurers, or Buffett or the Chinese might buy up huge stakes in the ailing financial conglomerates, and the markets zoom to the moon. Bernanke seems ready to start auctioning his personal effects on e-Bay to pay for more rate cuts, then a regional Fedhead says that inflation pressures are at a late-1970s-esque boil, and Mr. Market runs around in a circle screaming with arms and legs akimbo.

As long as that picture remains the status quo – selective bargain hunting in a handful of industry sectors alongside irrational zigs and zags in the financial sector – the market is more likely to continue this trend of sideways volatility. We think one of two things could cause a trend breakout. If the financials get their various problems in order sooner rather than later then a rally in financial stocks will likely lead the broader market upwards. On the other hand if the macroeconomic picture gets worse than the conventional wisdom thinks now – the consumer flat-lines while inflation grinds upwards – the present downside support could crumble in the time it takes to say "$7 gallon of milk".

In this challenging environment we reaffirm the approach we described at the outset of this year – lots of low-correlation positions to diffuse the higher level of market risk and performance tactics oriented to downside protection more than upside outperformance. We are indeed living in what the old Chinese proverb calls "interesting times".

With warm regards,

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