MVCM Quarterly Newsletter

First Quarter Ended March 31, 2013

Record Finish to a Strong Quarter…

The first quarter of 2013 was one for the record books. Like a sprinter who summons up that last burst of energy in the final ten meters of the 100 meter dash, the S&P 500 leaned in and closed out the quarter at an all-time historical high close of 1569. It has gone on to surpass that level repeatedly in the opening two weeks of the second quarter, setting a foundation for what looks to be a potentially strong year for US equities generally. The total return for the S&P 500 for the first three months of the year was 10.6%, while the Russell 2000 Small Cap index managed to gain 12.4%. Among the various style indexes midcap value came out on top, with the Russell Midcap Value Index returning 14.2% for the period.

One of the notable trends this quarter has been the return of the retail investor. Monthly retail fund flows into equities reached levels in January last seen at the height of the technology bubble 13 years ago, and the funds have continued to pour in since then. The money coming in off the sidelines provided a level of support so that when the rally paused and pull back a little there were always enough bids to keep the downturn shallow. This was particularly true in February, when the pace of the rally slackened a bit and talk started turning to the potential effects of the government sequestration. Volatility never really picked up (indeed, the CBOE VIX index that reflects volatility has been flirting with all-time lows). When the sequester came it was met with a giant yawn and markets continued their winning ways.

…But Some Quirks Remain

Despite all the warm and fuzzy sentiment abounding, there are some odd indicators that make us wonder how much farther this rally has to go before a more sizable correction occurs. For one thing, it has not been a rally that aggressively pushes out the risk frontier. In fact emerging markets – traditionally a riskier asset class that tends to do well in robust growth environments – have been a truly dismal place to be. The MSCI Emerging Market index finished the first quarter in the red, with a return of -1.57%. That gap has widened even further since then, so that on a relative basis EM is trailing the S&P 500 by more than 15%. Commodities, another usual flavor in favor when the bulls run, are also in negative territory. And all the while the yield on the 10-year Treasury, one of the most widely watched safe haven bellwethers, has remained below 2% for much of 2013 to date.

Those indicators tell us that there is still an undertone of caution to this market, no matter how impressive the rally has been to date. GDP growth in the US seems to be slowing down and the unemployment rate continues to present a mixed picture (though generally moving in the right direction). European woes periodically flash up, most recently with a nearly botched bank bailout in Cyprus that for a while had observers wondering about the potential for bank runs in other Eurozone periphery countries. The pace of growth in China has been a big question mark (and certainly an influencing factor in the woeful state of play for emerging market equities).

Much attention is also being paid to a radically new environment in chronically ailing Japan. The government of Prime Minister Shinzo Abe has embarked on an economic overhaul the centerpiece of which is a torrid burst of newly minted money supporting massive public investment programs. In a country that has experienced deflation for much of the past 15 years the Bank of Japan is targeting a 2% inflation rate, which it hopes to achieve through increased business investment and consumer spending. Time will tell if "Abenomics" is able to translate into earnings growth for Japan's moribund corporate sector.

And speaking of earnings, here in the US all eyes are fastened on the daily drip of reports and guidance as the quarterly earnings season gets underway. A somewhat restrained sentiment has taken hold as many analysts question whether the record levels of recent quarters can be matched. So far the results seem to be a mixed bag. With major market indexes trading in the upper reaches of their intermediate-term moving average resistance levels we will be watching closely for any significant surprises that could move the needle one way or the other.

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