MVCapital MANAGEMENT

MVCM Quarterly Newsletter

Second Quarter Ended June 30, 2010

The Highs and the Lows…

The second quarter saw equities markets reach up and set new 52-week highs, with the S&P 500 closing out at 1217 on April 23. By the end of the quarter the index was flirting with the 1000 level and technical bear market territory (defined as a retreat of 20% or more from the recent high). In between these points we saw the return of extreme volatility, characterized by wild swings of several percentage points or more in intraday trading and in particular the peculiar phenomenon of what we dubbed the "3:30 Club" – computerized trading programs that trigger massive moves in the last half hour or so of the trading day.

A very sensible question, and one we get from our clients on a regular basis, is this: What could possibly have changed so much in the space of 1 week, or one day, or one hour, for the market to register such dramatic changes in price? At the end of a particularly volatile trading week one might ask, is the state of the world really so different on this Friday from what it was the past Monday to justify stock prices lower by 5% on average?

Not only are these very reasonable questions, but they confront the rather peculiar fact that, simply from a macroeconomic standpoint, the state of the world really is not tremendously different from what it was in the run-up to the April 23 highs.

Looking at the usual data points – GDP growth, unemployment, consumer spending, inflation, manufacturing activity, home prices and so forth – one is struck by how unremarkable the differences are. Consumer spending, the engine of the US economy accounting for 70% of GDP, rose 0.2% in May. That's not a red-hot rate of growth by any means, but neither is it a swan dive off a cliff. We know very well the underlying causes of weakness – persistent unemployment, stagnant incomes and constrained household credit markets. The fact that people are still spending at all should be seen as a positive rather than a negative, no?

…and the Fragility Factor

Unfortunately, perhaps not. Sentiment is buffeted by a swirling mix of X-factors that remind us daily of the recovery's fragility. Three X-factors that are never far from the surface these days relate not directly to our economy but to those of our major global trading partners: Europe, Japan and China.

The Greek debt drama flashed onto our trading screens back in February but was largely brushed aside as we focused on interpreting signs of organic economic recovery. As debt payments for Greece's creditors loomed in May the fear of default spread virally across bond markets and called into question the very viability of the single-currency Eurozone.

Surprisingly robust action by EU monetary authorities and the IMF helped to assuage fears that we were heading towards another financial meltdown or the end of the world's second-most important currency. But it caused us to cast our eyes around the world looking for other trouble spots, and they came to rest on the world's second largest economy, Japan. A 22-year malaise of chronic deflation, massive debt (197% of GDP) and decidedly unfavorable demographics add up to an unappetizing cocktail of $5 trillion at risk.

And then there is China. Soon to overtake Japan as the global #2, China is also as of now the world's largest consumer of oil, displacing gas-guzzling Uncle Sam's eternal reign atop that chart. What happens in China absolutely does *not* stay in China, but affects the whole world. Yet for all its apparent dynamism China is beset by a bevy of internal socio-economic problems that make its road to economic leadership anything but stable.

So: indicators in our own domestic economy do not compellingly point to a return to recession, but we are constantly aware of how many variables could trip us up on the road back to health. Sentiment can change – but it may take some time to shake it off and see the glass half-full again.

MVCM 2010 0024
DOFU: July 2010