MVCapital MANAGEMENT

MVCM Quarterly Newsletter

Second Quarter Ended June, 2012

False Dawns, and Chasms Averted (Again)

As it would happen, the S&P 500 hit its high for the year to date right at the end of the first quarter, on March 31. Almost as if on cue the second quarter ushered in the third act of that staple of spring and summer for the last three years, the interminable Eurodrama. Risk asset markets promptly resumed the kind of volatility to which we had become accustomed in the middle of 2011. The returns patterns were familiar for this cycle: the S&P 500, MSCI EAFE and MSCI Emerging Markets all lost ground for the quarter in ascending order of drawdown magnitude. However all these broad-market indexes finished the first half of the year in positive territory, benefitting from the cushion of the 1Q rally. For the year to date 6/30 the S&P 500 was up 9.5% and the MSCI Emerging Markets index held on with a 4.12% gain.

The false dawns – rallies that peter out after a short run – are one of a kind with the chasms averted – drawdowns that stop short of tipping into a full market meltdown. They lead back to the central reality of this economic cycle: a stagnant global economy ranging from below-normal growth in the likes of China and the US to recession in much of Europe. At the same time, central banks continue to pursue aggressive policies, keeping interest rates at historically low levels indefinitely while intermittently enacting more stimulus and bailout measures. It would seem that while this status quo prevails the market can't go too far in either direction for a sustained period, though it can certainly zigzag wildly as it staggers along.

The forward-looking question is this: when the fever breaks, what direction will the new reality take? Will the practice of continually kicking the can down the road actually buy enough time to engender a new cycle of recovery powered by natural growth factors? History tells us that growth eventually returns, and we have confidence that it will do so again. We are twelve years into this gap market cycle, which is within the range of historical norms. The key is to maintain flexibility so as to be prepared when gap turns to growth.

Between a Rock and a Hard Place

All the high volatility in investment markets has understandably made many investors wary of taking on greater exposure to riskier assets. But there is a dilemma the risk-averse investor faces, which is that plowing the money into a traditional savings vehicle looks like an even worse option. Consider that the current Consumer Price Index is around 1.7%, though it has been as high as 4% within the past year. Now ask yourself, where could you park your savings to earn even a modest positive real return? The practical effect of a 1.5% yield on the 10-year Treasury note and Fed funds rate of zero is that savings is a losing proposition. On a real basis you aren't earning interest on your savings – you're paying it. It's a tax by any other name.

That's a big problem for all of us, but it is a particularly big problem for the corporations sitting on piles of cash after a series of record high earnings seasons. The job of a corporate treasurer is to decide where to put the money they are not investing in new business ventures or paying out in dividends. Treasurers are a conservative breed by nature and typically choose among a variety of near-zero risk alternatives. Pity the poor treasurer in this environment. Does she put the money into a pool of cash equivalents earning negative 1% or put the funds into riskier securities that could lose the company even more money? It's a dilemma – stuck between a rock and a hard place. All of us who have the responsibility of deciding between saving and investing feel this pain.

That having been said, there is a bright side to the dilemma, which is that there actually are all these piles of cash sitting on the sidelines. That is why we believe that when the fever does break, there is higher probability of a growth market environment rather than a collapse. Households have been paying off the debts they racked up in the first decade of this century. As cash and credit balances free up savings will turn to spending and a virtuous cycle will ensue. That's not a certainty, but we think it's more likely than not.

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4520 East West Highway Suite 400 ♦ Bethesda, MD 20814
(301) 656-6545 ♦ www.mvfgroup.com

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