MVCM Quarterly Newsletter

Second Quarter Ended June 30, 2011

Much Ado in All Directions

The S&P 500 ended the second quarter at 1320, not too far away at all from where it began the period at 1332 on April 1. In between the market went up, it went down, risk went on, risk went off. Market performance in 2011 has not been disastrous, nor has not been a bounty of riches. It has been surreal.

For a tour of the surreal landscape let us begin with the bond market. In November 2010 the Fed launched its second round of quantitative easing, called QE2. Now, when you announce plans to purchase $600 billion of some asset the logical assumption would be for the price of that asset to go up – yes? In fact the reverse happened. Prices on Treasury bonds – the asset the Fed intended to purchase with those hundreds of billions of newly printed money – went down. Yields on Treasuries, which axiomatically move inversely to bond prices, went up. Fast forward to May 2011. QE2 is about to end and there is no indication the Fed intends to rinse and repeat. Bond prices rally and the 10-year Treasury yield fall back below 3%.

There is a ready explanation for this. Investors have doubled down on a single paradigm that now rules supreme – "risk on/ risk off". Briefly, when Ben Bernanke announces the latest version of the "Fed put" – the readiness and willingness to prop up asset prices at any cost – markets respond by hitting the "risk on" button. Stocks, commodities, real estate – anything goes. Whenever it looks like there are reasons to be afraid – possible sovereign defaults in Europe, growth slowdown in China, unfathomable political impasses over the US debt ceiling – risk goes "off" and everybody goes back to the traditional – though by now surely dubious – safe haven of US government bonds.

And that's how the second quarter played out. The price of a share of stock on any given day had less to do with the value of its current and prospective cash flows – which is all a stock price is supposed to be – and more to do with whether the risk on or the risk off button was in operation that day.

2H Outlook: Fog, Sunlight Both Possible

Much of the performance in the second half of this surreal year will likely have to do with the answers to the following questions. First, if the Fed does embark on a third round of quantitative easing, as now appears to be the case (following Bernanke's statements to Congress on July 13), will QE3 play out according to the QE2 textbook? That is to say, will risky assets increase in price while the actual economy of jobs, household income, consumer and business spending stays flat? Second, and very much related to that, will corporate earnings show investors that there is some glimmer of organic growth to come?

We sense a great deal of "rescue fatigue" in the markets. In North America, Western Europe and Japan – the mainstays of the developed global economy – it seems like we have been doing little other than trying to stave off the worst. Europe is stuck in a debt solvency crisis that could ultimately remake the Eurozone – or more precisely retro-make it back to a collection of nations each with its own sovereign currency. When the Greece of Alexander the Great fell into eclipse it was succeeded in due course by the Roman Empire. Today the locus of Eurozone concern appears yet again to be shifting from Athens to Rome. Whether the Eurozone could survive a full-fledged Italian debt crisis is rather doubtful.

In the US whatever QE3 may emerge will likely do little if growing middle class woes catch up with corporate earnings. Those earnings have been quite spectacular since 2009. Most of the success has come from two sources – overseas profits (especially from growing emerging markets) and technology-driven productivity enhancements. But emerging market growth shows signs of being slower at the outset of the second half, and there are limits to short-term productivity gains. Now, if earnings don't disappoint and the QE3 sets sail then we could see "risk on" gains extending through the year. Right now there is dense fog – sunlight may be on the other side but so might dark clouds. Discipline and focus are paramount.

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