MVCM Quarterly Newsletter

Third Quarter Ended September 30, 2012

Nowhere (Not) To Hide…

A scan of the performance of broad-market benchmark indexes in the third quarter reveals what would seem to be a quality problem – there simply were not that many places where an investor could go and not make money. What a difference from the third quarter of 2011, when risk assets got crushed in the downdraft following the debt ceiling debacle. For 3Q 2012 the S&P 500 gained a whopping 6.4% to post a 16.4% total return for the year to date. The white-hot sectors pushing up the numbers were financials and technology – two of the most habitually volatile sectors. The DJ Financial Services return was 7.9% 3Q / 24.9% YTD, while the DJ Technology sector posted 6.58% for the quarter and 19.76% for the year to date. If you were in safer, higher quality equity exposures – high dividends or utilities for example – you were up but not by as much. On the other side you got no rewards for taking on more risk in some areas – both the MSCI EAFE and Emerging Markets indexes continue to trail the S&P 500 by wide margins for the year to date. The S&P was the place to be. But again, there were not many places not to be.

What explains the broad-based strong performance? Certainly not the economy, which mostly continues to shuffle along in search of a catalyst for real growth. No, the third quarter performance was all about the central banks. First the European Central Bank stepped up and announced it would spare no effort in keeping the currency union intact, eventually strong arming the ever-recalcitrant Germany on board. Then the Fed announced the Eternal Sunshine of Quantitative Easing in the form of an open-ended commitment to buy $40 billion in mortgage backed securities on the open market every month until things are okay again – whatever that means. Let's be clear, this is no longer the "Greenspan Put" of old. This is a clear, concrete-solid floor installed by the central banks to keep markets afloat while the search for a growth spark continues. For as long as investors believe the floor will work, the likelihood of a severe drawdown in asset prices appears less and less.

…But Slippery Conditions May Lurk Ahead

So what tremors could arise between now and the end of the year to cause the solid foundation of that floor to give way somewhat? One interesting clue lies in the bond market. Consider the following: since the beginning of the third quarter the S&P 500 has dipped as much as 2% from where it was on July 1, on its way to posting that 6.4% quarterly gain. By contrast the yield on the 10-year Treasury note has fallen by as much as 12% and lurched up by a whopping 17% from where is was at the quarter's beginning, only to wind up almost exactly where it was then. This tells us two things. First, trading in and out of Treasuries has been frenetic as there have been plenty of "risk off" days for big moves. Second, there has been essentially no correlation between the 10-year yield and the S&P 500. What we are used to is seeing yields rise when the stock market rises (investors moving out of safe havens into risky assets) and fall when the market falls. But the large gyrations in bond yields have been directionless – and they remain low relative to where past trends would indicate they should be. Investors seem to be keeping one foot firmly planted in "safe" bonds (we use that phrase somewhat ironically given those gyrations) and one foot in stocks and other risk assets.

That tells us that as impressive as the stock market rally has been, it is not a confidence rally. More like a relief rally that the central banks came in and installed the floor – but ready to pull back if the floor starts to look wobbly. When might that be? Our sights are set right now on November 7th and beyond – i.e. once the elections are over. There are some serious fiscal issues looming in the first month of next year. How those issues get handled – or not – depends in no small part of the composition of the executive and legislative branches that will have to hash out the issues and make decisions. There are various estimates floating around about what a full-fledged cliff dive – higher tax rates and draconian spending cuts all at once – would do to growth prospects next year (hint: nothing good). At that point what else could the central banks do that they have not already done to contain the collateral damage in the markets. Maybe something – the bankers have shown an unusual amount of creative resourcefulness in dealing with near-miss crises so far – but that could also be when that one foot in the bond market pulls in the one currently enjoying those nice returns in stocks. For now we need to remain defensive.

Important Disclosures

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