MVCapital MANAGEMENT

MVCM Quarterly Newsletter

Third Quarter Ended September 30, 2013

Third Quarter Review: Trend Reversals, Treasuries and Taperphobia

After a drama-filled June in both equity and fixed income markets, the early third quarter settled into a more laid-back rhythm perhaps appropriate for the summer season. The S&P 500 crawled out of the 5.8 pullback, which bottomed out on June 24, and entered the month of July at a price level of 1610. It would not return to anywhere near that level, at least for now. As the rally gained steam in July, we saw a gradual shift away from the defensive sectors, which had led the rally earlier in the year, to the more cyclical industry groups as well as non-US stocks.

For the quarter overall, the S&P 500 gained 4.7%, bringing the year-to-date return for the broad US benchmark to just under 20%. The materials sector led the way with a gain of 10.3% while utilities shares brought up the rear, barely breaking even with a paltry 0.18% return. The EAFE index of developed non-US equities also saw double digits for the quarter, gaining 10.5%. Emerging markets managed to claw back some of the dismal performance in the year thus far with a total return of 5.7% for the quarter.

Although interest rates leveled out somewhat from their steep ascent in May and June, the path still led upwards. The 10-year Treasury yield grazed 2.9% in late August, and then gathered a second head of steam to power above 3% in early September. The witching hour was approaching. On September 17-18 the Fed would be meeting to consider the "do we / don't we" question regarding quantitative easing. Stocks and bonds began to price in a $10-15 billion tapering and rallied sharply before the meeting.

Then came the month's seminal event: "taperphobia". The Fed backed off the guidance it had been providing since May and decided to sit pat. Equities enjoyed a brief sugar high from the prospect of more easy money, but then pulled back for a succession of trading days. Confusion set in about the Fed's decision, and eyes focused on looming partisan battles in Washington as the quarter drew to a close.

Fourth Quarter Outlook: Advance with Caution

In the opening days of the fourth quarter, risk asset markets have been what might be called "gingerly resilient". That is to say, the government has shut down and a second battle on the extension of the debt ceiling looms within the next two weeks, but indexes have yet to go into a severe tailspin. The atmospherics from the market seem to be: this is not our first rodeo. Political dysfunction is a permanent part of the landscape, but so is the likely ending: some not-very-pretty fix to stave off the worst case outcome and kick the can down the road.

We tend to agree with the consensus that a solution of some kind is more likely than an outright reneging on Washington's obligation to keep itself running and pay its bills. But these periodic crises add an unnecessary level of instability to the market environment. The actual implications of an outright debt default are unknown, and that adds a potentially volatile X-factor to defensive planning scenarios. As we look ahead to October, which historically can be a very tricky month to navigate, we most of all are focused on ways to adapt and be flexible if the environment worsens.

Heading towards another earnings season, investors' attention will likely gravitate away from politics back towards the "real economy". Consensus estimates for earnings and sales results among S&P 500 companies are lower now than they were earlier in the year. According to FactSet, consensus estimates for 3Q S&P 500 earnings per share average 3.5% as of October 2. That compares with a 9.5% average 3Q earnings consensus back in March. Lower expectations mean a lower bar for companies to come in ahead of those expectations; but it also raises the importance of not coming up short.

So far in 2013, markets have managed to plow ahead impressively with lower than usual levels of attendant volatility. That could provide a nice tailwind of momentum as the year nears its close. First, though, we have to get through the potential headwinds in the way.

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