MV Capital Management Weekly Market Flash

Return to Risk-Off?

January 24, 2014

Bond yields plunging. Defensive, high dividend stocks holding firm as riskier exposures sharply weaken. Emerging markets bloodbath. If it were not for the frigid temperatures plaguing the East Coast, it might seem like we're back in the summer of 2011, with investors scurrying into whatever safe havens they could find amidst the tempest. Is it Risk On / Risk Off version 2.0?

Revisiting the Law of Round Numbers

Last fall we wrote a piece on the weird magic of round numbers: namely, the S&P 500 and the Down Jones Industrial Average breaching the nice round figures of 1800 and 16,000 respectively. We noted that oftentimes, indexes take a while to reach escape velocity after breaking through a round number resistance level. So while 1800 and 16,000 were resistance barriers in autumn 2013, they are playing the role of support level today. As of this writing the Dow is flirting with 16,000 while the S&P 500 is trading around 1805. By the time we post this, we will see whether the support level has held or been breached. That could give us some insight into what might be happening in the days ahead.

Death, Taxes and Market Corrections

From our perspective, having been in this business for several decades, periodic market pullbacks are as dependable as those other two more well-known inevitabilities. Considering that the S&P 500 gained over 32% in 2013, a correction of sorts is not the most surprising thing in the world. Right now the market is about 2% off its December 31 high. Corrections of between 2-5% are typical of pullbacks in a larger growth market environment, whereas a range of 10-20% is more indicative of a building bear trend. Sometimes, though, the bear doesn't gain traction. Looking back to that turbulent summer of 2011, U.S. indexes did retreat by about 20%, but rallied strongly from the October 1 trough to recover all the lost ground by early 2012. There have been no 10% or more retreats since, and only a handful more than 5%.

A January Effect?

One thing vexing the bulls is the timing of this pullback. January has a history of being a more active than usual month both in terms of volume and market direction. The first month of the year saw price gains of 5% in 2013 and 4.3% in 2012, while the 5% drop in January 2000 and 6.1% retreat in the first month of 2008 were the canaries in the coal mine for the dismal periods to follow. Of course, it doesn't always work that way. A 3.5% drop in the S&P 500 in January 2010, and negative 2.5% reading in 2005, were followed by positive performance for the full calendar year. Still, it's a good idea not to completely discount notions like the January effect, because human behavioral quirks around calendars are as hardwired into the markets as those round number oddities.

Watch the Earnings

It's still relatively early in earnings season, but the general tone is more negative than positive. Large names like IBM and Procter & Gamble have disappointed, while positive "surprises" – when companies release earnings that beat analyst expectations – are fewer in number and less in scale than in recent quarters. We remain of the opinion that markets are expensive at current valuation levels, but not in bubble territory. A 2-5% pullback may be all it takes to shake a bit of froth out and then stabilize. But we need to remain vigilant and let the data inform what we do (and do not do) in the coming days and weeks.

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