MV CAPITAL MANAGEMENT

Weekly Market Flash

Nice Rally, But Don't Get Too Comfortable

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Since setting a multi-year low on February 11 the S&P 500 has enjoyed a robust relief rally, gaining 6.7 percent through the 2/25 close. The rally has garnered plenty of skepticism, but there are some impressive aspects. It has been fairly broad, with seven of the ten major industry sectors posting gains of more than six percent. Consumer discretionary – an important sector given its central role as a driver of GDP growth – is up more than nine percent since that February 11 low. Industrials and tech have also done well: the SPDR Exchange Traded Funds for those two sectors (XLI and XLK) gained 7.5 percent and 6.9 percent respectively in the same time period. This rally is not, as some observers have argued, simply a dead cat bounce for oversold energy and financial shares.

The technical damage is far from repaired: the index is still almost four percent below its 200 day moving average, for example. But it has managed to break through both the fifty day moving average and a key resistance threshold level of 1950. Since the 2/11 low the index has closed up by more than one percent five times, and down by more than one percent just once. Reasonable people might want to know: is the pain over? Despite the positive attributes, we would caution against settling too comfortably into the good vibes. Plenty of headwinds remain.

Volatility's Two Faces

For starters, let's take a closer look at those one percent-plus days we mentioned in the last paragraph. There have been a lot of them this year. Twenty three, to be exact, which is about sixty five percent of the total number of trading days thus far in 2016. By comparison, the index experienced a daily gain or loss of one percent or more just fifteen percent of the time in both 2013 and 2014. In 2011, the last year in which a pullback of a similar magnitude to this year's took place, the market registered a gain or loss of one percent about thirty eight percent of the time.

To be sure, we are not inclined to assume that the volatile patterns of the year's first two months will be sustained for the next ten. Other risk measures like the CBOE VIX index and the S&P 500's rolling thirty day standard deviation have come down substantially over the past two weeks. But those daily lurches of one percent or more are symptomatic of environments driven largely by events rather than fundamentals. The unhealthy correlation between equity gains and oil prices hasn't gone away. Off-the-cuff remarks by Venezuelan oil officials appear able to drive intraday prices more than durable goods reports or GDP revisions. What the headlines giveth, the headlines taketh away. There is no way of knowing which way tomorrow's headlines will galvanize animal spirits.

An Earnings & Valuation Ceiling?

Not that anybody is paying much attention to the fundamentals today, but they are likely to present a formidable obstacle to overcome at some point if the current rally continues. The S&P 500 currently trades at a 15.9 times multiple to projected next twelve months' (NTM) earnings. That is roughly the same multiple at which it traded in late 2014. At the beginning of 2012, as the index was embarking on a vigorous three year expansion rally, the P/E ratio was 11.6 times NTM earnings. Valuations today are not in bubble territory, but neither are they cheap or even average (the average NTM P/E for the last ten years is 13.9 times). Analysts' expectations for 2016 full year earnings are predicated on a strong pickup in the second half of the year after posting declines in the first half. If the consensus turns out to be rosier than reality – as often happens – then valuations will be even more expensive.

In this kind of environment we recommend paying more attention to risk-adjusted return than to absolute outperformance. A mix of a modest amount of cash and exposure to low-correlated strategies like market neutral or merger arbitrage, while underweighting riskier equity styles, can be a sensible approach for long term diversified portfolios to ride out the volatility while still being positioned to participate in upside growth.

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