MV CAPITAL MANAGEMENT

Weekly Market Flash

Quality Rally, We Hardly Knew Ye

March 11, 2016

In a fundamental sense, not a whole lot has changed for the global economy since the beginning of the year. Economic growth remains below trend just about everywhere, hindered by the well-known headwinds of weak demand, stagnant wage growth and supply-demand imbalances among others. US companies continue to experience earnings headwinds from a strong dollar. X-factors abound, from capital outflows in China to the refugee crisis in Europe and the unusually volatile political climate in the US.

When we surveyed this landscape back in early January we could see a plausible case to make for a continuation of the kind of quality rally that had characterized a good bit of the second half of 2015. Sales growth a challenge? Opt for the companies with a demonstrated model for growing the top line by double digits despite the headwinds. Productivity not what it used to be? Focus on those enterprises able to sustain strong operating profit margins.

Sales, Schmales

Nice idea in theory. In practice, not so much. We are indeed experiencing a rally in global equities now, after the rocky start to the year. But a quality rally it is not. Perhaps our January outlook will be vindicated before the end of the year, but for now the market appears reactive to anything other than fundamental quality measures.

A glance at some key performance metrics for S&P 500 constituents bears testament to the seeming disregard for quality. The top ten percent of companies in the index, ranked by total stock price return for the year to date, showed average revenue growth for the last twelve months of minus 4.2 percent. By contrast sales growth for the bottom ten percent – i.e. the companies with the lowest total stock price return for the year to date – was a positive 2.3 percent for the last twelve months. Same goes for EBIT (earnings before interest & taxes): this year's outperformers grew by negative 4.8 percent compared to a positive 3.0 percent for the dogs of 2016.

But markets are forward looking, right? Maybe investors are more interested in next twelve months' growth prospects than in last twelve months. Then again, maybe not. The consensus estimate for next twelve months EPS (earnings per share) growth for that top decile cohort is 4.7 percent. For the bottom decile the consensus outlook is more than twice that, at 10.7 percent. And that bottom contingent is also less leveraged, with a debt-to-total capital burden of 47 percent versus 53 percent for the top decile.

Super Mario's Bright New Shiny Objects

If investors are not paying any attention to fundamentals, it's a pretty good bet that what they *are* focused on rhymes with "ventral tanks". By all accounts the central bank in question this week is Mario Draghi's European Central Bank. The ECB made headlines on Thursday when it announced a raft of new stimulus measures, including some genuine novelties. The market expected the deposit rate cut to minus 0.4 percent. Rather less expected, though, was an easing of the terms by which the ECB provides liquidity to banks through long-term refinancing operations (LTRFOs). Essentially, Draghi & Co. will pay banks to make loans through rates as low as minus 0.4 percent on LTRFO facilities. Other goodies in the ECB swag bag included an expansion of monthly QE purchases from €70 billion to €80 billon, and a broadening of QE-eligible instruments to include corporate debt. Draghi seemed to be at pains to emphasize his goal to see this round of stimulus actually work its way into the real economy through a higher level of credit creation.

Market reaction was predictably all over the place. The euro plunged within microseconds of the ECB announcement on Thursday morning, then turned around and rallied hard, finishing up more than two percent against the dollar. Likewise for equity markets, which condensed a "best of times/worst of times" sentiment into a single day of trading. After sleeping on it, Mr. Market seemed to like what he saw, and European bourses chugged ahead with gains of mostly two percent or more on Friday trading.

There and Back Again

That kind of intraday volatility is characteristic of an environment entirely at the mercy of central bank announcements and other macro events. It is what keeps our own sentiment in check and wary of reading too much into any directional trends. There are plenty more central bank moments on tap this year, starting with the Fed next week. How will Janet Yellen and her colleagues explain their thinking about the appropriate trajectory for rate policy here at home? The policy divergence theme – with the Fed going one way and the rest of the world going another – is back on center stage. We don't expect the Fed to move next week, though it is worth noting that the February inflation numbers will be released just as discussions are getting underway on the second day of the event. If the recent string of upbeat numbers continues, there will be some tough decisions ahead for the FOMC.

Unfortunately, the takeaway from all this is that expectations for markets to wean themselves off central bank dependence were premature. We've reverted back there after an oh-so-brief flirtation last year with free cash flows and return on invested capital and the like. If this rally continues, though, at some point someone is likely to look up and notice that, gasp, valuations are really stretched. The results may not be pretty. In the end, fundamentals do matter.

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