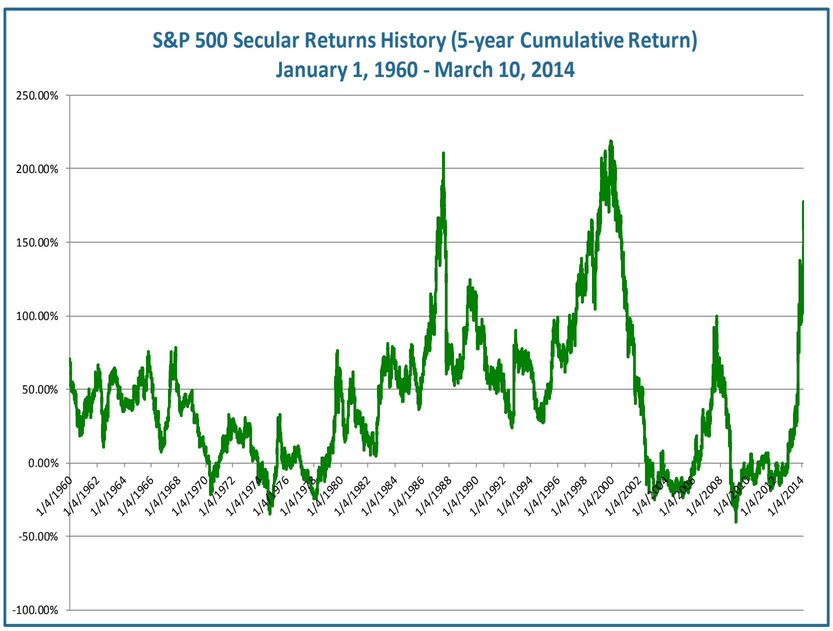
MV Capital Management Weekly Market Flash

Event Risk Is Back

March 14, 2014

This week has served up a large plate of negative macro events, and global asset markets have reacted accordingly. The S&P 500 is currently hovering right around its recent technical support level of 1850, about 1.5% down from the record high set a week ago and about where it was at the beginning of the year. International markets are faring worse; the MSCI Emerging Markets Index is down by -5.6% for the year to date, Japan is off -5.2% and the Eurozone is about 1.5% lower than where it was on January 1. The classic risk on / risk off play also seems to be back in vogue: the 10-year Treasury yield has fallen from 3.0% to 2.6% over the last two and a half months.

The headline events driving the recent wobbly asset performance are the geopolitical conflict between Russia and Ukraine, and mounting concerns over a string of weak macroeconomic data from China. Other issues lurk not far from center stage, including economic woes in Brazil and a worsening employment situation in peripheral Eurozone countries. And this bout of event risk is happening at a very inopportune time, as it coincides with equity valuation levels at ten year (or longer) peaks. Investors cannot be faulted for wondering how much more there is to gain from being fully invested in the current climate.

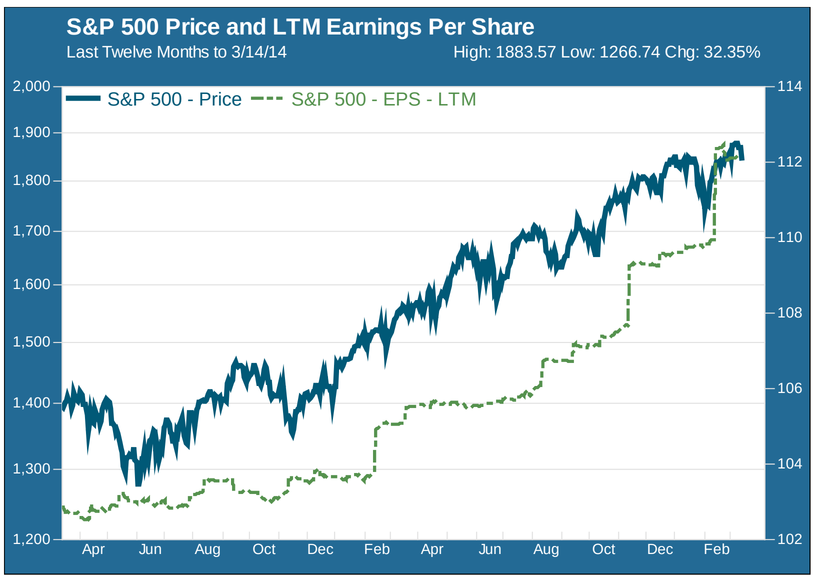


Source: FactSet, MVF Research

The above chart shows one view of U.S. equities which may be fueling the embers of doubt among investors. This shows the rolling 5-year cumulative price return for the S&P 500 from 1960 to the present. In other words, each point on the line represents how much the S&P 500 gained from the previous five years to that point. It is clear that the current 5-year cumulative return level is well above the average; in fact it has been at this elevation only twice before – at the peak of the late-1990s bull market, and during the initial growth phase of the macro growth market of 1982-2000.

None of this necessarily means that markets are ready for a significant intermediate reversal. The situation in Ukraine still has to play out, and in the end the negative effects may be localized in Russia's already poorly performing economy and financial markets. China remains the larger concern, though there is a positive interpretation to some of the latest numbers. China's policymakers appear serious about implementing some much-needed reforms in an effort to rebalance the composition of GDP. If a handful of small to mid-sized companies default on their bond obligations it may a necessary – and manageable – price to pay. This requires close monitoring, but remains well short of a panic situation.

With a little more than a month to go before U.S. companies begin reporting 1Q earnings, the focus will likely start to shift away from global macro events to corporate performance. 2013 ended on a positive note, with S&P 500 company earnings growing by a blended 8.6%. That helped reduce some of the multiple expansion we were seeing in valuation levels (multiple expansion is simply when stock prices – the numerator of the P/E equation – grow at a faster rate than per share earnings). This is illustrated in the chart below.



Source: FactSet, MVF Research

If 1Q earnings – and perhaps more importantly top-line sales – are generally favorable that could give a renewed tailwind to equity indexes, provided that we don't see a significant elevation in the threat level of the various macro events at play. In the interim, we expect that baseline risk will likely continue trending upwards with periodic large intraday movements. In our opinion it is not a time to run for the exits – but neither is it a time to sit back complacently.

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