MV CAPITAL MANAGEMENT

Weekly Market Flash

The Dog Days of Spring

March 31, 2017

It is something of an annual tradition: at some point, usually in the middle of a humid and lazy Atlantic Seaboard August, we will write something about the "dog days" of summer in investment markets. You know – light trading volume and mostly listless price direction, occasionally punctuated by an exaggerated surge or plunge based on some rumor or stray macro data point. Well, this year the dog days have arrived early. A couple one percent-plus days – one down and one up, for reasons that are barely remembered – provided some color to an otherwise tepid month long on political headlines and short on directional action. As the second quarter gets underway, we consider what might – or might not – puncture the market's smug haze of mellow.

The Beta Economy

The present occupant of 1600 Pennsylvania Avenue may fancy himself an alpha human, but the economy in which his administration finds itself is decisively beta. That's not a bad thing, mind you. A beta economy means real growth somewhere around two percent – nothing like the alpha economy of the 1990s, but perfectly acceptable, with modest price inflation and a mostly healthy labor market. Much of the rest of the world is enjoying a similar beta vibe. GDP is actually a bit higher in the EU than it is at home, Japan is managing to stay out of recession, and China's factories are humming along nicely with recent PMI readings for services and manufacturing comfortably above the growth threshold number of 50.

Importantly for investors, a beta economy supplies the most compelling reason not to get fooled by a momentary sell-off like the little one last week. With no sign of a recession in sight, at home or anywhere consequential abroad, there simply isn't much of a case to make to run for the hills. But what about the upside? Can businesses crank out alpha earnings in a beta economy?

Those Elusive Double Digits

Q4 2016 earnings season is over, and the 5.1 percent growth registered by S&P 500 companies falls well within our definition of "beta," in the context of the last couple decades of quarterly results. Surprisingly, 5.1 percent is also very close to what analysts were predicting last fall: the FactSet consensus of analyst projections on September 30 pegged Q4 earnings growth at 5.2 percent. Reasonable! But that same consensus group also gave their Q1 2017 estimates on that same day, and that number was a very alpha-like 13.9 percent. Do they still feel that way? Not so much – the revised Q1 consensus number as of today, right before the actual figures start to come out, is 9.1 percent.

That's still not bad, but it's not the double digits investors would prefer to see to validate those valuations nearing nosebleed territory. The last twelve months (LTM) P/E ratio touched 20 this week, a level last seen in the post-trough recovery following the 2001-02 recession. The price to sales (P/S) ratio, is at levels last seen in the heady final days of the dot-com bubble at the beginning of the 2000s. We have believed for some time that the "valuation ceiling" remains the biggest headwind to substantial upside gains. Of course, this view has taken quite a bit of flak of late from the ever-popular "reflation-infrastructure trade" that has dominated market chatter for the past five months. Which brings us to our final musing about Q2 market direction…whither the animal spirits?

Momentum Is Its Own Momentum, Until It's Not

What market pundits continue to call the "Trump trade" has been durable, even as prospects for any kind of sweeping, historic tax reform and massive new spending on infrastructure build out – never an obvious outcome to begin with – have looked less and less likely. But, as we have noted elsewhere in recent commentaries, such

upside as there has been for the past couple months really has less to do with those reflation-infrastructure themes than it does with plain old momentum and those robust animal spirits.

Consider industry sectors. Sector-wise, the Four Horsemen of the reflation trade that ignited after the election were financials, materials, industrials and energy. These also happen to be the four sectors trailing the market in 2017 year-to-date, while technology, healthcare and consumer discretionary have all outperformed. Tech and discretionary, in particular, seem like pretty reasonable places to be if you're comfortable with that beta economy and looking for a low-impact way to continue participating in equities. This low-key sector rotation has kept the rally going even as the original theme behind it went stale.

The problem, of course, is what happens when momentum wanes, as it eventually does? The first thing to watch out for is signs of the return of volatility, which as we all know has been strangely absent for the duration of this most recent phase of the bull market. Even that one-day pullback last week failed to elicit much more than a shrug from the supine VIX index. The market's vaunted "fear gauge" has stayed in a volatility valley well below 15 for the entire year thus far (compare that with an average level above 20 for the first two months of 2016).

We tend to pay less attention to the VIX's occasional sharp peaks than to the mesas – those extended periods of baseline elevation around 15-17. A new mesa formation on the VIX would, in our opinion, raise the prospects of a sizable near-term pullback in the 5 – 10 percent range. At which time we could, mercifully, shake off the dog days and get into some desirable new positions at more reasonable values.

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