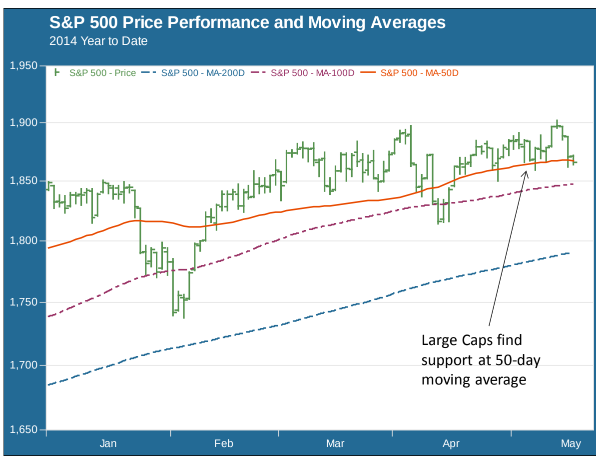
MV Capital Management Weekly Market Flash

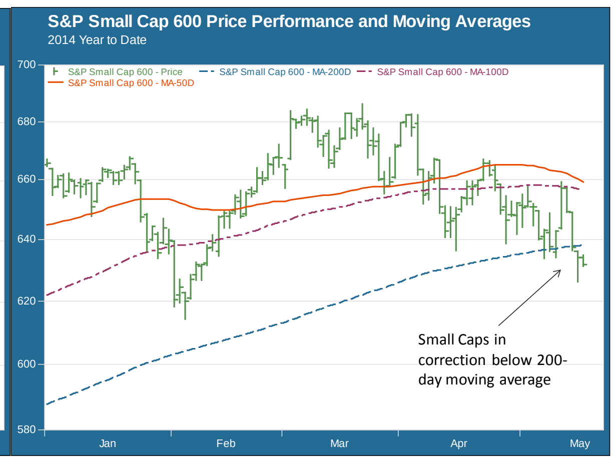
The Split Market: How Will It Un-split?

May 16, 2014

On Tuesday this week the S&P 500 reached an all-time high, nudging past the psychologically important level of 1900. The broad market index has since pulled back, but remains above the 50-day moving average: indeed, it has maintained a positive distance from this intermediate support level for all but a handful of days after rebounding from the 5.8% pullback of late January – early February.

As the charts below show, there is an altogether different trend taking place in small cap equities. The S&P 600 Small Cap index is in correction mode – a pullback of 10% or more from the last high water mark – and is struggling to find support around its 200-day moving average. The market is split; the question is how it will un-split. Will small caps drag the broader market down into a second 5%-plus pullback, or will they find support and rally back sharply to catch up with the market? Or, as a third option, will this unusual split simply continue apace?





Source: MVF Research, FactSet

Sector Concentrations

One distinguishing feature of the current market environment is that the bad news started with heavy sector concentrations. In particular, areas like biotechnology and Internet services suffered, with the S&P Biotechnology sector falling 18% from its February high to the low point in the middle of April. The impact of this sector-specific retreat has been more pronounced among small cap names than large cap.

What seems to have happened since mid-April is that the concentrated weakness diffused into a broader array of small-cap sectors while only minimally impacting the broad market. Both biotech and Internet services have firmed up somewhat since those mid-April lows while, as the above chart shows, the S&P 600 Small Cap index continues to set new post-February low points. And there has been attendant volatility in small caps that is largely absent from large cap equities. The large intraday spreads in the S&P 600 show a level of jitteriness out of sync with the

CBOE VIX, the broader market's so-called "fear gauge", which remains close to the very subdued levels that have prevailed for most of the past one and a half years.

Janet Yellen, Stock Pundit

Last week small caps took a broadside from another, rather unexpected source. In a routine and otherwise largely unremarkable address to Congress on May 7, Fed Chairwoman Janet Yellen tossed out the observation – seemingly as an aside – that there are potentially "pockets of over-valuation" in small cap equities. Presumably Ms. Yellen will learn over time that seemingly innocuous phrasings – think "six months" or "taper" – can become dynamite when issued from the Valhallan heights of the Fed. Nor is the ensuing tempest necessarily short-lived, as illustrated by last year's manic four-month climb in the 10-year yield after Bernanke's initial tapering comments.

The Fundamental Picture

Moving averages, Fedspeak and the like are helpful tools for navigating the rapids from day to day, but we need to step back and look at the broader picture as we try to determine where the split market goes from here. Fundamentally, the theme of sustained economic recovery in the U.S. remains in our opinion largely unchanged, with the potential for a return to double-digit earnings as companies shake off the drag of the rough winter that impacted 1Q14 performance. Moreover, we would expect other risk factors such as geopolitical flash points and economic question marks in the Eurozone and China to have a less direct impact on domestic small caps than on the large companies with more international exposure on their financial statements.

Given the evidence at hand, with the obvious caveat that the immediate future is unknowable, we see a reasonable case to make for an eventual convergence of the split market without an undue level of pain for the broader market. A small cap overlay may be appealing for the tactically inclined, so long as one is mindful of the attendant risks.

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