MV Capital Management Weekly Market Flash

Summer of Noise

August 8, 2014

It's summertime, but the living has been anything but easy for the past couple weeks. A news cycle full of geopolitical flare-ups, health crises and dissension at the Fed has brought volatility and wild intraday price swings back onto center stage. Yet there appears to be less to the daily drama than meets the eye. For all the lead stories spilling out of the world's trouble spots, the real force driving volatility is the low levels of activity typical of summer. Since the beginning of July, daily volume on the S&P 500 has been below its 200 day moving average 82% of the time. Low volume amplifies price swings. We think this environment is less about news, more about noise.

Geopolitics Priced In (For Now)

Of all the current flashpoints, arguably the escalating tension between Russia and the West is cause for greatest concern. This tension certainly has not helped Europe, which depends on Russia for the majority of its energy imports. Shares in broad Eurozone market indices are down nearly 10% from where they were at the beginning of July. But Russia's role in the global economy is less impactful than China's or Brazil's. Even if economic sanctions between Russia and its main trading partners worsen, the effect is likely to more localized to companies with significant interests in Russia (major international energy companies come to mind) than widespread.

Events in the Middle East are likewise unsettling, but contained in terms of practical economic impact. Crude oil prices – often a barometer for tensions in the Gulf – are at their lowest levels for the year to date. Questions remain about the level of U.S. engagement as the crisis in Iraq creeps towards the oil-rich Kurdish state, but for now any potential use of ground troops is fully off the table.

Support, Resistance and Round Numbers

There is nothing particularly magical about round numbers or 100 day moving averages, but in the capital markets perception creates its own reality. The S&P 500 broke through the 1900 resistance level back in May, and was closing in on 2000 before gravity kicked in late last month. The Dow Jones Industrial Average topped 17,000 before the latest tumble. On the other side, though, the major indexes are all finding support around intermediate-term moving averages: the S&P 500 is currently trading right around the 100-day average.

Bear in mind that over 60% of the daily trading volume on U.S. equity exchanges is machine-driven, reacting to algorithms rather than human decision makers. Many of these algorithms are programmed to react specifically to things like round numbers and moving averages, and that is why they figure so prominently in observed trading patterns. Given the pace of the rally that started in mid-May, it is scarcely surprising that we see a brief pullback and perhaps an extended period of trading in a narrow support-resistance corridor. Whether it turns into something more remains to be seen, but for now the noise factor appears to predominate.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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