Weekly Market Flash

Drifts and Shocks

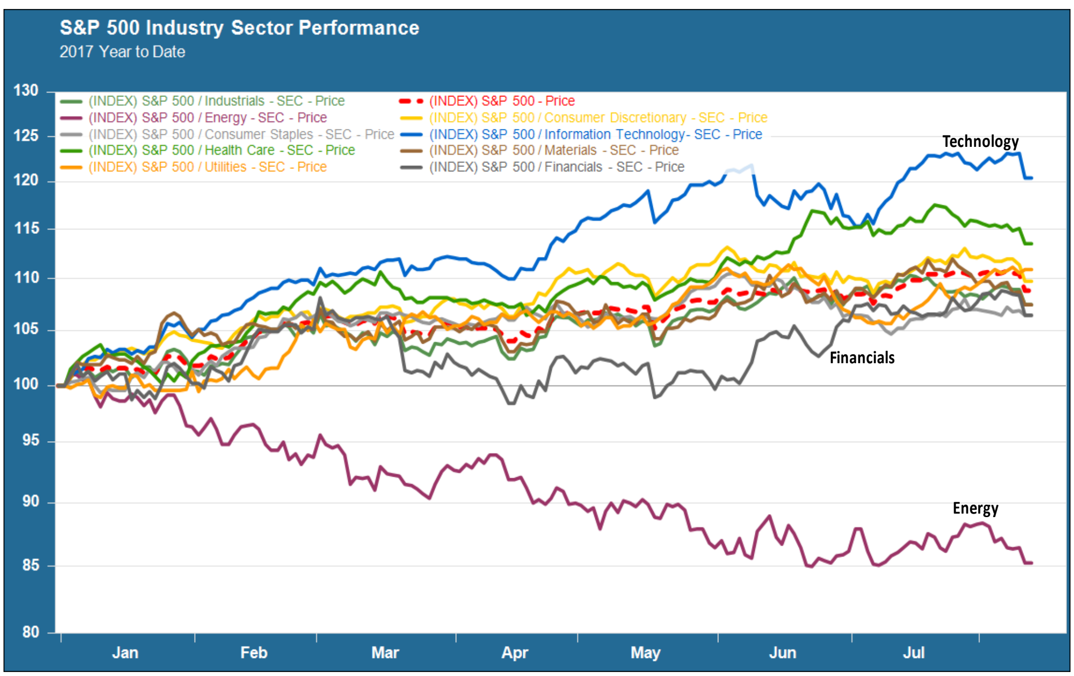
August 11, 2017

Should you be concerned about the somewhat bumpy ride US stocks have encountered in the past couple days? Or is this a welcome chance to get in some long overdue bargain hunting before the S&P 500 resumes its lazy upward drift to a series of new highs?

The answer would depend, we imagine, on whether you see the unrest on the Korean peninsula – arguably the best go-to explanation for yesterday's 1.45 percent pullback in the US benchmark index – as something genuinely serious and potentially destabilizing, or as little more than a spate of made-for-Twitter taunts that will, as these things generally do, settle down. As you contemplate this, bear in mind that most of the intense geopolitical flashpoints in history (notably including the 1962 Cuban Missile Crisis) have had relatively negligible impacts on asset returns in the months following the event. We have noted before that disaster doesn't strike far more often than it does strike.

Caveat Bargain Hunter

That being said – and our instinctive proclivity towards bargain-hunting notwithstanding – there are some reasons entirely unrelated to geopolitics that merit some thought before doubling down on your equity market exposure. This comes back to a theme we have discussed extensively with clients in recent weeks, namely, the rather listless, leaderless nature of the market's upward drift this summer. Consider the chart below, which shows the relative performance of the main S&P 500 industry sectors against the benchmark index for the year to date.



Source: MVF Research, FactSet

In this chart we draw particular attention to three sectors: technology, financials and energy. These are the three sectors that were the key drivers of profit growth in the just-concluded second quarter earnings season. Energy led the way with a triple-digit earnings rebound from the depths of the sector's miserable 2016. Technology and financials both enjoyed double-digit earnings growth and the tech sector's top line was strong as well, helped along by the benign tailwind of a weaker dollar against major trading partners.

Earnings, Schmearnings

With the exception of tech, though, these earnings haven't translated into share price performance. Energy continues to be the market's problem child, seemingly unable to convince investors that the current trough recovery in earnings is sustainable. Financials, of course, were the darling of the post-election reflation trade before that ill-conceived flight of fancy crashed and burned in this year's first quarter. Banks and their ilk have trailed the benchmark since then. And tech, even though it maintains a solid performance lead this year, has shown itself to be vulnerable on several occasions, most notably with that big pullback in early June.

The apparent lack of attention paid to earnings extends to the level of individual stocks as well. A Financial Times article earlier this week reported on the market's apparent failure to reward companies beating their Q2 earnings estimates, noting that "there has been little or no reward for companies reporting better than expected earnings per share and sales." This observation fits in squarely with our contention that, while the market drifts higher in the absence of a compelling negative headwind, it lacks a sustaining theme. And without such a sustaining theme the market is, we believe, more vulnerable to the types of external shocks we have seen this week.

Labor Day Looms

As we write this before Friday's market open, we have no crystal ball to tell us whether yesterday's pullback will extend for a few more days (S&P 500 futures are about flat with 20 minutes to go before the open). We haven't seen a multi-day pullback for more than a year and a half, but they do happen with some regularity. We think it more likely than not that the Korea kerfuffle will subside in due time, playground taunts from both heads of state kept in check by cooler heads. But the listless market will still be exposed to these kinds of periodic shocks, and they may come into sharper focus as the traditional back to school season approaches. Yesterday the VIX, the market's "fear gauge", shot up above 17 after weeks of historically low dormancy. Until we have another compelling, sustainable positive trend narrative, we should not be surprised to see more of these periodic, brief solar flares.

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