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## Weekly Market Flash

### Competing Narratives for Back to School Week

August 25, 2017

It's that time of year again. Here in the mid-Atlantic region we are getting the first taste of dry, cool nights in place of midsummer's relentless humidity. High school cross country teams are running through our neighborhoods to get in some practice before the season's official start in a few days. And, of course, investors across the land are wondering what mix of surprises are in store for the deviously tricky stretch of the calendar between Labor Day and Thanksgiving. The sense of expectation is palpable; it seems like an eternity since anything has penetrated the smug, self-satisfied forward motion of the S&P 500. Will the good times continue to roll?

There are of course many variables at play, and a broad spectrum of possible outcomes. We think these can be broadly divided into two high-level narratives: (a) nothing new here, carry on as before, or (b) signs of wear and tear in the long-running bull that could spell trouble. We look at each of these narratives in turn.

#### Narrative 1: Nothing New Under the Sun

Over the course of the year we have been treated to numerous explanations of what's been going on in markets by the furrowed brows of CNBC analysts and their ilk. But when you stand back from all the earlier, furious rotation – into and then out of financials, into and then out of tech, into and then out of healthcare – the easiest explanation for the positive trends of 2017 is the near-absence of anything new. The US economy has been growing at a slow rate, with low inflation, a decent labor market and favorable corporate earnings, for most of the second decade of this century. Within the last year and a half or so our modest growth has been joined by that of Europe and Japan. There are no glaring trouble spots in emerging markets, with China and Southeast Asia reclaiming the lion's share of global growth. The global economy appears serenely detached from the chaos of worldwide political dysfunction.

Almost no headline data points have challenged this macro-stability narrative thus far this year. And under the placid surface, of course, remain the central banks whose actions over the past six years have put a supportive floor under asset prices. Sure, there's some debate now about how the Fed and the ECB steer their policies towards something more "normal," whatever that is. But almost nobody expects that the bankers would sit back and watch from the sidelines should risk assets suddenly hit a nasty and sustained patch of turbulence. This attitude may appear complacent, but it is also entirely rational given all the evidence accrued over the past few years.

#### Narrative 2: Be Careful What You Wish For

Calm, gently upward-trending asset markets are an investor's dream. But all dreams eventually end and the dreamer wakes up, remark observers skeptical that the Goldilocks conditions of the year to date can last much longer. Do the naysayers have anything substantial to present as evidence for a sea change in market trends, apart from simply repeating "no free lunches" ad nauseum?

Well, perhaps they do. As Exhibit 1, the Cassandras may trot out the performance of recent small and mid caps. Both the S&P 400 Mid Cap index and the S&P 600 Small Cap index are trading below their 200 day moving averages, more than 5 percent down from the year-to-date highs both attained in July. And while on the subject of 200 day averages – a subject about which we have had remarkably little to say for a very long time – the number of S&P 500 stocks trading below their 200 day averages is close to 50 percent. The current stage of the bull, in other words, is not particularly broad-based. A trend of narrowing outperformance has in the past been a frequent sign of impending market reversal (though, we should note, it is not particularly useful as a market timing measure).

The other evidence our skeptical friends may muster in support of the case for correction is the very absence of volatility so celebrated by the bulls. There was a stretch recently when the S&P 500 went 15 days in a row without moving more than 0.3 percent up or down – a 90-year record for low volatility. That serenity would appear to misprice the inherent risk in holding common shares – which, as any finance professor will happily tell you, represent a completely unsecured claim, junior to all other claims, on a company’s residual assets. When common stocks exhibit the volatility properties normally associated with fixed income securities, that would seem to indicate that the market has something wrong. Be careful what you wish for! And these arguments, of course, take place against the backdrop of a market more expensive, by traditional valuation measures, than any other than those of the bubbles of 1929 and 1999-2000.

The thing about each of these narratives is that they are entirely plausible. The worrying trends highlighted by the skeptics are believable and suggest caution...but so is the seemingly fixed-in-stone macroeconomic context of slow, reliable growth and benign conditions for corporate earnings. We also imagine that, if we do see a pullback or two of any size in the coming weeks, a quick, Pavlovian buy-the-dip response would be more likely than not. That in turn may afford some additional intelligence on whether conditions going forward appear wobbly enough to support building up some additional defenses.

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