MV CAPITAL MANAGEMENT

Weekly Market Flash

Five Things We Learned This Week at the Crazy Farm

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Well, that happened. The technical correction we have all talked about for the past four years finally showed up and sent pretty much any asset class with a risk component into a tailspin. The magnitude of the correction (thus far) is nothing particularly out of the ordinary as these things go: the S&P 500 was down 12.4 percent from its May 21 high when the markets closed on Tuesday (it recovered about half of that in the subsequent two days). But this action-packed sequence of six negative trading days produced some curious artifacts and served notice that, while history is more likely to record this event as a bull market correction than a bear market onset, we should be prepared for more twists and turns down the road. Here are five things we observed from this week's craziness.

#1: ETFs – The Scream Heard 'Round the World

Call it a delayed coming-out party for an asset that came into this world some twenty two years ago. ETFs promised cheap, efficient access to the market via index proxies, and by and large they have delivered on that promise. More recently, though, ETFs have become the asset of choice for a wide range of active and quasi-active strategies, employed by a spectrum of participants from seasoned investment pros to couch potato day traders. Their presence during the more insane moments of the pullback was unmistakable.

Consider the S&P 500 – the very living, breathing embodiment of a broad market benchmark. Two ETFs widely used as proxies for the S&P 500 are SPY, the SPDR product present at the ETF creation in 1993, and IVV, the BlackRock iShares offering. SPY has a market value of over $163 billion, while IVV clocks in around $67 billion. Pretty liquid, no? But something went seriously wrong with IVV on Monday morning. From a Friday close of $198, IVV shares briefly plunged to a low of $147 shortly after the Monday open. That's a loss of almost 26 percent - far more than the index itself. Far more, in fact, than SPY, which in the same time period lost about 7.6 percent from its Friday close, more in line with what the market itself was doing. Now, the discrepancy didn't last long, and both ETFs finished the day closely tracking the index. But that will be small comfort to those whose IVV orders were filled at peak divergence. Small comfort, as well, to the rest of us who care about fair and orderly markets.

#2: Rear-Window Vision Is Alive and Well

Pullbacks – as opposed to actual bear markets – are like sandstorms in the desert. You know they're going to happen, but you're still surprised every time the sand blows up into your face. As always, it didn't take long for pundits of various stripes to start filling pages with their "I saw this coming" narrative. Did we learn anything new about the world last Friday? Sure, Shanghai and Shenzhen took another pasting. Yes, sagging commodities prices are probably a better measure of China's economic slowdown than the official statistics. But A shares started tanking back in June, and China's more modest pace of activity has been an ongoing story for the last year.

So why now? It's a variation on the butterfly wings of chaos theory – a conflux of random events around the world creates the conditions for the storm. Same as it was last October, when the Ebola scare, a mysterious drop in bond yields and falling oil prices were ascribed to that month's 7.5 percent pullback. Now, are there investors out there on the right side of the trade when these events happen? Of course – statistically it would be nearly impossible for there not to be. But getting the timing right for these brief flare-ups is much more about luck than skill.

#3: Noise 1, Signals 0

While the size of the reversal was not out of line with past correction environments, certain metrics seemed way out of line. Front and center among those is volatility. On Monday, August 17 the CBOE VIX closed at a gentle 13, not far from where it had traded throughout a mostly calm summer. One week later it was reaching intraday levels last seen during the 2008 meltdown and closed at 41 – roughly the same as where it closed on the first post-9/11 trading session back in 2001. Very likely, the unusually high vol spike is not unrelated to our observation #1 above – the amplification of price swings provided by ETF-heavy short term trading strategies.

The so-called Copenhagen Interpretation theory of quantum mechanics posits that the act of observing an event at the subatomic level influences its outcome. Increasingly we seem to have a Copenhagen Interpretation of the capital markets: the aggregate behavior of the tens of thousands of algorithms programmed to go this way or that when triggered by a signal wind up altering the signal – arguably making that signal less useful as a predictive metric going forward. Traders using traditional volatility signals would probably be well-served to revisit their algorithms once the dust from this flare-up has settled.

#4: It's 1998 Again!

Not really, of course. But there are some interesting parallels. In the middle of 1998 we were well into a bull market, valuations were stretched (to say the least) and various unsettling things were going on in the world. All of which was enough to send the S&P 500 into a 19 percent reversal from its July high to early October. As usual, it was easy for commentators to conjure up world-is-ending talking points: Russia defaults! LTCM goes bust! Clinton impeachment! We were both there – the times were indeed unsettling. But investors who bailed out in a September panic missed out on another year and a half of a stampeding bull. Again – we do not mean to be facetious and suggest that history will repeat itself. Sooner or later the bear will likely emerge from its lair. But we think it more likely that the bear will reveal its hand with a few more corrections – with at least one giddy "melt-up" along the way – before we write the coda on this bull.

#5: The Song Remains the Same

Every so often we go back to the Annual Outlook we published back in January to see where our views have changed and where they haven't changed. It is noteworthy as to how much of this year's story remains the same. Continued modest but steady growth in the US? Check – amid this week's mayhem we had strong readings on consumer confidence, durable goods and the 2Q GDP revision. Europe managing to stay a few feet away from the deflation abyss? Check. Emerging markets struggling to regain their long-lost tag of "growth engine" while China struggles to maintain momentum? These are the fundamentals as we see them. They are in our opinion not inconsistent with the type of correction we saw this week, but also not the likely ingredients for a global recession that would drag down global asset markets for a long spell.

We expect to see more volatility ahead, with an eventful September just around the corner and the tricks and treats of October lurking beyond. For the time being, though, we think these are conditions to play through, and not panic over.

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