MV CAPITAL MANAGEMENT

Weekly Market Flash

Dr. Pangloss's Market

December 30, 2016

"It is demonstrable that things cannot be otherwise than as they are; for as all things have been created for some end, they must necessarily be created for the best end." Thus spake Dr. Pangloss in Voltaire's satirical short story *Candide*. Stripping away the eighteenth century rhetorical flourishes, Pangloss's philosophy can be read thus: "All things always happen for the best." Satirizing that attitude was the French Enlightenment wit, Voltaire's way of poking fun at the smug certainties of the popular mindset of his day.

Mr. Market and the Gradually Filling Glass

Voltaire seems an appropriate touchstone for this, our final commentary of the year 2016, as we have spent much of the past six weeks or so gently poking fun at the popular mindset of our day, at least as it pertains to sentiment in risk asset markets. Let's step back, take a brief trip down memory lane (as one is wont to do at this time of year) and look at the larger picture.

2016 started off with Mr. Market viewing the glass as half empty. The Fed's rate hike in December 2015, followed by some mildly disturbing news from China as the opening bell rung stocks into the New Year on January 2, served up our first technical correction (pullback of 10 percent or more) since 2011. The "Fed put" reliably arrived to contain the damage, and interest rates marked time. Stocks rebounded and settled into a corridor, with the S&P 500 mostly fluctuating between its May 2015 high of 2130 and an arbitrary magic-number floor of 2000.

Britain Leaves, Elephants Heave

Then along came Brexit, and the glass went from being half empty to half full. Stocks surged, crashing through the valuation ceiling to set a series of new highs in July before settling into another lackluster sideways trading pattern in August. In September, investors were on watch for some important policy events, but Mr. Market sailed through these with an air of insouciance.

Finally, in November, Republican candidate Donald Trump scraped together some 100,000-odd votes in the key battleground states of Pennsylvania, Michigan and Wisconsin to eke out a victory in the Electoral College that surprised just about everybody, including the Trump campaign team. Now the glass went from being half full to being full to the brim and sloshing over the sides onto the coffee table.

It is not entirely true to say that a new paradigm was born overnight. Financial stocks, the big winners of the last two months of the year, had been outperforming the market before the election as steadily improving wage data indicated a likely upswell of pressure on prices. But the election did catalyze two dominant themes: the "reflation-infrastructure" trade, based on expectations of a flood of new public works projects (and a corresponding spike in the deficit, interest rates and the dollar); and a sharply lower corporate tax rate that would flow straight to the bottom line and goose up corporate earnings per share.

Simply the Best, Better Than All the Rest

Enter Dr. Pangloss and the best of all possible worlds. Where the market is priced today (including market risk levels at multi-year lows alongside record high stock prices) seems to reflect a broad sentiment among investors that, of all the variables good and bad swirling around in the global economy and its policymaking centers of influence, only the good ones will actually happen. Infrastructure spending that translates to actual GDP growth? Check. Corporate tax reform that not only cuts the statutory rate but widens the base by getting rid of all the loophole goodies (through which most companies pay far less than the statutory rate today)? Yes, certainly! Debilitating trade war with China? No way! Geopolitical shock waves as long-standing alliances are called into question and traditional adversaries brazenly throw down the gauntlet to challenge them? Uh-uh, not gonna happen. All things were created for some end, and that must necessarily be the best end, said Pangloss.

To be perfectly clear, we, too, hope that 2017 will serve up more in the way of positive than negative developments. But our analysis is never based on hope. It is based on connecting the dots between disparate pieces of empirical evidence to arrive at a view on where assets appear priced relative to the value drivers and risk factors affecting them. As 2016 closes out we find ourselves still faced with large open spaces between as-yet unconnected dots. We will be coming back to work next week with our pencils sharpened, ready to crunch the numbers as they come in.

Meanwhile, we wish all our clients and friends the happiest of New Years, and a healthy and personally fulfilling start to 2017.

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