MV Capital Management Thought Leadership

Postmodern Finance

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Part II – Directionless Volatility

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The two most noteworthy characteristics of markets in 2011 are these: first, they have been more volatile for a longer stretch of time than ever before; and second, they have gone essentially nowhere. The general pattern has been – up 1% one day, down 2% the next, up 1.5% the next day and so on *ad infinitum*. The only extended directional moves this year have largely cancelled each other out. In the space of about eight trading days in late July and early August the S&P 500 fell from 1345 to 1120, a drop of about 16%. In early October the index rallied from 1100 to 1285, an upsurge of over 14%. We would argue that both those events – the August plunge and the October rally, were based on vapors rather than substance – subjective mood rather than objective reasoning. The August plunge came on the heels of the debt ceiling debacle, a self-inflicted problem on the part of politicians for whom the art of governance is clearly a bar too high. Conversely, the October rally was based on…what exactly? That Europe still exists? For the moment, in any case, that rally appears to have been short-lived; a general negative trend has characterized most of November thus far. Of course that could always change again before year-end. Looking at the bar chart of the S&P 500 for the past four months is like nothing as much as it is the path of a drunkard's walk – lurching from side to side but going nowhere.

Are volatility and directionlessness merely two sides of the same coin? We would argue yes, and furthermore that they represent a – dare we even say the word – *rational* pattern of trading for a capital market that seems to have completely lost its bearings. Let's start with directionlessness, which is perhaps the easier of the two to explain. We can posit the question: what fundamental assumptions would a directional trend be based on? The global economic picture is mixed. The economy is not growing by much, but it is still growing. US GDP, although it was again revised downward recently, is still around 2% based on the 3rd quarter reading. That is not much to get excited about, and it does nothing to solve the problem of persistent high unemployment and underemployment, but it is still better than zero percent growth or a fall back into technical recession territory (for those who are on the wrong end of that employment measure, of course, the last recession never actually ended).

Tepid growth by itself might be enough to sustain a rally to the upside. Corporate earnings, after all, have continued to do much better than top-line GDP numbers because companies have figured out how to make more with less – lower labor costs, higher investments of productive technology, access to growth markets in Asia and elsewhere, and borrowing costs of next to nothing. Look at the valuations for many blue chip stocks and you could convince yourself that they are quite undervalued on an historical comparison. Why not take a little directional position on an earnings-led path back to moderate growth?

Because of the Eurozone, that's why. If the absence of negative growth provides a floor below which equities prices appear reluctant to go, then the interminable problems on the other side of the Atlantic supply the wet blanket that stifles any attempt to soar with eagles. It was two years ago that the Athens stock exchange started to tank while the rest of the world was enjoying the continuation of recovery from the March 2009 market lows. Two years later and what do we know? That the European common currency project is in dire straits, that policymakers are absolutely frozen like so many deer in the headlights, that bond investors are playing Russian roulette with some of the world's largest national economies – and the band plays on. There are policy decisions that could provide relief from the intensity of the crisis in the short term, but the fact is that Europeans still do not vote for technocrats – they vote for national politicians based more on issues of local, regional or occasionally national importance than on

whether the ECB's mandate should be redrawn to allow for wholesale bailouts of Eurozone sovereign bondholders. This policy stasis could always change, but for now it remains deadlocked.

So that's directionlessness. Now we come to volatility. There is much that we did not anticipate at the beginning of this year – bond yields falling to levels last seen in the 1940s being perhaps the signature example. But what we saw that clearly did come to pass was volatility – though the sheer magnitude and persistence of this volatility day in and day out is less easy to comfortably explain. How is it that the Dow Jones Industrial Average sees an intraday swing of less than 100 points just one day in the entire period from September through the day before Thanksgiving? Why has it become the "new normal" that the S&P 500 close up or down by 2% or more on any given day? We know there is lots of uncertainty in the market. The question is, why is there so much short-term trading around this uncertainty every day? Is this a stock market or a casino?

The question does not permit a simple answer – many factors are at play in a complex ecosystem from which emerge unforeseen properties. But there are plenty of disturbing data points. Insider trading by politicians and by investors with access to key policymakers means that information trades into those large hedge funds with their servers backed up to the floor of the stock exchange, and the computer algorithms operated by those funds spit out buy and sell orders, and the rest of the world watches on in bafflement. For some reason this activity (which has been chronicled by mainstream news sources over the course of this fall) appears to fall outside the boundaries of illegal insider trading as defined by the SEC. Why it is less "illegal" to trade on the knowledge of some upcoming Operation Twist or QE3 (Fed decisions almost certain to move short-term markets) than it is to trade on a tip by XYZ Company's CFO about upcoming earnings guidance is something that is frankly astounding and, given that it appears to be standard operating procedure, more than just a little alarming. Stay tuned for more of our thoughts on these developments in the coming weeks.

So much is afoot, and much is at stake. Rest assured that we are in the kayaks, navigating the twists and turns. In the meantime, as we all prepare for the last-minute bustle in preparation for the holiday, we wish each and every one of you a happy Thanksgiving in the company of your loved ones.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

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