Quarterly Newsletter

MV FINANCIAL

First Quarter Review: Struggling to Break Out

After closing out 2013 at (mostly) record highs, major US equity market indices turned sour in the month of January. Since that time the stock market has struggled to maintain any kind of sustained upward momentum. A late surge helped the S&P 500 eke out a 1.8% gain for the quarter, but it promptly lost all those gains in the first week of April. For most of the last two months – since recovering from a 5.8% pullback in early February – the S&P 500 has traded in a narrow band on either side of 1850, right around the level at which it began the year.

In the global economy cautious optimism continues to prevail, with some potential trouble spots. Recovery in the US continues at a measured pace, though economists have puzzled over how to interpret some of the recent job numbers. The unemployment rate has ticked down to 6.7% as of the end of March, but payroll gains have been relatively unimpressive and the labor force participation rate is at historically low levels. Elsewhere, the Eurozone is trying to head off deflation, Japan's consumer sector is adjusting to an increased consumption tax, and recent data from China hint at possible growth troubles.

A more likely reason for the mostly directionless stock market is simply that investors see limited upside potential given the expansion in valuation multiples resulting from 2013's strong performance. The next twelve months (NTM) P/E ratio for the S&P 500 remains at levels not seen since the middle of 2007. Certain sectors, notably technology and healthcare, are even more expensively valued than the broad market. Indeed, we have seen something of a rotation in sector and style trends recently, away from the growth darlings of the last nine months and into more value- and dividend-oriented plays.

Fed watchers had a busy March, parsing the tea leaves of new Fed Chairwoman Janet Yellen's inaugural press conference. The flash consensus was that the Fed struck a more hawkish tone than expected, though that may not have been an obvious insight to draw from the language of Yellen's press release. The Fed removed quantitative benchmarks from its forward guidance formula, giving it more leeway in deciding when and under what conditions a rate hike might begin. Nonetheless the yield on the 2-year Treasury note, a benchmark for short term rates, spiked after the mid-month meeting. They have subsided since, and indeed remain below their beginning-of-year levels, but credit markets will continue looking intently for clues about the Fed's next moves.

Second Quarter Outlook: Geopolitics and Earnings in Focus

Geopolitical instability is back. This time the focus is on Ukraine and the intentions of its neighbor to the north, Russia. Reaction to the annexation of Crimea was relatively tepid, but that could change if the current unrest in Ukraine's more pro-Russian eastern cities spills over into something more. Tens of thousands of Russian troops are massed along the eastern borders, and several government facilities have been overrun by crowds of unconfirmed origin. The economic impact of a prolonged conflict could be significant in places outside the former Soviet Union, particularly Western Europe.

Earnings season is once again at hand, and this likely will also be a key factor influencing near term market trends. The consensus estimate for first quarter earnings has come down significantly since the beginning of the year. According to FactSet, blended earnings for the S&P 500 are expected to be slightly negative for the quarter, as compared to the 4.4% growth rate forecast at the beginning of January. Unusually bad weather accounts for a not insignificant part of that expectations decline. Investors will be looking for evidence that results were not worse than expected, and poised to bounce back later in the year.

As the second quarter gets underway we have seen a strong recovery in emerging markets, both equities and fixed income. Emerging markets stock indexes remain well below their levels of a year ago, so the potential exists for more upside. However, in our opinion this remains an asset class with higher than average levels of risk. Question marks remain about China's growth trend and whether its attempt to rebalance the economy towards more consumption and less speculative investment will bear fruit. National elections in India may bring an untested, controversial leader to power. And these markets remain vulnerable to the Fed's interest rate policy. It may be wiser to add slowly and cautiously to this sector than to jump back in with both feet.

MVCM 2014 0033
DOFU: April 2014