Quarterly Newsletter

MV FINANCIAL

First Quarter Review: V Is For Volatile

Symmetry lovers will appreciate the geometry of the first three months of 2016: a near-perfect V-shaped trajectory for US stocks. The S&P 500 fell 10.5 percent from the close on December 31, 2015 to February 11 of this year. The index then enjoyed a breathless rally of 12.6 percent, closing out the quarter in the green after spending most of it in the red. For all the volatility, though, very little appears to have changed in the fundamental landscape. Most of the headline macroeconomic data suggest the same story we have been hearing for some time now: a slow but steady recovery in the US, stagnation in Europe, a slower-growing China and weak or negative growth in other key emerging markets.

So why all the ups and downs? Let's start with central bank policy, which after seven years of this bull market remains the key influencing variable at play. In December, you will recall, the Federal Reserve raised interest rates for the first time in nearly ten years. It was a gentle raise – just 0.25 percent , and unprecedented given how far into the recovery we already are – but a raise nonetheless. Meanwhile Europe, Japan and China were all committed to varying degrees of monetary stimulus. Heading into the end of last year, investors were concerned about the uncertainties of policy divergence between the US and the rest of the world. Then, on the first business day of the New Year, an unexpected devaluing of the Chinese renminbi set the tone for a global selling wave. Markets fell by one percent or more day after day. Oil joined the freefall, while investors piled into safe haven assets like Treasuries and gold.

Central banks took their usual cues and lined up to outdo each other in more stimulus. Janet Yellen blinked both in January and in March, and in a speech late last month finally admitted what everyone has more or less known all along: when the Fed says it is "data driven", it means data from the price feeds of stock and bond indexes, not data from some high-octane models its internal brain trust developed. The FOMC is watching the S&P 500 and yields on the 10-year, just like you and we are. Meanwhile, the ECB announced a new set of measures including a facility to literally pay European banks to go out and make loans. The Bank of Japan went NIRP – negative interest rate policy – in efforts to talk down the yen and stimulate risk assets. As they say, though, the best laid plans…since the BoJ's new measures went into effect the yen has soared to a 12 month high against the dollar and the Nikkei 225 stock index is sharply lower.

Second Quarter Outlook: V Is (Also) For Valuation

Investors remain wary about what the rest of the year holds in store, despite the latter-half Q1 rally. One important reason for skepticism is that, eventually, any asset's progress will be tethered to its underlying fundamentals. And the valuation metrics that reflect those fundamentals remain decidedly expensive. At the depths of the Q1 pullback, the ratio of price to next twelve months' earnings (NTM P/E) for the S&P 500 fell to 15.2 times. That is just barely below the peak level the NTM P/E reached in October 2007 at the height of the 2003-07 recovery. In other words, the pullback didn't make stocks cheap, and the subsequent recovery has returned them very close to last year's 17.1 times peak. With the first quarter earnings season (currently underway) likely to produce a fourth straight quarter of earnings per share losses for the index, we see a "valuation ceiling" providing stiff resistance against too much further upside.

We are also somewhat skeptical about some of the mean reversion plays that took place in the first quarter. Emerging markets equities fared very well, with the MSCI Emerging Markets index gaining 5.8 percent for the quarter. A standout EM performer was Brazil, up 30 percent for the quarter. Brazil, of course, is mired in a chronic recession and a toxic political environment with a possible impeachment looming for the country's president. It appears investors saw Brazilian stocks as oversold and saw opportunity for short term gains; unfortunately these mean reversion moves tend to have limited duration when the underlying story remains negative. Likewise it is not hard to make the case that the fundamental headwinds facing oil and other commodities have not changed, which will inhibit chances for a sustained rally. On the positive side, the prospect of a US recession remains distant. As long as that is still the case, we believe that a full-on bear market is not yet at hand. We continue to advise caution, though, and focus on risk management more than outperformance.

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