Quarterly Newsletter

MV FINANCIAL

Second Quarter Review: The Great Calm

As the second quarter opened, U.S. equity markets were stuck in neutral. The S&P 500 was trading in a fairly tight corridor on either side of 1850, the level at which it started the year. There were no significant pullbacks, but no breakout on the upside, either. Then, as the month of April ran its course, large caps and small caps diverged, with the latter eventually failing to maintain support above its 200 day moving average, a key support level. The question in the minds of market observers was whether weakness in small caps and other recent momentum darlings would drag the broader market into a protracted drawdown.

The answer turned out to be a resounding “no”. All broad-based U.S. equity asset classes, and most key non-U.S. exposures, recovered their nerve and rallied from mid-May through the end of the quarter with only the most minor and occasional of pullbacks. Even more impressive than the near-daily record highs being set was the utter absence of volatility. The CBOE VIX index, a widely followed measure of equity market risk, fell to its lowest levels since the first quarter of 2007. That time, of course, the calm climes turned out to be a deceptive lull ahead of a nasty storm. Investors will be hoping for history not to repeat itself.

A bigger puzzle confronted investors in the bond market. After starting the year above 3%, the yield on the 10 year Treasury note fell below 2.5% towards the end of May. This trend seems to be at odds with most of the headline economic data that came in over the course of the quarter. The Consumer Price Index ticked up above 2%, which is the Fed’s target level. Unemployment continued to fall and is now at its lowest level since September 2008. Those numbers would indicate an interest rate increase sooner rather than later. While it is true that we saw a sharp downward revision of 1Q GDP, which is now estimated to have fallen 2.9%, most observers regard that as an outlier and still expect strong 2H GDP growth. So what explains the fall in intermediate term yields?

One clue lies in comparing the respective trends of shorter and longer term rates. While the 10 year yield, an intermediate term benchmark, is well below its January levels, the same is not true at the shorter end of the curve. In fact the 2 year yield currently sits at its highest level since 2011. What seems to be happening is that investors are indeed pricing rate increases into their 2015 models, and this is influencing a rise in short term rates. Intermediate and long term yields are benefitting from other factors, though, such as increased demand from non-U.S. investors. For example, Japan invested a record $33 billion into Treasury notes and bonds between April and June, more than offsetting the Fed’s reduction of QE purchases over the same period.

Third Quarter Outlook: What Flavor of September?

The third quarter is often a quirky time of the year in asset markets. There are the summer months of July and August, characterized by light volumes that can result in either lazy meanderings or exaggerated price lurches. Then comes September, a month which often sets the tone for the rest of the year – for better or worse. On the back of 2013’s strong gains, most investors would probably be perfectly happy to see out the year in the upper single digits. Concerns persist about current valuation levels, though, and there is a general feeling that the market is overdue for a correction. It has been more than 400 days since the S&P 500 broached its 200 day moving average. Were the index to fall back to that level it would imply a fall of 6.6% from where it is today.

Such a pullback is by no means inevitable, of course. Should one occur, with no significant change from the current economic narrative, we imagine it may be seen more as a buying opportunity than as the onset of a secular bear environment. It will be important to closely monitor economic trends as the rest of the year unfolds, but at present the chances of a significant slowdown or recession appear remote. None of this is to say that it will be smooth sailing. But our base case remains little changed from where it was at the start of the year: modest risk asset price growth in the context of measured economic improvement, and a structural tilt to higher rates as 2015 approaches. We’ll see where we are in September.

MVCM 2014 0058
DOFU: July 2014