Quarterly Newsletter

MV FINANCIAL

Second Quarter Review: Yet Another Stall-Out

One is the loneliest number, as the song goes, but 2130 may be the stubbornest. 2130, of course, is the all-time high price at which the S&P 500 closed in May 2015, a full year and two months ago as of this writing. A price chart for the index since then shows a series of rally attempts made on that all-time high, including two in this year's second quarter. Thus far, though, 2130 remains as remote as the peak of Mt. Everest in a winter blizzard. Therein lies a general summary of the current state of things: not the worst of times, but not the best either. Risk assets other than US large cap stocks were a mixed bag during the quarter. Many European bourses are in double-digit negative territory for the year, while Japan's Nikkei 225 is stuck in a bear trend. Commodities have done well simply by rising off a very deep multi-year trough. In emerging markets as well there was a bit of a "things can't get much worse" attitude regarding Brazil, Russia, Turkey and other recent underperformers. Meanwhile, risk-off asset classes including government bonds, gold and the Japanese yen have been the standouts.

The market's almost-comic hesitancy is perhaps best illustrated by its trading pattern in the days following "Brexit" – the referendum in Great Britain resulting in victory for those who would prefer to leave the European Union (even as they were frantically Googling "What is the EU?" in the hours following the June 23 vote). The Brexit outcome was a shock to most observers; as late as the closing NYSE bell on Vote Day, major media outlets had already moved on, assuming that "Remain" would carry the day. Stock markets and the pound sterling plunged as soon as it became clear that the Leavers would win. The pain lasted two days, followed by the now-familiar V-shaped recovery to claw back all the losses and then some. And then…stall-out, yet again. Relief rallies, it would seem, can only go so far. Valuations remain rich – both the price-to-earnings and price-to-sales ratios for the S&P 500 remain close to their decade-plus high points. Q2 earnings are expected to be negative for the fifth quarter in a row. And, post-Brexit, "FX headwinds" may once again be the familiar lament of quarterly earnings calls.

Third Quarter Outlook: Uncertainty Is the Only Sure Thing

Brexit drove home the point that anybody who claims to know what is going to happen in the world (and how it will affect asset markets) doesn't know what he or she is talking about. Lots of so-called smart money was caught flat-footed on the wrong side of that trade. And there will be plenty more opportunities for event-driven traders to flounder as the second half of the year unfolds. Many-flavored uncertainty is probably the only thing we can count on.

While it is true that markets hate uncertainty, we do not necessarily expect that a murkier than usual crystal ball will result in a sharp downturn in risk assets. In our view there would be two primary drivers of a bear environment, neither of which we see as a high-likelihood event for the immediate future. The first would be heightened expectations of a global recession. Yes – growth in Europe and Japan is nearly non-existent, while the US and China are both below normal trends. But none of the major data points – not GDP growth, inflation, jobs, consumer confidence or the many other numbers we follow – suggest that a recession is on the horizon. Things can change – that's why we pay such close attention to the numbers. But for now we ascribe a low probability to the recession scenario.

The second thing that could drive markets into bear country would be evidence of clear-cut policy failures on the part of central banks. The "policy floor" is probably the single best explanation for that familiar V-shaped pattern of pullbacks we have seen in the past six years. At this point the collective wisdom of the market simply doesn't believe policymakers would allow stocks to crash. Central bankers themselves give investors every reason to think that way; Janet Yellen has all but told the world that CNBC market feeds are a fixed staple of FOMC rate deliberations. If the collective wisdom were to stop believing in the efficacy of policy as an asset-supporting tool, then bad things could certainly happen. Again, we believe the probability of an imminent outcome of this nature is low.

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Over the past five years or so diversification has not been kind to portfolios; a simple mix of S&P 500 stocks and Barclays Aggregate bonds has proven ferociously hard to beat. We have been challenged on this, and the way we answer the challenge is to remind our clients – and ourselves – that disciplined, prudent diversification is still the best antidote to uncertainty. We will remain committed to this approach as we navigate the twists and turns of the next six months.

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