Quarterly Newsletter

MV FINANCIAL

Third Quarter Review: After the Gains, Some Pain

Every stock market correction is miserable in its own unique way. The tag lines for some recent reversals are nothing if not colorful: think “Ebola Panic”, “Taper Tantrum” and “Fiscal Cliff” just to name three pullbacks of 5 percent or more that took place between 2012 and 2014. “Shanghai Surprise” would be an apt title to bestow on the events of 3Q2015, when this one is finally recorded and filed away in the annals of stock market history. As with those other reversals named above, the actual news did not seem to justify the market drama. Yes – China’s legendary growth machine is slowing, and its domestic stock market crumbled (though only after rising more than 100 percent in the brief six months from January to June). But there was no particular reason – no new and surprising news – that would seem to merit the 12 percent drop from its most recent high the S&P 500 experienced over a mere three days in late August.

When this happens – when stocks slide for no really compelling reason – the chances are fairly good that the damage will be limited and the span of time relatively brief. There is a very meaningful difference between a bull market correction and a bear market, when stocks fall by more than 20 percent and remain subdued for months, even years. Bear markets do not happen very often. Corrections happen with some measure of frequency. Consider that since 1950 there have been 177 separate instances of the S&P 500 falling by more than 5 and then recovering by more than 5 percent (our MVCM research group calls each such instance a “pullback event”). Now consider that in this same stretch of time there have been only five genuine bear markets: in 1962, 1969-71, 1973-74, 2000-02, and 2007-09.

As we write this newsletter, in early October, the S&P 500 is still about 7 percent below its high point for the year, reached back on May 21. But while it is still too early to call an end to this pullback event, the structure of the market looks much more like 1998 or 2011 – years in which stocks experienced a major correction but recovered fairly rapidly – than like 2000 or 2007. We think of these events using the imagery of desert sandstorms. They appear out of nowhere, are very unpleasant while they are raging around you, and then they are gone. The best advice for investors when they happen is to play through and not panic at the bottom. History does not repeat itself, but it often rhymes. A historical perspective on pullbacks past can help you stay calm when the squall hits.

Fourth Quarter Outlook: A New Phase

While we believe that the current environment is a correction in an ongoing secular bull market, we also believe that we are in a new phase of the bull. The key variable in the 2009-14 period was the Fed, and by extension other central banks around the world which opened the spigots with torrents of monetary stimulus. The signature contribution of this stimulus has been the lowest global interest rate environment in recorded economic history. Low rates give businesses nearly cost-free access to capital. Businesses have responded to this opportunity mostly by raising capital for mergers & acquisitions and for returning money to shareholders via share buybacks and increased dividends. Both M&A and share buybacks are currently at record high levels. All of this activity has been net positive for the stock market. Stock prices have grown by much more than have corporate earnings. The price to last twelve months’ earnings (P/E) ratio for the S&P 500 is currently 16.3 times, well above the 12.3 times level where it began its torrid three year growth run in January 2012.

What has been missing from the equation is real organic growth. It is this factor – growth – that we believe is shaping up to be the key variable in market performance going forward. And here there is cause for concern, based on what the data tell us today. China continues to grow, but more slowly as we noted above. Europe is stagnant and rife with serious problems of both an economic and a humanitarian nature. Japan’s “Abenomics” stimulus program is stalled. And many key emerging markets, once the world’s growth darlings, are in outright contraction. In this environment the US serves as the world’s growth engine. The good news is that we are growing, with healthy real GDP growth, consumer confidence and job creation. But the growth is modest by historical comparison. The next several quarters will be a critical time for corporate performance. How businesses solve the challenges of a strong dollar and weak overseas growth will in turn influence the kind of returns possible in this phase of the market. It will in our opinion require a smart mix of offense and defense.

MVCM 2015 0073
DOFU: October 2015