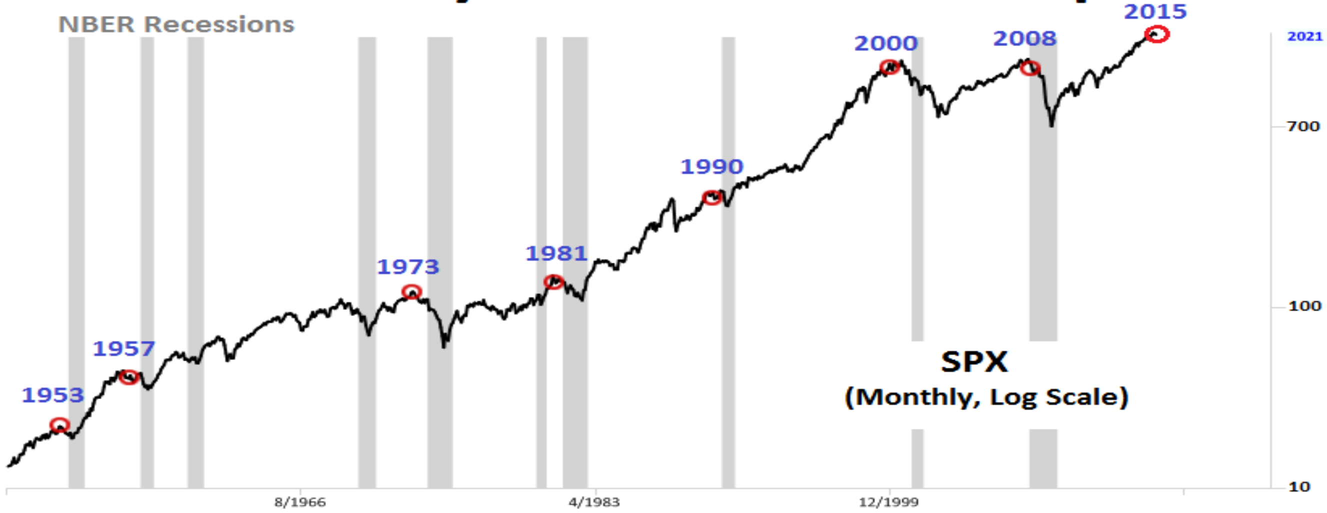
February 2nd, 2015

Crosscurrents…
Capital markets closed the books on 2015's opening act with bifurcated results across asset classes. Yield sensitive investments kicked off the year in torrid fashion as the 10-year Treasury yield fell to 1.68% at the end of January after ending 2014 at 2.13% which carried over to REITs, utilities, healthcare, and long-duration bonds leading the performance tables in January. The S&P 500 declined 3.2% on the month which history suggests isn't a good omen – "as January goes, so goes the rest of the year" – but at this time last year the S&P 500 had declined by 6% only to recover the entirety of the pullback within the next four weeks before going on to notch a double digit return for the year.

Without question volatility in the equity markets has picked up this year as almost 75% of trading days have experienced intra-day movements of greater than 1%. The narrative being scripted by the action in stock prices has clearly transitioned from the "buy the dip" philosophy that has rewarded investors over the last several years to a philosophy of "selling the rallies".

The S&P 500 is about 5% off its December 29th all-time high which is a modest pullback compared to the median 8% downdraft during corrective phases in the index since 2010. The median length of previous declines was 18 days compared to the 22 days of this current episode. On a technical perspective traders will be paying close attention to the 1970 support level on the S&P 500 and if this doesn't hold expectations are for the index to trade down into the 1905-1925 range which would represent an 8-9% decline.

Down January After 3 or More Up Years



1929-Present	Jan Return	Feb Return	Rest of Year	Whole Year	Next NBER Recession Start	Months to Next Recession
Jan-1953	-0.72%	-1.82%	-5.95%	-6.62%	Aug-1953	7
Jan-1957	-4.18%	-3.26%	-10.58%	-14.31%	Sep-1957	8
Jan-1973	-1.71%	-3.75%	-15.93%	-17.37%	Dec-1973	11
Jan-1981	-4.57%	1.33%	-5.40%	-9.73%	Aug-1981	7
Jan-1990	-6.88%	0.85%	0.35%	-6.56%	Aug-1990	7
Jan-2000	-5.09%	-2.01%	-5.32%	-10.14%	Apr-2001	15
Jan-2008	-6.12%	-3.48%	-34.48%	-38.49%	Jan-2008	0
Jan-2015	-1.83%?					???
	AVG	-1.73%	-11.04%	-14.75%	Median Time to Recession	7 Months
	AllPeriodAvg	0.70%	8.08%	8.83%		
	T-Stat	-3.06	-4.36	-5.53		
	# Up	2	1	0		
	# Down	5	6	7		

Nautilus Capital Research

Data Source: Bloomberg 1/30/2015

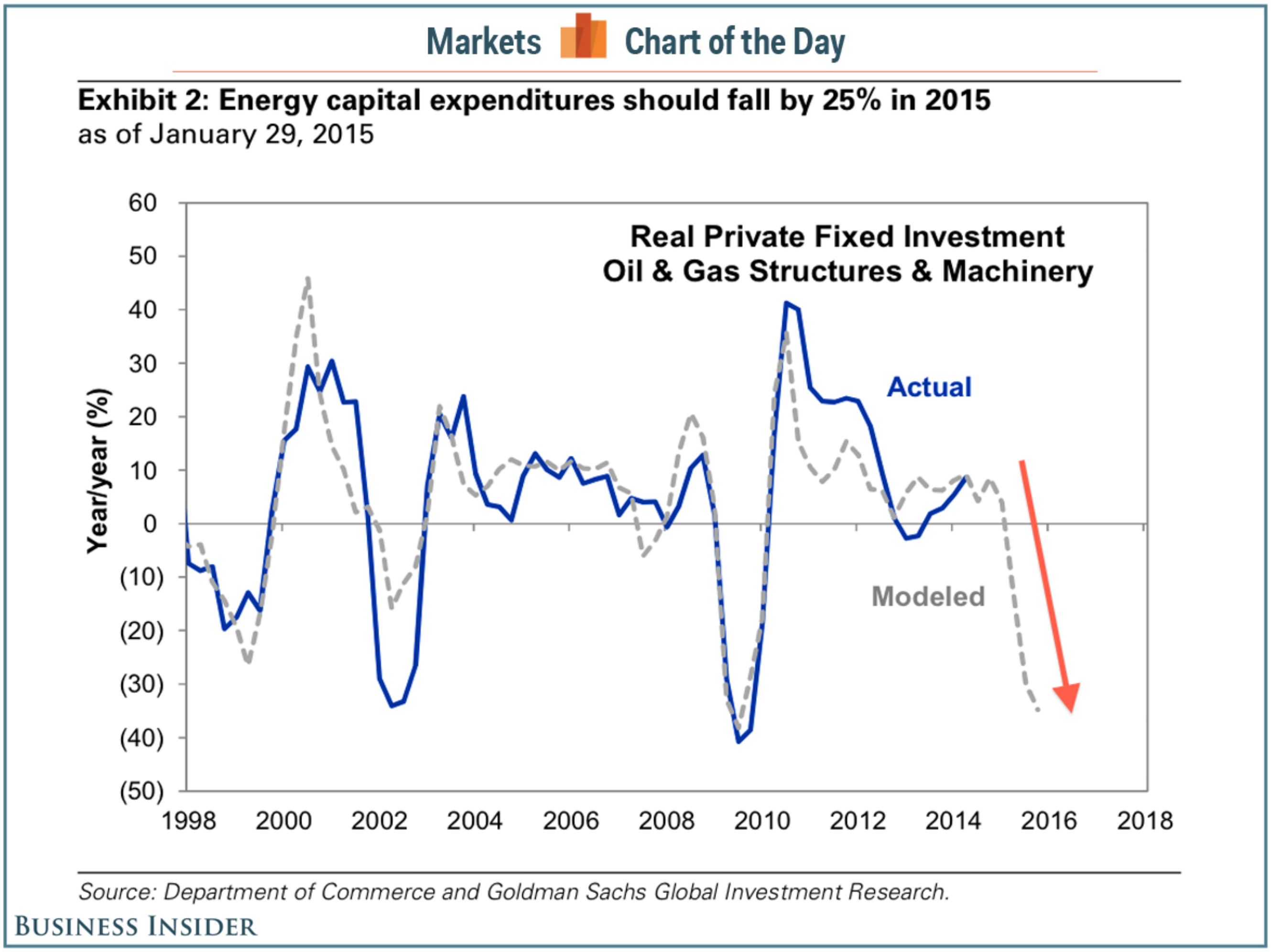
I found the above chart rather striking and would be remiss if I didn't share it with interested readers. I did not include it in this commentary as a forecast that history is destined to repeat, as I believe each business cycle is unique in its own characteristics that script its future path, but I am a big proponent of perspective and always like to comb the historical archives for perspective from previous market patterns. That being said this data provides some context on the downside possibility that exists given similar prior market occurrences. Once again this is just history, not a prelude, but when attempting to handicap the future you need to take into account any and all information that is available to make the most informed decision on your view. That being said, forewarned is forearmed.

The list of crosscurrents sending conflicting signals to investors is growing: surprise moves by central banks (fourteen central banks cut rates in January alone), increased occurrences of global terrorist actions, mounting currency wars creating uncharacteristically large swings in exchange rates, interest rates in 75% of the world's GDP anchored at 0% or dropping into negative territory, moderating U.S. economic growth (the expansion is still on solid footing, but the rate of change of the data is decelerating), the collapse in oil and other commodity prices (the Baltic Dry Index just hit a 29 year low), underwhelming corporate earnings results calling into question EPS growth for 2015, waning economic growth out of China (the world's second largest economy), and of course the revival of the Greek tragedy in the Eurozone. This laundry list of global uncertainty only adds credence to the herky-jerky price action investors are witnessing in securities markets.

Let's add some color and context to some of these crosscurrents.

Last Friday, crude oil staged one of the largest one day rallies in recent history as prices spiked more than 8% on a combination of short-covering and more announcements of cuts coming across the entire energy sector.

Over the past several weeks we've received a barrage of announcements by large energy players in an effort to more align their expenditures with the new price environment: Conoco Phillips is cutting its capital budget by 15% after already shaving it by 20% in December, Royal Dutch Shell announced plans to reduce its spending over the next three years by $15 billion, Occidental Petroleum slashed its capex budget by 33%, and Chevron announced on its Q4 earnings call that it would be slashing its spending by $5 billion in addition to suspending its $5 billion stock buyback program for 2015. See the chart below from Goldman Sachs investment research showing the capex decline in the oil and gas space.



These announcements coincide with the latest rig count data from Baker Hughes which showed the largest single weekly drop (90) since 1987. The current rig count stands at its lowest level in five years. To be sure, none of these cuts will do anything to avert the present day reality of an oversupply of crude oil, but they will be a key variable contributing to supply and demand coming into balance sometime in the not too distant future.

You see, oil production naturally declines as wells deplete through a drill cycle and this is why oil companies need to invest in new production to not only replace this decline in production from legacy oil fields but to add new production to meet growing demand. This is why it is so difficult to get bearish on oil prices in the long run, as producers can just cut off investment into new exploration and production which will impact future output. Furthermore, even with the advances in technology that have made previously hard to tap oil fields financially viable opportunities, Chevron CEO John Watson indicated on its quarterly conference call (and I'm paraphrasing here) that there isn't a project in the world that is economically feasible (from start to finish) at $50 per barrel.

Moving on to the price action in the stock market, which has become worrisome as breadth continues to deteriorate and daily 100 point swings do little to instill confidence for would be incremental acquirers of stocks. Last Wednesday's reaction to the release of the Fed statement was the first time since June 2013 that the stock market elicited such a negative response, and this was in reaction to rather bullish statement for stock investors – the FOMC raised their growth outlook and reiterated its intention to exhibit patience leading up to and throughout this rate hiking cycle.

A market that does not respond bullishly to bullish news is not bullish. In reality, while the Fed is doing its best through macro-prudential forward guidance to alleviate investor jitters over a premature rate hiking cycle the fact remains that it is one of the few central banks that is actually not in the process of easing policy. This is one of the major contributors to the strength in the dollar which has appreciated more than 15% since the beginning of last year and left a negative imprint on the corporate earnings season (more on this later).

The recent December 29th high in the S&P 500 is somewhat misleading because the NYSE stock market composite (which is a more comprehensive and inclusive representation of the overall stock market) actually peaked in early July last year and has failed at each retest attempt. This is an indication of a market lacking breadth and being led higher by fewer and fewer names, not a signal of broad based health in the market average – also of note the S&P 500 was about the same level (1985) at this July peak as it closed at Friday.

On the earnings front, 226 companies representing 63% of the S&P 500 have reported Q4 2014 earnings and according to data from BofA Merrill Lynch Equity and Quant strategy team, 55% of companies have beaten on EPS, 54% have beaten on sales, and 37% have beaten on both. Bottom-up EPS results are now running 1.5% above lowered estimates with Q4 earnings growth of 4.2% year-over-year (10.2% ex. Energy & Financials) and sales growth of 0.8% year-over-year (4.5% ex. Energy & Financials). Now to be fair, better than expected results from Apple provided a big boost to EPS with AAPL contributing about 2% to Q4 S&P earnings growth (EPS growth excluding Apple is 2.6% YoY).

References to a challenging foreign exchange market and the translation effect on profits from the strength in the dollar has littered earnings releases and conference calls which management has used to lower the bar for EPS expectations over the rest of the year. But keep in mind that the history books indicate that a strong dollar normally coincides with a strong stock market as multiples expand due to the solid economic fundamentals that underpin a strengthening currency.

Speaking of the bar being lowered, Bespoke Investment Group recently put out a piece of research illustrating that CEOs are more pessimistic about earnings than at any time since the financial crisis – the reasons cited are a stronger dollar and lower oil prices. When the leaders of corporate America lack visibility on the horizon it's a tall order to expect investors to have much conviction on the road ahead.

So we know the technical back drop remains a near-term headwind for stocks, valuations are indicative of a market that is fully priced (not rich, not expensive, but far from cheap) which are also causing some resistance to additional price gains, the economic data is solid but expanding at a decelerating pace (Friday's initial release of Q4 GDP showed the economy grew 2.6% – below consensus expectations for 3.0%, and lower than the 5.0% and 4.6% growth in Q3 and Q2, respectively), and investors moods are showing some complacency.

The recent Investors Intelligence results show that investors at this time remain undeterred by the increase in volatility as the bull camp increased to 53.1% from 49.0%, the bear camp slipped to 16.3% from 17.4%, and those in the correction camp moderated to 30.6% from 33.6% previously. A similar shrug was exhibited in the AAII Investor Sentiment Survey as those bullish on the near-term outlook increased by 7% to 44.2% compared to a long-term average of 38.9% and the bear camp declined to 22.4% (down 8.4%) vs. a long-term average of 30.4% and those with a neutral view on the stock market remained steady at 33.4% (up 1.4%).

The 22% spread between bulls and bears is reminiscent of January 2014 when investors came into the year with an optimistic outlook only to experience a quick 6% pullback in the major averages before this gap reversed by 5 points in February which coincided with the interim bottom for stocks on the year.

As for the bond market I continue to believe it's a market driven by two key variables: 1) a lack of supply to meet the insatiable demand from global central banks around the world – mind you these are buyers that don't have to worry about a quarterly P&L line as they are likely buying Treasuries and other sovereign debt fully knowing they will retain that security through the entirety of its maturity structure. And 2) the ultra-low yields emanating out of Europe – namely the German bund of which the 10-year U.S. Treasury has an over 90% correlation with – the 30 year German yield is 1% (think about that for a moment, 1% for 30 years), Portugal 10-year bonds yield 2.71%, Spain 1.47%, Italy 1.61%, UK Gilts 1.37%, and France's 10-year yield is 0.55%.

With this representing the competition to sovereign debt, it only makes sense to expect that the path of least resistance for the U.S. 10-year at its current level of 1.67% is to follow its European counterparts and set new all-time lows.

Yes, the global economic backdrop remains riddled with uncertainty, but this has always been the case in both bull and bear markets. The seas of change are a-turning, but nothing at this point dictates investors should be over-reacting to the increased volatility. As I have stated recently, the dynamics in this market have changed and should be evaluated with more than a subtle touch of skepticism, but little has changed enough to elicit a significant allocation adjustment in a prudently allocated portfolio. Trimming around the edges and opportunistically attempting to capitalize on opportunities as they present themselves should be acted upon, but remember the only free lunch in the capital markets is diversification. This will help you stay in the game and dampen portfolio volatility while also providing you with some dry powder if a significant opportunity presents itself. The key to long-term investment success is "time in the market" not "timing the market".

For the time being, investors who understand and are comfortable with their current risk exposure, the most appropriate course of action is to stay the course and weather what is now the 15th corrective storm over the course of this 5+ year old bull market. What we have is more volatility than what has been the case over the last couple years, which is not atypical as we transition into the mature stage of an economic cycle and the data plateaus following the robust stage of expansion. This doesn't necessitate the end of a bull market, but it does signal the end of the easy money part of the cycle.

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