August 24th, 2015

"Sell the rally" has displaced the "buy the dip" mentality…

It was a sea of red ink across global equity markets last week as U.S. stocks suffered their worst weekly loss in four years, with the Dow Jones Industrial Average capping off a tumultuous week by plunging 530 points on Friday alone. The tally by week's end for the major equity averages was a 1018 point decline in the Dow (equivalent to 5.8%), and a 121 point dive in the S&P 500 (also a loss of 5.8%) – both point declines were the largest since the darkest days of the credit crisis in October 2008. Meanwhile the Nasdaq Composite fell 6.8% while the Russell 2000 small cap index claimed the top spot on the podium by only declining 4.6% on the week (oy vey).

Outside the U.S., the carnage was just as bad with the Nikkei 225 losing 5.3%, the EuroStoxx 50 dropping 7.0%, Shanghai plunged 12%, Frankfurt lost 7.8%, and the MSCI Emerging Market index fell 6.0%. All the data flow out of China over the last month (last week's Markit manufacturing PMI dropped to a 77 month low of 47.1) is signaling further deceleration in growth to below 7% through the second half of the year and beyond. This is likely the reason the Shanghai has given back all of the gains it made following the numerous radical interventions by Chinese policymakers over the last several months to stem the stock market's slide.

After last week's bludgeoning, the Dow Jones Industrial Average became the first major U.S. index to officially enter correction territory, having declined 10.1% from its May record high and is now down almost 8% on the year. Other equity markets that joined the Dow in correction territory as of Friday's market close were Belgium, Spain, and the Netherlands.

As for the S&P 500, it is off its May high by approximately 7.5% and now down 4.3% on the year. A worrisome sign for the bulls is that equity market breadth within the S&P 500 continues to deteriorate as 328 of the 502 stocks that make up the S&P 500 are in correction territory (a correction is defined as a decline 10% or more) – 147 of these 328 companies have fallen into a bear market (a decline of 20% or greater) with Apple being the largest company as measured by market cap in the bear market group.

Many market prognosticators will be attempting to find a narrative as to what caused the drubbing in global equity markets last week, but I don't believe this will be an easy task. It is my opinion that the pressures weighing on stocks have been mounting for some time and the escalating fears that a global recession could become a distinct possibility boiled over last week.

The foundation of such anxiety stems from the fact that the economic recovery in the U.S. – from what was the most severe recession since the Great Depression – has been much more subdued than expected. GDP growth has averaged a lower than anticipated 2.0% per year since the inception of this recovery and as a result excess capacity has not been soaked up at the rate most economists have expected. Whether it is the result of the typical pattern recoveries follow when exiting a deleveraging cycle, the lack of effective fiscal policy actions, or a failure of unprecedented monetary policy through the introduction of QE, this recovery has been the most muted expansion since World War II. Perhaps the best illustration of the gap between expectations and reality is exhibited in the Federal Reserve's own GDP projections over the last several years.

The Fed vs. Reality

The "central tendency" projections of real GDP growth by Federal Reserve governors and bank presidents compared to actual GDP

Year	Fed projection*	Actual
2011	3.0-3.6%	1.6%
2012	2.5-2.9	2.2
2013	2.3-3.0	1.5
2014	2.8-3.2	2.4
2015	2.6-3.0	1.5 (first half)

*Fed projections were made in either November or December of the previous year. The central tendency excludes the three highest and three lowest projections.
Source: Federal Reserve Board

My intention isn't to play Monday morning quarterback or second guess the Fed's monetary policy actions following what was an unprecedented global financial crisis, but as an active observer and participant in the capital markets I find myself questioning the ongoing effectiveness of monetary policy. And why this is an important variable for investors to assess is because financial assets around the world have become dependent in a sort of 'Pavlovian" way on central banks supporting asset prices. If this relationship is in the process of breaking down and the Fed's credibility comes under more intense scrutiny, it could spell a prolonged period of weakness for risk assets.

The Fed's quantitative easing policy was implemented to drive up asset prices in the hopes that it would create a wealth effect which would then filter through the economy through increased consumer confidence which would spur increased consumption, and thereby set off a positive feedback loop to jump start economic growth.

This policy experiment has been extremely effective at raising asset prices, but the spill-over effects into the real economy through a robust pick-up in economic growth has been far less effective. Now here we are a little over six years into this recovery in the U.S. and the rest of the world (Europe and Japan in particular) are following in the footsteps of the Federal Reserve's policies, yet the verdict is still out on whether or not these policies are a viable solution to stimulate sustainable long-term growth, or nothing more than a short-term high that feels great in the moment but comes with unpleasant side-effects.

Central to my concern within the capital markets is the view that the Federal Reserve is finding itself in a box where it wants to raise interest rates for numerous reasons, but has been (and continues to be) unable to do so because the economic data doesn't support such action. However, over the last 6+ years of zero-interest-rate-policy, pockets of risk, asset bubbles, and excesses have developed in financial markets. One example is the crash in commodity prices over the last year where oil prices have declined by more than 60% in part as a result of the cheap financing available to many undercapitalized oil companies – who otherwise wouldn't be in business – thus perpetuating the glut in oil supplies.

This ongoing supply glut is the biggest issue confronting oil prices and was fully apparent last week when the EIA reported a 2.62 million barrel inventory build in the U.S. versus expectations of an 820k drawdown. The supply/demand backdrop remains the same story that has belabored any recovery in prices all year long – nobody has responded to low prices by cutting output: not the USA, not Iraq (where production is up an estimated 700k barrels for the year), not Russia, and most importantly not the Saudis whose production has increased to 10.4 million barrels per day compared to 9.8 million last fall.

Talk is beginning to circulate that a bottom in crude prices is somewhere in the $30 range, which may or may not turn out to be the case, but expectations for a ‘V’ shaped recovery should be quelled because the fundamentals suggest it will take some time to work through the 2 million barrels of excess supply. This will prove to be even more problematic if the demand side of the equation were to reverse course, which will assuredly be the case if a global recession were to unfold (keep in mind that demand will moderate just as a result of the post-summer seasonality).

Beyond oil prices, which briefly ticked below the $40 level last week, copper prices fell to under $5,000 per ton and are riding a seven week losing streak. Only gold has been performing well of late, likely benefiting from its alternative currency properties in a world of currency devaluation and the receding expectations of a September Fed rate hike.

Another victim of the unintended consequences of central bank actions are emerging market economies that benefited from capital inflows during the height of QE and are now seeing those flows and economic growth recede. Meanwhile this is causing the entire global currency market to re-price as some governments around the world take matters into their own hands by orchestrating their own currency devaluations.

China devaluing its currency two weeks ago got everyone’s attention (rightfully so given their global economic standing), but the ripple effects across Asia are beginning to spread. Last week the State Bank of Vietnam weakened its reference rate by 1%, sending the dong lower by 1.2% on the day, down 2.4% for the week and 4.4% for the year (China has been Vietnam’s biggest trade partner since 2007). Malaysia’s ringgit has declined 6.4% so far in August and is down 15% on the year, while another big China trade partner, Indonesia, has seen its currency fall 11%. Meanwhile, Kazakhstan, Central Asia’s biggest crude exporter, saw the tenge decline 4.4% last week in its steepest retreat since February 2014.

It’s fair to surmise that the entire Emerging Market currency sector is in a state of disarray that we haven’t seen since the Asian Contagion in 1997/98 – the Russian ruble is in freefall, protracted negotiations over a new coalition government in Turkey has sent the lira to a new record low, the Brazilian real is in a tailspin, and the South African rand is entrenched in a sharp selloff. Fears of a global currency war can be put to bed, because on all accounts it appears as if it has become a reality. For those not that versed in currency markets, fluctuations this large are abnormal and as such have become a significant contributing factor to the escalation in global risk aversion.

Also weighing on U.S. equity markets is the lackluster earnings results coming out of corporate America, and this is at a time when valuations are at cycle highs. Second quarter earnings season has largely come to end with many pointing to the results as being solid if you exclude the Energy sector, however looking under the hood suggests a more mixed picture. According to data from Howard Silverblatt, Senior Index Analyst for Standard & Poor’s, Q2 operating EPS has declined 7.7% from the July 30th tally and is down 10.6% year-over-year.
Furthermore, what is perhaps more troubling as it speaks to the quality of earnings results is the fact that “operating” EPS came in almost 8% higher than “as reported” EPS during the seven quarters between Q1’13 and Q3’14 (operating EPS figures allow for companies to report one-off events like asset impairments, discontinuing operations, write-downs… as non-recurring items whereby they shouldn’t be viewed as a part

of a company's on-going operations). However the gap between "operating" EPS and "as reported" EPS rose to 17.3% in Q4'14 and 18.3% in Q1'15, indicating that the quality of earnings results has deteriorated over the last two quarters. Over time these two figures tend to converge, which calls into question the recent widening in this ratio.

When revenue growth becomes challenging as overall economic growth stalls, it's not uncommon for the bean counters in corporate America to get a little creative with their accounting to make sure the numbers the analysts are expecting get met. It's no wonder U.S. equity averages have been marking time all year long with earnings growth in Q1 at 1% and Q2 results coming in negative, not to mention revenue growth contracting in each quarter. As it stands now, S&P 500 trailing earnings are $108.38 (down 3.1% year-over-year) with expectations for EPS to once again decline in Q3 before bouncing back in Q4, putting full-year 2015 estimates at $111.88. With the S&P 500 closing last Friday at 1970, the S&P 500 is trading at a P/E of 17.5 which remains above its historical average P/E of 15x.

When valuations are as high as they are, confidence is crucial and throughout this bull market, central banks have been that shock absorber to prop up confidence when it was waning. But that faith and confidence investors have had in the Fed backstop is changing and the extent to which it changes will dictate the degree to which asset prices adjust lower. After all, for several years central bankers around the world pushed the pedal to the metal with experimental monetary policy actions only to see world economic growth expand at barely 3% with deflation still lurking just about everywhere.

So with the major U.S. equity averages in the midst of their worst drubbing in 18 months – it's worth keeping in mind that it's been nearly four years since the last time there has been any meaningful correction – investors need to keep in mind that this is one of the characteristics that accompanies stock ownership. True, they are much less fun than ripping bull markets, but they are part and parcel for the territory and the most important thing is to keep your wits about you during these times.

Recession risks may be low, but things are getting very complicated and the unprecedented policies implemented over the last half decade from global leaders around the world is unique and therefore the number of possible outcomes has drastically increased with the probability of good outcomes for investors lessened.

Yes, a lot of damage has been done and more may be on the way, but if you have adhered to a disciplined investment strategy that diversifies your assets, your portfolio has found refuge in fixed income, hedged investment strategies, and cash during this sell-off. In that case there is no need to overreact – weather this storm, and let this episode run its course. At the current juncture of this sell-off there are strategies at play that are designed to unwind and/or flip flop positioning during turmoil which will likely propel and increase short-term volatility. For the time being it's best to maintain resolve, act prudently, don't try to be a hero or pick the bottom, reduce risk if you're out over your skies, and step aside for the near-term.

The 'buy the dip' strategy that has rewarded investors so handsomely during every pullback over the last four years has, in my opinion, shifted to a 'sell the rally' strategy. Meaning that we may well see some bounce back in risk assets in the ensuing weeks, but the tell for investors will be if any of these rallies end up having legs or if they just provide investors who continue to carry too much risk an opportunity to sell.

Attempting to time this market's twists and turns in what looks likely to carry some heightened volatility into the fall promises to be challenging and any success one achieves is just as likely the result of luck as it would be from skill. I've been of the opinion since the fourth quarter of last year that investors should be lightening up on risk as the risk/reward pendulum in many asset classes was shifting toward the risk side of the scale. Nothing has changed with this thesis, and we will continue to take action as we see fit if the fundamental backdrop were to further deteriorate. Given the macro headwinds swirling, the growing deflation risk, and increasing evidence that a global recession is a real possibility – not probable, in my opinion, but it demands it's due respect from an objective analysis – it seems the prudent approach in the near-term is to remain cautious and on-net manage risk down another notch.

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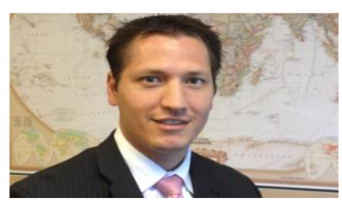

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