August 31st, 2015

What a ride…

It truly has been a wild ride for the equity markets over the last several weeks as the recent manic moves have been rivaled only by the action in stocks in late 2008 and early 2009, but back then we were in the midst of a severe recession and a potential failure of the banking system – this is not the case today. Outside of volatility in the stock market there really is not that much in common with what transpired during the 'Great Recession' – back then real GDP growth year-over-year was -2.8% compared to 2.3% today, housing starts were plunging 40% year-over-year, not rising 10%, the ISM manufacturing index was at 33, not 53, the ISM non-manufacturing index was 40, not 60, and back then we had 30% of the general public negative on the macro outlook (as per the Conference Board confidence survey) compared with 8% today. So extrapolating the "Great Recession - Part Deux" is a bit of stretch, in my opinion.

I will concede that the last two weeks have been especially trying for any investor who has had capital in the stock market as it was only August 17th when the S&P 500 closed less than 1% below its all-time closing high. However within a week's time it had lost 11% and then three days later it had regained half of those losses by surging 6%. According to data from David Bianco, a drop of this magnitude and at such speed has only happened nine other times in the past 80 years – all of which were precipitated by (perceived or real) political or economic crises:

- 8/25/15 – China crisis
- 8/8/11 – U.S. debt downgrade
- 10/7/08 – Height of financial crisis
- 7/23/02 – WorldCom default
- 8/31/98 – LTCM crisis
- 10/19/87 – Black Monday stock market crash
- 5/28/62 – Kennedy steel tariffs
- 5/14/40 – Invasion of France/Netherlands
- 3/29/38 – Depths of the 1937-38 recession

The level of intensity in the daily swings in the major averages seems to add credence to the view that 'high frequency' and 'algorithmic' trading as well as large margin calls are dominating markets in this thin "Dog Days of Summer" seasonal period. This is underscored by the fact that from the day the Chinese devalued the Yuan through the recent low in stocks on Monday morning's washout, 92% of the decline in the S&P 500 has occurred in overnight trading – cash hours have been nearly flat. This implies two things: 1) much of the move in stocks has been in reaction to events overseas, and 2) unless an investor is trading in the futures market there has been little they could do during normal trading hours to hedge or profit from a significant move in stocks.

At this time, I am unwilling to concede that this is anything more than a corrective phase. Yes, I think it's important for investors to acknowledge and accept that the global economic landscape is showing some warts, scars, and gray hair, but these blemishes are not dire enough to set off the next bear market. The current environment is a testament to the age old adage of the market climbing a wall of worry.

It seems like only yesterday when the markets were fixated on the drama playing out in Greece to only transition straight into the intensifying financial, economic, and policy instability in China, a sprawling global currency war rippling through the once hot emerging market space, and the latest and most pernicious leg of the plunge in oil and industrial commodity prices. Mind you, it's important for investors to maintain perspective as it's been four years since equity investors last experienced a serious correction. Usually, even in the context of secular bull markets, corrective phases that help the market rid itself of speculative and/or overvalued excess tend to occur every 12 to 18 months, not the 47 months we've gone in this most recent instance.

So to surmise that we have been long overdue would be a slight underestimation and this correction is coming at a time when valuations are stretched and the margin of safety is razor thin, so stocks have had very little protection to insulate them on the way down. What we have on our hands is a plain vanilla correction, not a bear market, and the reality is that corrections are typically severe but swift. Furthermore, they are part and parcel of the investment process even if they are a nuisance, and while no one ever rings the alarm bells once they end, several indicators that I pay attention to and that have had a reasonable track record in the past are indicating that this one is very nearly done.

The most recent sentiment readings are showing that a lot of panic has already been priced in as the Investors Intelligence poll for the latest week showed another precipitous slide in the bull camp to 31.6% from 37.7%, the bear camp expanded to 22.5% from 18.4%, and those anticipating a correction rose to 45.9% from 43.9%. The key metric to watch in this survey data is the bull-to-bear spread as it narrowed from 19.3 to 9.1 last week and is at its tightest level since October 2011. Recall that back in October 2011 stocks were nearing a bottom while in the midst of a 17% decline in the S&P 500 before going on to stage a huge rally into year end.

Also of note last week was the VIX index hitting 53 during the height of last Monday's hysteria and remaining above 25 for six straight sessions, another classic contrarian signal as is the fear mongering that has littered the papers over the last week. The media is great at capitalizing on the innate primal instinct of fear that oozes through the veins of human nature, an instinct that is far superior to our affinity for greed, but all successful long-term investors know the importance of keeping their emotions in check.

With that being said it is imperative that the Dow does not end up undercutting the panic low from last Monday morning of 15,370 – it closed on Friday nearly 1,300 points above this level at 16,643. On a technical basis it would not be a surprise to see the market consolidate around current levels if not give back some of the recent gains and retest the lows of last Monday. However, if no buyers show up on that test then the sellers will regain the upper hand and this corrective phase will become more extended.

As for the economy and the Fed, it's a tale of 'good' but not 'great'. All year long estimates for 2015 global GDP growth have been coming down, from 3.6% last September to 3.4% in January to 3.2% in April to 3% now. A similar situation has been playing out with estimates for 2016 as calls from a year ago of growth hitting 3.8% have receded to 3.5% as of this month. This is likely what has been assisting with the bloodbath in commodity prices and it's not until we see these revisions stop falling that we will see a bottom put in for the downtrodden commodity sector.

In the U.S., real GDP, final sales, GDI, retail sales and personal consumption are all growing about 2.5 - 3.0% year-over-year. Housing starts and sales are at eight year highs, railroad loadings are at all-time highs and trucking tonnage is near its recent highs. The latest revision to Q2 GDP saw the economy expand 3.7% quarter-over-quarter with the set up for Q3 tracking 2.5 - 3.0%. This week will bring with it a litany of economic data and will provide the Fed with its most up to date assessment of how the U.S. economy is digesting the latest bout of global economic turmoil and capital market volatility.

The Fed has been placing a big emphasis on the labor market and on that front they have been getting what they want with payroll growth averaging 211k this year and showing little in the way of slowing. Both the narrow U3 and broad U6 unemployment rate continue to trend lower, falling 0.3% and 0.8%, respectively this year. Inflation remains low, but "the committee expects inflation to rise gradually toward 2% over the medium term, as the labor market improves further and the transitory effects of earlier declines in energy and import prices dissipate." Stripping out energy and import prices, PCE inflation is running at about 1.5% and is inching higher.

As the markets continue to sell-off, an increasingly popular view among investors is that the Fed won't hike until next year. Global growth is weak, Chinese policy mistakes have destabilized their markets and the U.S. equity market has finally succumbed to the pressure with a roughly 10% correction. This has caused fed funds futures to price in less than a 1 in 4 chance of the Fed hiking in September and a 40% chance of them hiking at all this year with some prominent economists pushing their forecast for the first hike out to March of 2016. It's become easier to justify a delay in the timing of the first rate hike, but an extended delay is unlikely, in my opinion.

Yes, if the Fed met today, they would very likely take a wait and see attitude and delay hiking. Why create further market volatility? Why not wait to see whether this is an economically important shock? However, there are three weeks before the Fed decides. If the markets stabilize, the Fed outlook will feel a lot different. Ultimately, the economy will dictate the Fed's exit and unless there is a big shock to U.S. growth (which has picked up steam throughout the year), rate hikes are coming as soon as the dust settles.

Looking ahead it will be imperative for investors to keep their wits about them over the ensuing couple of weeks and months. Undoubtedly capital markets will continue to be caught up in some erratic volatility before the dust finally settles. However, it is important to keep in mind that the fundamental underpinnings of this bull market cycle remain intact and this is not the first time markets have been confronted with strong international headwinds – it's only the most recent episode which causes us to fear the worst and forget all the previous obstacles we've overcome in the past.

Over the last two years stocks have been extremely resilient as they had to cope with a possible Greece exit from the Eurozone, political strife with Putin, fragility in emerging market growth, the unpegging of the Swiss franc, a 60% plunge in oil prices, fears of a Fed policy misstep, Ebola, Iran, ISIS… yet the sun has still managed to rise every day. My experience tells me that a couple months from now, this latest episode of turmoil driven by concern over China will pass and we will be talking about or adding another item to the market's wall of worry.

One thing I do encourage all investors to do is assess how this latest correction impacted their investment portfolios and revaluate if their capital was appropriately calibrated for their willingness, ability, and capacity to take risk. While I believe this is a pause that refreshes, I also think we are in the mature stages of this expansion and bull market cycle. At this point I interpret the rate of change in the economic data as decelerating and with that being the case we will continue to look for opportunities to gradually and methodically moderate overall risk exposure in client portfolios rather than layering it on from this point forward.

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