October 12th, 2015

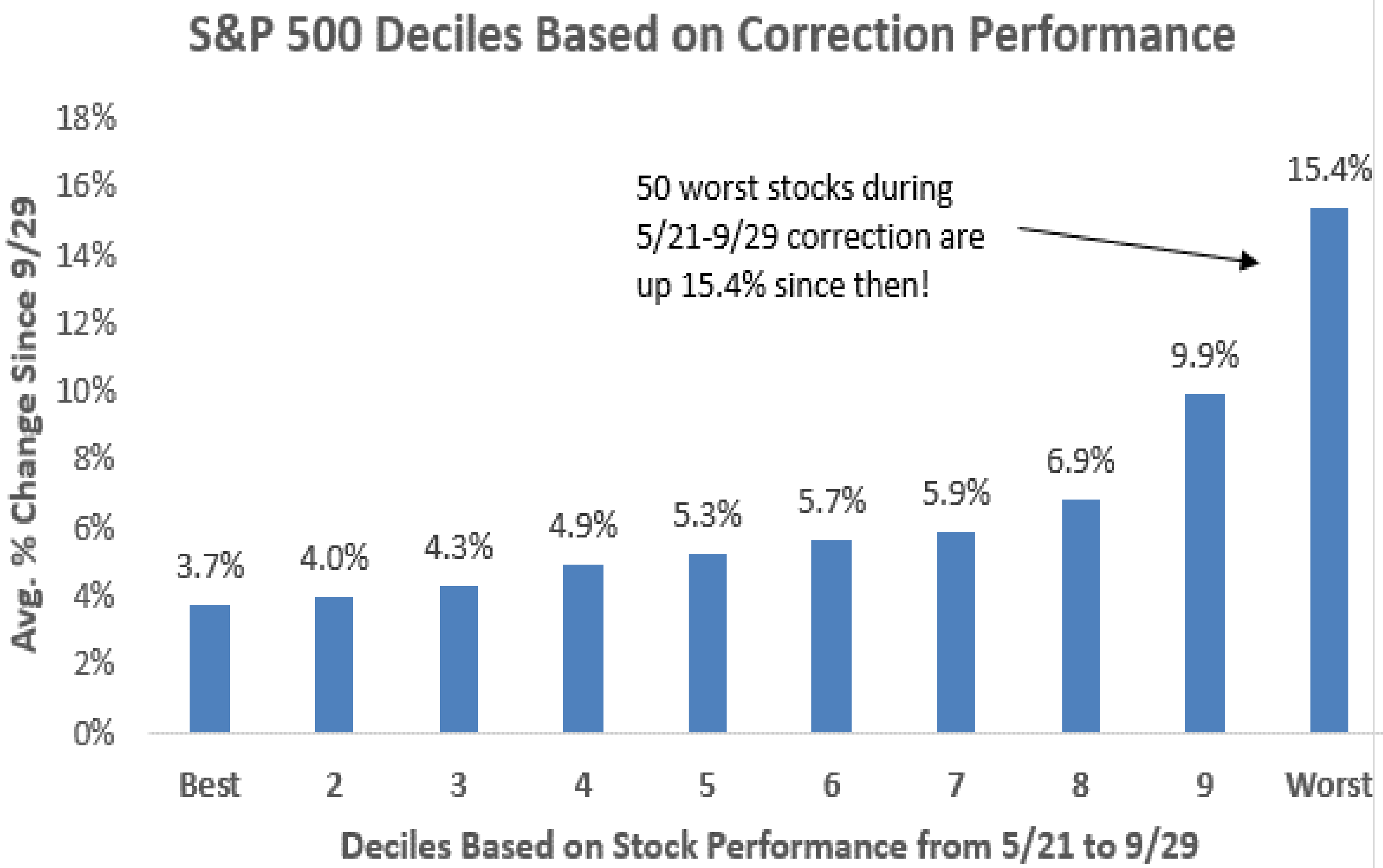
A rally to 'no man's land'…

The 'risk on trade' is back as global equities rallied last week sending the S&P higher by 3.2% (its best weekly showing since October 2014) with the index closing higher in 8 of the last 9 trading days. This rally, which started on September 29th when the S&P 500 traded down to 1871 – for all intents and purposes retesting the August 24th low of 1867– has healed much of the technical breakdown with the S&P 500 reclaiming its 50-day moving average for the first time since the China induced slide in the middle of August.

Some interesting tidbits about this rally:

- The S&P 500 has added 143 points or 7.6% over the last nine trading days while the Dow Jones Industrial Average has added 1,142 points or 7.2%.
- The transportation sector closed above its 100-day moving average on Friday and has been higher in 8 of the last 9 days.
- At the August 24th lows only 4% of the companies in the S&P 500 were trading above their 50-day moving average, but the rally over the last two weeks has caused a swift reversal in this metric with 60% now above their 50-DMA.
- The CBOE's Volatility Index (VIX) – also known as the 'fear index' – has collapsed back to 17 and stands just a hair's breadth away from taking out the 200-DMA to the downside.

- Oil has rallied more than 30%, closing Friday above $50/barrel for the first time since mid-July.
- The MSCI All-Country World Index has jumped 8% – a mere addition of over $3 trillion to global equity wealth.
- Laggards have become leaders in which the segments of the market that got beaten up the most in this correction have soared 15% in this rally while stocks that held up best during the tumult have lagged, increasing by a meager 4% (see chart below from Bespoke Research).



This rally has been a welcome respite from the 12% correction in the S&P from its May 20th high of 2134, but a little back and fill here while holding key support levels around the 1950-1960 area will be key. Moreover, the 2060 level on the S&P 500 is the next level to watch as it represents the 200-day moving average which remains in a downtrend and is sure to offer significant upside resistance.

Short-covering has been an instrumental variable in this ‘rip your face off rally’ where the most shorted stocks have been squeezed – forcing traders to step in and cover their positions which creates buying demand for equities, but this is artificial demand and not the actions of strategic long-term capital commitments on the part of big money players that one would like to see to confirm there is some conviction behind this move. Further to this point, last week equity funds experienced net redemptions to the tune of some $4.3 billion while money-market funds yielding essentially nothing garnered a massive $53 billion in in-flows.

A constructive sign and something that would unearth my animal spirits would be to see some of this monstrous sized cash position sitting on the sidelines makes its way back into equities, but I’m not altogether convinced that this will happen.

What we’ve learned over the last several weeks is that the ‘bad news is good news’ investment philosophy is now back in favor. Two weeks ago we got a disappointing non-farm payroll report which has since been followed by a continued decline in the ISM Manufacturing Index to 50.2 (its lowest level in almost 2 ½ years – no doubt driven by the slowdown in global growth and the 20% increase in the trade weighted dollar), a tick down in the ISM non-manufacturing index, and a notable widening in the trade deficit. All of which is feeding into the 1% GDP forecast for Q3 from the Atlanta Fed’s GDP Now model. Estimates for Q4 GDP are narrowly hanging on to a 2-handle, but both

Q3 and Q4 are coming under pressure from an inventory build and trade data that will dissipate going into next year. However, one must now be mindful of the multi-year trend of low Q1 output, so the possibility of three consecutive sub-par GDP quarters is a material risk to bullish-sentiment.

Outside the U.S., the data hasn't exactly been setting the world on fire with German export orders slumping 5.2% month-over-month in August (the most since the height of the 2009 global meltdown) which followed surprising declines in factory orders and industrial production. Adding to the downbeat data out of Europe was the Bank of France releasing its September Business Sentiment Index which fell to 97 from 98 (expectations were for a print of 100) and in the process the central Bank trimmed France's Q3 GDP growth estimate to +0.2% from +0.3%. Spain saw output decline a hefty 1.4% month-over-month, all of which is feeding into the IMF's recent lowering of its global growth projections for this year and next. Then there was Citigroup's global economics team out last week upping its global recession odds to 55% – time will tell how this forecast turns out, but it is a sure fire way to garner some attention.

Now look – the global economy is fragile to be sure, but it is not at risk of falling apart. All the hoopla over China's imminent demise is drastically overplayed with some signs that a turn has been made for the better, but this has yet to be captured in the data. Furthermore, China has ample room to ease both monetary and fiscal policy to assist its economy as it continues its transition from an export and infrastructure dependent nation to one where growth is driven by consumption.

Both Europe and Japan are committed to extending or expanding their QE programs if necessary, and the possibility of a floor being put in for commodity prices could bring a much needed breather to the unrelenting pressure that's been a drag on emerging market growth.

And yes, global trade has been under assault with trade flows having receded, but I have a hard time buying into all the negativity surrounding the recently inked Trans-Pacific Partnership which represents the first major accord since NAFTA and the largest in history. Now I'm not going claim to have read all 30 chapters of the agreement, but to think that easing tariffs on what is now 18,000 U.S. export items (increasing the global competitiveness for these goods which we produce) can't be all bad. Nor do I believe that integrating 40% of the global economy under a new set of trade rules while lowering the prices on a wide swath of imports into the U.S is a net negative.

What gets lost in the shuffle with these political hot-button issues is the definition of compromise. After all, that is the theoretical derivation of why trade makes sense – choosing to allow parties to specialize in an area in which they have a decisive competitive advantage, lowering the cost / increasing the quality to all consumers of said product/service. But the recent history of the growing dysfunction in our political system (the fact that the GOP can't even agree on Speaker when they are in the majority about says it all) illustrates our current lack of global vision. Not to say we can't regain this global leadership post (and I believe we will), but it is unlikely to happen until our hand is forced (a la a debt downgrade which is what it took back in 2011), which I hope doesn't come as a result of significant setback in the economy or global peace.

But it does look like the 2016 election is going to be a very clear referendum over whether Americans want to move left or move right. The fact that Trump continues to lead the Republican polls indicates that American's are thirsty for change and for better or worse Mr. Trump just so happens to be that outsider with an outsized personality that has captured their attention. Hillary has had to move further to the left as she feels Bernie Sanders nipping at her heals in the polls. So this is setting up as a choice between black or white with no shades of gray between the forces that want to redistribute wealth and those that focus on how to create it.

Getting off of my soapbox and back to the capital markets, it is a bit disconcerting that we are heading into year number seven of this economic recovery and we still require so much monetary stimulus.   Last week's Fed minutes provided risk assets with another jolt of insulin as the minutes illustrated a Fed with a wavering hand over the liftoff policy lever – uncertain enough on the outlook to decide it was "prudent to wait for additional information." Then again, perhaps this repeated delay of 'liftoff' is what's best for this expansion as it was the seventh year of the recovery back in 1930's when the Fed decided to tighten which proved to be ill-fated as the U.S. economy soon found itself back in recession. Inevitably they will have to start the interest rate normalization process and investors will all have to deal with whatever repercussions come with it, but perhaps the right call was and has been to wait rather than risk tightening policy prematurely.

What really stuck out in parsing through the minutes was the number of times the term “downside risk” was used (12 instances versus 6 in June and 5 in the March minutes and the most in three years).

It’s no coincidence then that the fed funds futures market is pricing in a less than 10% chance that the Fed raises rates at its October meeting, a little more than 1 in 3 chance that they hike in December (a month ago market expectations were almost 60% that they would go in December), and 50/50 odds that ‘liftoff’ doesn’t occur until March 2016. Fed Vice-Chair Stanley Fischer recently joined the chorus of several other Fed officials suggesting that a rate hike this year remains in the cards, given the economic data comes in consistent with the FOMC's expectations. Lower for longer, indeed.

So here we are, back into the throes of a market that is being driven by easy Fed policy. The fact that we are seeing this reflexive rebound in global equity markets, even in the face of economic numbers in the U.S., Japan, and the Euro area that have been short of stellar is a signpost that too much bad news was priced in at the lows, just as too much good news was being discounted at the Spring peaks. Surely, a market that does not trade bullishly on bullish news is not bullish, but that also goes the other way as well – a market that does not trade bearishly on bearish news is not bearish – and that is what we currently have on our hands.

In my opinion, with the S&P 500 trading at 2,015 we are currently sitting in 'no man's land', almost smack dab in the middle of the 1,867 low and the 2,134 high. Where we go from here will be dictated by corporate earnings and incoming economic data. Keep in mind that the bar for Q3 earnings has been lowered considerably with analysts expecting earnings to decline 5.5%, which will likely be beaten as we progress through the earnings season, but the focus of investors is going to reside on what management is saying about their expectations for the future. This will hold the key for what P/E multiple investors will be willing to put on the future earnings steam of corporate America.

Unless earnings surprise in a big way, Q3 will represent the second consecutive quarter in which earnings have declined – this hasn't happened since we were working ourselves out of the trough of the Credit Crisis in 2009. Much of these low expectations are currently priced into the equity market with investors giving companies the benefit of the doubt that the last two quarters have been hampered by transitory issues (steep rise in the dollar, sharp fall in commodity, and slowing in global growth) which will subside in the quarters ahead and allow comps going forward to look more favorable.

However, this benefit of the doubt comes with a price tag given that the S&P with this recent rally has now traded back up to a P/E multiple of 18x trailing earnings and 16.8x forward earnings. Neither of which is cheap, but a discount to the lofty levels at the May 20th high in the S&P 500. Another hurdle for stocks is the fact that the revenue line (more difficult to manage and smooth than EPS) has contracted for two consecutive quarters and is not a constructive signal for future earnings power.

That’s the set-up for equity investors – an equity market that is trading at full value, near record high profit margins, cash rich corporate balance sheets with plenty of ammunition to support stock buy-backs, buoyed by zero-interest-rate-policy and the promise of an elongated normalization cycle. However, it’s constrained from further multiple expansion given the sluggish global growth backdrop, fears of interest rate liftoff, and broadening signs of a maturing economic cycle.

Hence, we remain in an investment environment that continues to favor integrating prudent risk management strategies into your investment process. I find it very difficult for any investor to have a lot of conviction in any outcome as the probability of a variety of potential outcomes has increased with the pay-off for best case outcomes being outweighed by the possible downside from worst case outcomes.

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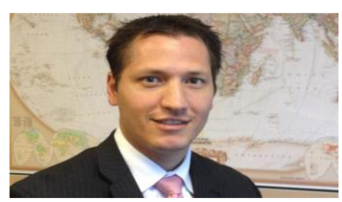

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