July 27th, 2015

It's a probabilistic world…

It's interesting how quickly the sentiment tide can turn in the capital markets. It was only last Monday when the S&P 500 was setting up to overtake its all-time high following yet another bail-out deal for Greece and indications that policies implemented by Chinese leaders to rescue their sinking equity markets were finally having some affect. However, weak earnings results from some large U.S. multinational bellwethers, a continued precipitous plunge across the commodities space, and feeble manufacturing data out of China has moved investors back into a risk-off mood. Last week, the Dow sold off 518 points or 3%, the S&P 500 declined 2.2%, the Nasdaq lost 2.3% (even with a 10% move in Amazon on Friday after beating on earnings and revenues), and the sell-off wasn't just relegated to U.S. markets as the MSIC World Index dropped 2%.

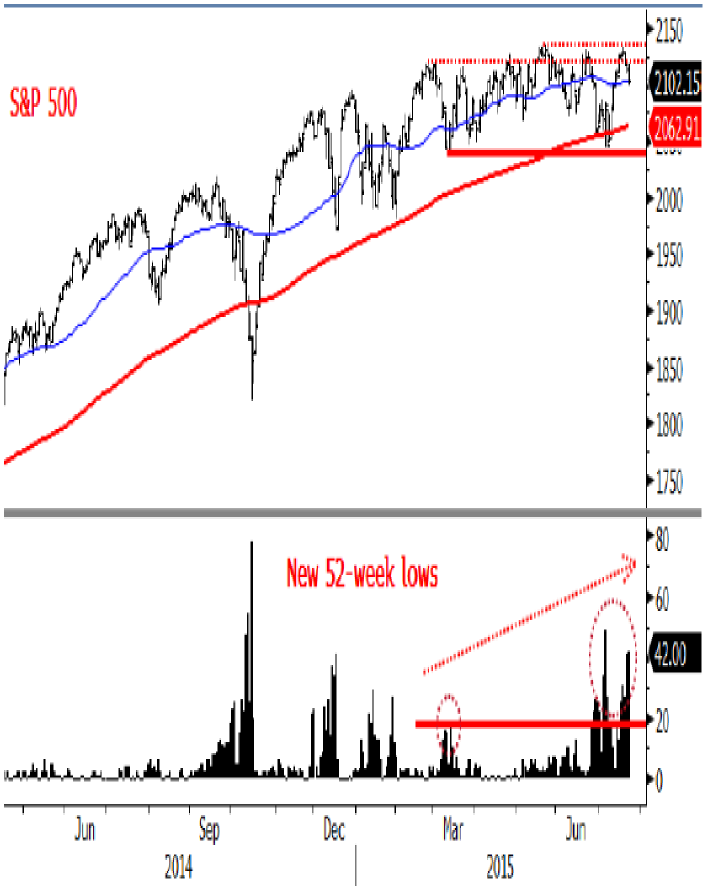
It was a bloodbath in Asia overnight as the Shanghai Composite dropped 8.5% (its biggest one day decline in 8 years) as rumors swirled that the PBOC would "wean the market off state support." Perhaps there is a lesson to be learned here that government intervention and free markets aren't compatible. The sell-off in China was broad-based with 75 stocks declining for every 1 advancing. Presumably the sell-off could have been larger as more than half of the stocks in the Shanghai Composite hit their 'down limit' in Monday's trading, as China's market rules prevent share prices from moving freely once they rise or fall by 10%.

The price action in China's equity market over the last week along with the corresponding reaction by the government has turned investing in this market into a crapshoot and far removed from fundamentals. Although the Shanghai Composite is up 6% from its July 8th low it remains down 28% from its high in June and valuations (depending on your perspective) are not exactly compelling. The Shanghai Composite trades near its long-term average at 15 times forward earnings (per Bloomberg data), but if you strip out China's banks, which trade at a significant discount due to investor fears of hidden bad loans, valuation levels look much richer. For example, the tech-heavy Shenzhen market trades at 31x forward earnings – a 65% premium to its historical average.

As for the U.S. equity markets it's clearly become a story of the haves and have nots as breadth has narrowed in what is the third longest bull market since 1940, and a bull market that has not experienced a 10% correction in nearly four years. A couple of stats regarding the current technical make-up are implying some near-term caution is warranted: 1) as the S&P 500 was approaching its record highs last Monday there were nearly as many stocks hitting one-year lows as one-year highs, 2) as of the end of last week's trading there were more stocks in the S&P 500 down 10% year-to-date (142) than up 10% (118), and 3) six companies (Amazon, Google, Apple, Facebook, Gilead, and Walt Disney) account for more than all of the $199 billion in market-cap gains in the S&P 500 so far this year.

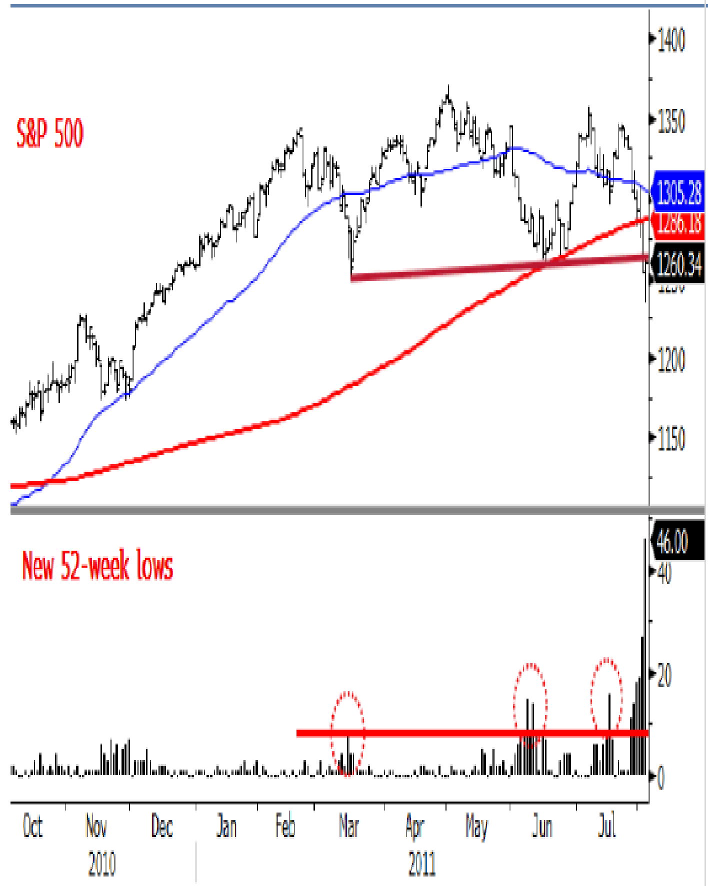
One last point on the weakening in market breadth: BofA Merrill Lynch Technical Analyst Stephen Suttmeier put out his monthly chart portfolio over the weekend where he highlighted the increasing number of companies in the S&P 500 hitting new 52-week lows (42) and drew comparisons to a similar technical breakdown leading up to the 19.4% decline in the S&P 500 back in 2011. Whereby, back in 2011 less than 20 companies hit their 52-week low prior to the market breaking down.

Chart 1: S&P 500 with new 52-week lows now



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 2: S&P 500 with new 52-week lows in 2011



Source: BofA Merrill Lynch Global Research, Bloomberg

The S&P 500 is up roughly 2% on the year, but depending on how investors have been positioned their results could deviate significantly relative to this broad equity market benchmark. One example is the recent outperformance of “Growth” indices versus “Value” indices across the market cap segments that make up the equity market. The table below details the divergence in these two investment styles since July 1st:

	Growth	Value
S&P 500	5.35%	-1.09%
S&P 400	7.05%	-1.60%
S&P 600	7.56%	-2.90%

On a sector level, more than 100% of this year's increase in the Standard & Poor's 500 Index is attributable to two sectors: health-care and retail. That's the tightest clustering for an advancing year since at least 2000, according to data compiled by Bloomberg. While the bulk of the gains in the S&P 500 can be attributed to significant outperformance of only a couple sectors, the breadth isn't quite that bad with half the sectors that make up the S&P 500 down on the year and half the sectors still in the green. If your portfolio is comprised of an equal weighting between the Telecom, Utilities, Industrials, Materials, and Energy sectors this year then you are down approximately 8%. But if you're long Tech, Consumer Discretionary, Consumer Staples, Financials, and Healthcare then you are up roughly 5% on the year.

We are far removed from the market of the last five years where you could just buy an index and ride the wave to profits. Today's market is comprised of winners and losers where accurate calls on security selection and sector rotation have been rewarded.

The plunge in commodities prices – and in particular crude oil – has been a painful place for investors this year. It's been an almost surreal aligning of the stars that has created such a weak backdrop for the price of oil. We have a sluggish two-steps forward one-step back recovery in the U.S. economy, which is capping any significant pick-up in demand (not to mention advances in technology focused on energy efficiency). The trend in economic growth in China is declining, fiscal challenges have disrupted any sort of sustainable economic recovery in the Eurozone, Abenomics has done wonders for the equity markets in Japan but economic growth remains elusive, Brazil is a mess, and growth has been challenged in the rest of the emerging market constituency – all of which has taken global GDP growth to a 3.3% average annual rate in the six years following the Great Recession, compared to 4.8% growth in the six years before the Great Recession.

The uneven plains of economic growth from around the globe as well as the diverging path of future monetary policy has created a significant shift in exchange rates – causing the dollar to rally over 20% in the last year and pushing it into a full-fledged bull market. Couple the growth and dollar appreciation headwinds with mounting global supply and you have yourself a perfect storm for a bear market in oil prices.

Now I often like to take the contrarian perspective as it relates to sentiment, and I think we're getting closer to a capitulative level in several commodity markets, but I don't believe we are there yet. However, when I see headlines like this one in the FT: "*Oil groups have shelved $200bn in new projects as low prices bite*", it tells me that we are getting closer. Another contrarian signal is percolating in market positioning as hedge funds have moved to their most bearish level in almost five years. According to the data as of July 21st from the U.S. Commodity Futures Trading Commission, hedge funds hold a net long oil position equivalent to just 118 million barrels (the smallest net position since September 2010) which is down from a recent high of 294 million barrels eleven weeks ago. The ratio of long to short positions, at just 1.7:1, is the lowest since September 2010, and has fallen from more than 4:1 over the last 11 weeks.

As for the Federal Reserve, they conclude their two-day Fed meeting on Wednesday with expectations for them to take a pass on hiking rates at this meeting, but all eyes will be on the statement for any verbiage change that may shed light on what they need to see for them to hike at the September meeting. We got some insight into what the Fed's economic staff is thinking when it inadvertently released projections for interest rates and the economy last week. While the release indicated the staff's view that the output gap is narrowing and slack in the employment market is being soaked up, it's the FOMC members that ultimately hold the cards in the decision for when this rate hiking cycle will commence.

What we know is that the Fed is data dependent and they are preparing the market for a hike that could come at any meeting from this point forward, but unlike prior tightening cycles they are by no means on a preset course, like ’94 or ’04. Chair Yellen has repeatedly voiced her preference for “early and gradual” versus “late and steep” as the Fed attempts to normalize interest rate policy. My view is that while the initial volley may bring with it a short-term spasm in the capital markets, it’s not the end game for this bull market cycle and focusing on it as such is a gross miscalculation. Believing that the Fed can thread this tightening cycle needle without a glitch is one of many risks facing investors, but it is far from the only one. So an investment strategy predicated on handicapping when and by how much the Fed moves is really missing the forest through the trees in the complex capital market environment facing investors today.

I’d like to spend a moment philosophically waxing about risk and risk management before signing off on this week’s missive. The investment community most regularly measures risk through the prism of volatility or the fluctuation of an investment over a defined interval of time – standard deviation and beta are two common metrics. I prefer to adopt Howard Marks’ view on risk, which he defines as “a permanent loss of principle.” Under this thesis one can allow for volatility to run its course as it is prone to do in the equity market when ‘short-termism’ and headline grabbing noise can cause sudden kneejerk shifts in sentiment. These price spasms can sometimes cause even the most steady-handed investors to fall prey to its gyrations at just the wrong times.

You see, investing is all about probabilities – assigning probabilities to expected future outcomes and positioning yourself to best take advantage of those highest probability expectations while still accounting for those low probability outlier outcomes that can significantly impact your capital if they were to materialize. No one on the planet is so clairvoyant that they can suggest with a high level of confidence that they know what is going to happen in the capital markets. However, than can perform rigorous analysis on variables that historically have an impact on how a certain investment is expected to perform and assign probabilities to a subset of expected outcomes under various scenarios.

With virtually no investment on the planet having a zero probability of never losing money, an investor is forced to calibrate scenarios that pose the greatest risk to their underlying principle. A ‘black swan’ event could be one of those scenarios, but that is why they are given the term ‘black swan’ – they are rare and impossible to predict. Correctly predicating a ‘black swan’ event is called luck, or applying a high probability to an event that rarely occurs and therefore this investor has likely miscalculated on many other predictions (which no one hears about). Furthermore, attempting to invest or hedge a portfolio for every expected outcome would be a very costly endeavor and likely diversify a portfolio to such an extent that in no situation could it make money.

Where I’m going with this philosophical digression is that the noise factor and volatility in the capital market backdrop his materially increased this year – where indecision and uncertainty is weighing on investors, which has turned this sixth year of an equity bull market into a trendless environment over the last eight months. And as I work through my checklist of metrics that frame my opinion on expected outcomes for the capital markets, my probability levels have changed, which is customary as fundamentals, valuations, and sentiment shift. Another variable that I believe is very important for investors to evaluate is where we are in the business cycle, as this provides some very important insight into what potentially could lie ahead for the capital markets.

Across the board I'm finding my probability estimates for positive future expected outcomes in the equity and fixed income market moderating with the distribution of potential outcomes expanding. On a fundamental basis the economic recovery is intact with nothing at the current time indicating that a collapse or recession is on the near-term horizon.

However, I do believe this cycle is in its mature stages as we're seeing data that typically coincides with the latter stages of a business cycle: profit margins at peak levels, the rate of change in employment beginning to turn down, wage growth picking up…to name a few. As for valuations, they are above their respective historical averages on many common measurement metrics which erodes the margin of safety on stocks and increases the potential risk.

Lastly, sentiment as gauged by various survey measures suggest that investors are skeptical (which is a constructive sign that euphoric activity has taken hold), but other measures of investor positioning (NYSE Margin debt, equity ownership as a % of household net worth, and the TINA – There Is No Alternative – philosophy) suggest that a lot of good news is already priced into stocks. Furthermore, the latest break down in market breadth – while only one part of the equation in a prudent investment decision making process – is a bit worrisome.

Therefore, with my conviction and moderating probabilities of positive future outcomes on capital market investments, I believe it is prudent for investors to take steps to lessen the overall risk profile of their portfolio. I'm not advocating an all cash portfolio or strictly a canned goods and ammo portfolio, but a more balanced allocation of stocks and bonds with perhaps a little higher weighting to cash and hedged-type investment strategies than has been the case during the last couple of years. In a nutshell, a little more defense and a little less offense, but both players should remain on the field for a prudent long-term investment strategy.

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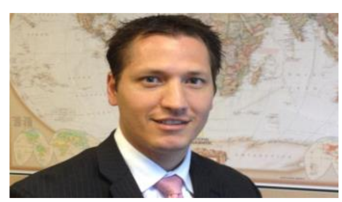

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