New Albany
Investment Management

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Market Insight: Conflicting Signals

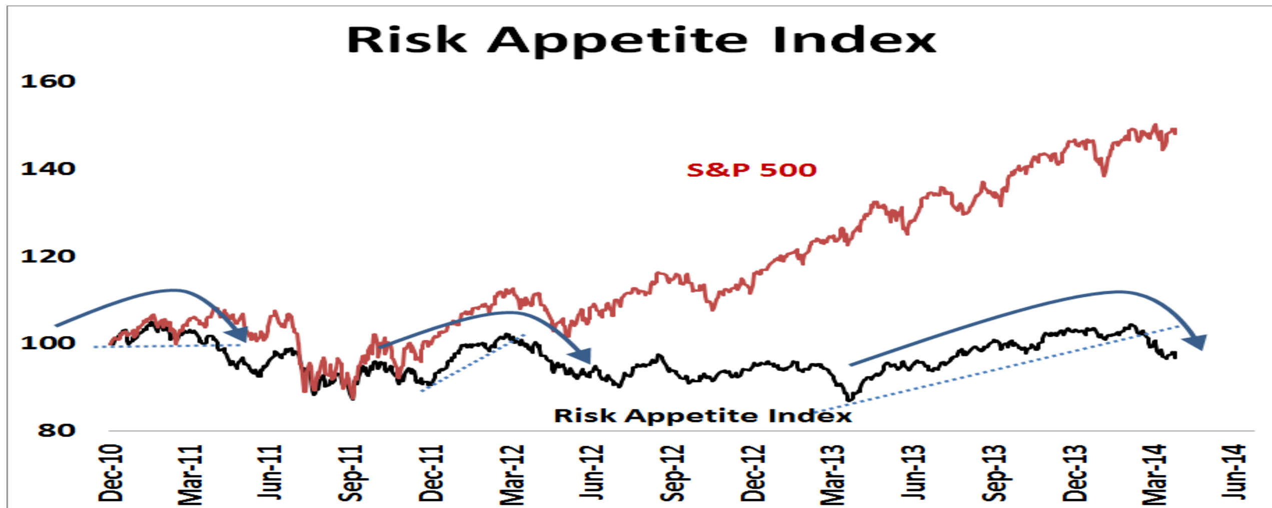
US Stocks have seen wide swings recently, but year-to-date major indexes are roughly flat. The recent volatility is perplexing because there is not a specific catalyst driving price action. Usually volatility is associated with uncertainty or fear of future events, but from a fundamental standpoint, the investing horizon looks quite calm. The economy appears to be picking up steam and earnings season has been generally better than expected. The Fed continues to sound a dovish tone, which is very supportive to both the stock and bond market. Is this just a period of consolidation before the market launches higher, or is the market signaling a turn lower?

The following is a look at key market measurements that offer conflicting signals:

Fundamentals disagree with Technicals. Over the long run, the market is moved by fundamentals such as the direction of the economy, earnings, fiscal and monetary policy. By these measures, the market should be advancing. Nearly all recent economic readings (except housing) are signaling acceleration in growth. At the same time, companies are issuing positive forward guidance on earnings, a first in more than 10 quarters. By these indicators, it is blue sky ahead. But the short term technical indicators, which reveal the health of the price action, are telling a different story. Sector leadership, volume, momentum, and the number of stocks making new highs are all flashing warning signs of a potential deeper correction. Recently, the market leadership has shifted from growth to value and cyclical to defensive. This action is quite odd when the economy is on the cusp of accelerating.

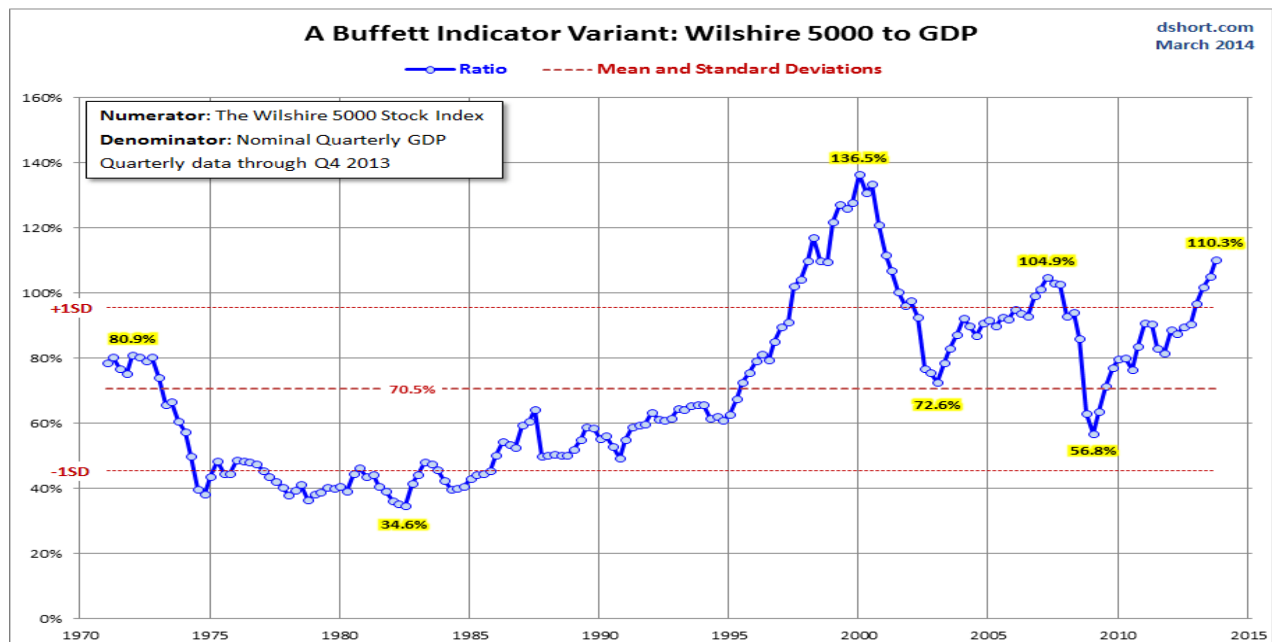
Leading Indicator: The stock market is considered a leading indicator, as it looks past today's news and into the future six to twelve months ahead. Put another way, today's price level has a built in expectation of future economic growth and earnings. With the recent shift from growth to value, it says institutional investors, at least are pulling in their horns, and possibly a sign growth could be slowing ahead. Of course the smart money is not always correct, but more often than not, is has been a good leading barometer of future growth. SO even though the economist are expecting growth to accelerate, the Market is saying otherwise.

Risk Appetite is falling: The Risk appetite index is a ratio of the relative performance of growth vs. value stocks. Since growth stocks are generally more volatile (riskier) than value stocks, a rising index indicates investor are willing to take on more risk which occurs when they are optimistic about the future. Recently, the risk index has been falling, reflecting the shift to more defensive posture by investors. To put this into context, take a look at the chart on the next page which shows the risk index vs. the S&P 500 since 2011. In 2011 and 2012, the index declined and accurately foreshadowed a significant market correction. However, the decline in March of 2013 was a false signal, and the market continued higher thanks to the Fed again promising to add more stimulus. The question is, without the Fed, is the index once again signaling a correction?



Valuation: Market Capitalization to GDP: Yet another way to look at the market today is valuation. Is the market cheap or expensive? A favorite measure of Warren Buffet's is the Market Cap-to-GDP ratio. He considers this ratio the "single best measure of where valuations stand at any given moment." It compares the total price of all publicly traded companies to GDP. This metric can also be thought of as an economy wide price to sales ratio.

The charts below shows the Market Cap/GDP ratio back to 1950. Today the Market Cap/ GDP ratio is about 110% of GDP. In the year 2000, just before the market cracked in the dot-com bubble, the market capitalization was 136% times the GDP. And in 2007, just as the housing credit bubble was bursting, the ratio was 105% times the GDP. So the current level is above the average zone. But, it is important to note, <u>the absolute level does not in and of itself determine a change in trend but it does show the vulnerability and magnitude of a potential correction</u>. An expensive market can get even more expensive long before it corrects. As Buffett has said, "the ratio has certain limitations in telling you what you need to know. Still, it is probably the best single measure of where valuations stand at any given moment."



So what to make of all the Measures? The technical picture, which is more forward looking, is warning of a correction, while the fundamentals, which are more lagging indicators, are supportive of future gains. Current prices relative to GDP say the market has gotten ahead of underlying growth. In sum, it is definitely a mixed bag of factors influencing market direction. As such, expect continual choppy markets for the foreseeable future with vulnerability of a correction.

Investment Strategy in Volatile Markets: Over the last two months, risk has been reduced through broader diversification across sectors, rotation into defensive sectors and cash. The portfolios are well positioned to benefit when the markets are rising, and yet at the same time, ride through volatile market shifts.

Please contact me with any questions or concerns.

Kind regards,

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