New Albany Investment Management

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Market Insight: Turbulence

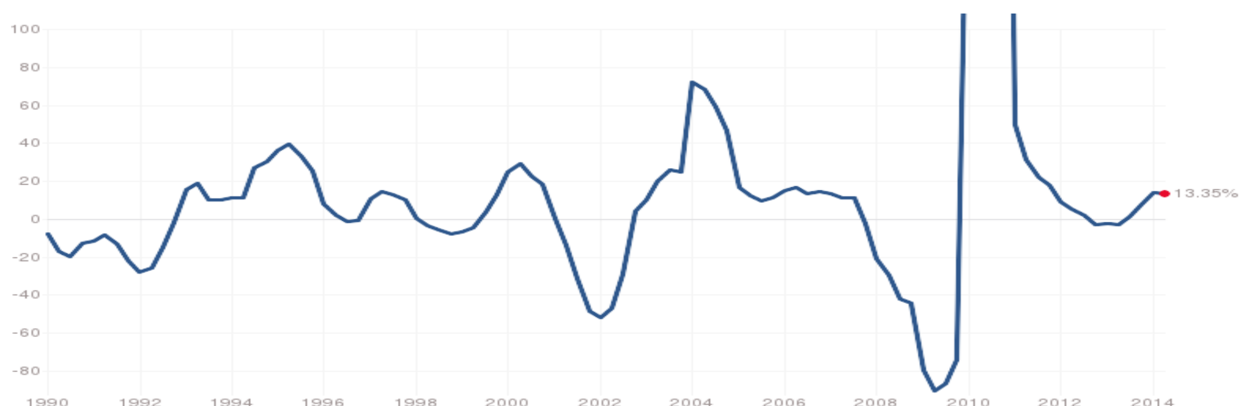
Webster's dictionary defines **Turbulence** *as "the quality or state of being" causing great "commotion or agitation"; "irregular atmospheric motion especially when* ***characterized by up-and-down currents"; a departure from fluid motion.***

So far this quarter has been a turbulent ride for investors with some sectors making new all-time highs, only to quickly reverse and wipe much of the year's gains. Other sectors, like Small Cap and Consumer Cyclicals have been especially hard hit, and are now down -3 and -5% for the year. Yet earnings have been largely better than expected and economic growth has rebounded sharply. So why has the market hit an air pocket? Is this just passing turbulence or should investors be putting on their PFD?

Dog Days of Summer:
This time of year is considered one of the biggest seasonal void periods for the market where information and market flow is light. The Fed won't meet again until September, U.S. legislators are on recess, European politicians and citizens en masse go on vacation, and Americans squeeze in their last trips before school begins. This often results in lower trading volume, allowing for any and every concern to push the markets around, and sometimes by a more pronounced magnitude. At the same time, investors have become accustom to an ultra- smooth market environment, so when the market hits an air pocket and falls -2% in one day (which by long term historical standards is quite normal), we hear and see news headlines calling for a market crash. More likely it is a sign of an exhausted Bull that needs a rest.

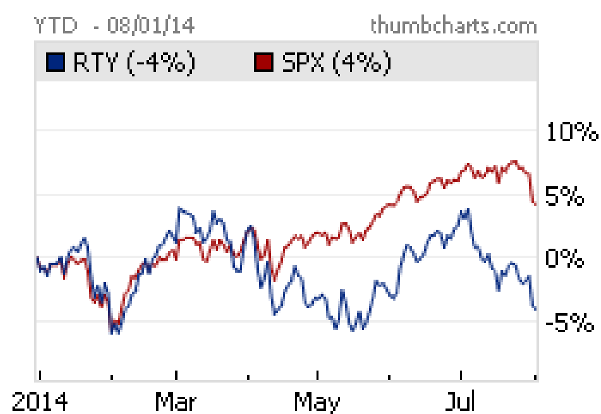
Fundamentals and Technicals diverge: When a market fails to respond to good news it does raise a caution flag but often it is symptomatic of a divergence in fundamental and technical indicators. US economic growth is strengthening: employment, manufacturing data, consumer confidence, and employment are all improving. At the same time, companies are showing legitimate earnings growth. All of these indicators give a very positive picture and should continue to be supportive of stock prices.

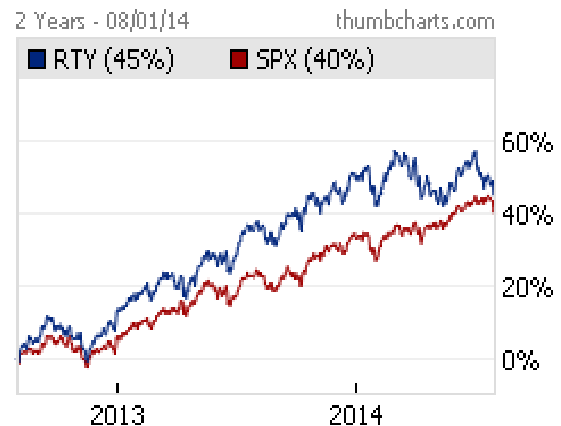
Below is a chart the S&P 500 earnings growth rate since 1990 and current rate at 13.3%. This picture shows the both the level of growth is not too extended and the direction of growth is rising- both healthy conditions for owning stocks.



But the technical picture looks poor. Specifically, since April, the Russell 2000 (Small/ Mid cap sector) has been significantly lagging the S&P 500 (Large cap). From early March 2009 through early March 2014, the Russell 2000 consistently outperformed the S&P 500 during uptrends. Since the first week of March 2014, however, the Russell 2000 barely eked out a new all-time high on July 1, 2014, and rapidly moved lower again. During the same four-month period, the S&P 500 achieved numerous all-time highs. In the past, whenever small-caps in any sector are persistently underperforming their large-cap counterparts, it has been a leading indicator of a downturn. In fact, one common characteristic of 1928-1929, 1972-1973, and 2007 sell offs was the sudden shift from outperformance to underperformance for small stocks prior to the downturn.

The charts below show the relative performance of Russell 2000 (RTY) verses S&P 500 (SPX) year to date and for 2yrs.





Fear of Rising Rates: So what is causing investors to shift away from more risky sectors (Small/Mid cap) and into more defensive sectors (Large cap)? Rising Rates. The scenario goes like this: The spigot of global stimulus is slowing to a trickle. The world of investing as we have all known for the last five years is about to change as the US Federal Reserve is preparing to end its policy of flooding the market with liquidity. Rates will rise, snuffing out the most vulnerable businesses- namely small and mid-size companies. Hit the 'sell' button.

Rising rates is a legitimate fear, triggering a change in market psychology and market correction. But it is unlikely to cause a full blown bear market because the fundamentals say otherwise. In fact, **rising rates are linked to rising growth**, which is actually very bullish for stocks. Well known economist David Rosenberg, at Gluskin Sheff explained it this way (via Business Insider):

*…the last rate hike occurred in 2006. And, (if the Fed raises rates in 2015) it will be nine years (since the last) hike…He writes, a rate hike is "long overdue," and that he is worried the Fed might outstay its welcome. The **history books show that at no time did a bull market end after the first rate hike.** Typically - in terms of trough to peak moves in the SP 500 - we are only one-third of the way into the bull run on the eve of the first Fed tightening in rates. That is an average, but the median is almost identical and there has never been a time when the cycle was more than halfway through at that point of the first rate increase." Rosenburg points out that the stock market only begins to "peak out and roll over"… when Fed rate hikes are already under way.*

In other words, the Bull is tired but not dead.

Fed Chairwoman Yellen seems set on assuring the markets that the first hike won't likely occur until sometime in mid-2015. However, comments from some Fed members as well as signs of growing inflation indicate hikes could come sooner than expected. But, you can be sure, **growth and full employment are top priority for the Fed and it will not derail what it has worked so hard to establish over the last five years.** Thus, it is in everyone's best interest that the economy keeps on improving.

Turbulence maybe more frequent: No doubt, the transition away from the Fed's emergency policy measures to normal monetary policy will cause the market to hit air pockets from time to time. Worry and fear bring volatility. But as long as the key fundamentals of economic and earnings growth continue to rise, the markets have a foundation to build on.

Investment Strategy: Price action is expected to continue to be choppy into the Fall until more clarity and confidence in the strength of 3rd quarter GDP and earnings develops. Portfolios are fully invested however risk has been further diversified across asset classes. High yield exposure has been reduced and allocated into investment grade short term bonds.

Please don't hesitate to contact me with any questions or concerns.

Kind Regards,
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