SELECTOR
Real-Time Money Management

Monthly Commentary

August 18, 2015

"Good investors gather information, put that information into current and historical context, then make sound decisions."

In a Dr. Zhivago update (reference the July Monthly Commentary) there was a pretty good battle scene last week. Equity markets were engaged in a robust test near the bottom of their seven month trading range. After lively cavalry charges in both directions on Monday and Tuesday, Wednesday opened with a dramatic break lower that appeared ready to pierce important support levels. Such a break would potentially expose equity markets to being overrun. During this challenge both the Dow Jones Industrial Average and the S&P 500 were pushed into negative territory for the year. At midday, however, there was an exquisite reversal and equity markets managed to completely regain all of the territory lost in the morning hours of the struggle. From an intra-day, technical perspective, it was quite impressive. But, from a weekly and monthly perspective, it ended up looking like just another scene in a very, very long movie.

Closer scrutiny did uncover a couple of positives, namely with the Dow Jones Industrial Average's cousins, the Dow Jones Utilities Index and the Dow Jones Transportation Index. Both of these indexes had been in gentle declines since March. These divergences can toss a wet blanket over the rest of the stock market. The end of July both of these indexes managed to break their respective downtrends. The transportation index made a very nice, positive test after breaking its downtrend. As I mentioned last month, this sector could be a catalyst for the rest of the equity market. The utilities sector actually made a rather robust move almost immediately afterwards. It was very striking that on the crucial day of last week's trading range test there was significant rotation into utilities. Only two equity sectors were positive that day, utilities and energy. They stood alone. Utilities have been steadily continuing their move higher every day since. This wasn't to be the case with energy.

The energy sector, which shared the limelight with utilities briefly last week, failed to break their downtrend. And while the utilities and transportation sectors had been suffering from bad colds, it appears that the energy stocks have developed pneumonia. Their problems run much deeper, primarily in the form of massive oversupply. It is now estimated that the United States has over one billion barrels of oil in storage. We use a few million barrels a day. Iran is pumping oil, free of sanctions, like there is no tomorrow. Russia is pumping full bore because they need the revenue. The Saudis are pumping because their recovery costs are so low and they are battling the shale oil recovery business, which is not cost effective when oil prices are sub-$60. The world is literally drowning in oil. It has been reported that virtually all of the major oil companies are not anticipating an improved environment for oil production until 2017. A hard cap on oil prices does not translate directly into a cap on energy equity prices, but it does create a strong headwind.

International equities have been steadily deflating for three months now. European equity markets appear to be trying to establish a trading range environment like domestic equities, but have had difficulty in getting traction near their lows. As a result, they have slipped under both their 50-day and 150-day moving averages. Positions that were established early in the year and that were so productive mid-year have been disappointing in the third quarter. Their relative strength compared to domestic equities has weakened considerably. Emerging markets have been particularly weak this quarter, breaking down to yearly lows. In just a couple of months they have gone from the top of the leaderboard to the bottom.

Nobody likes to hear 'I told you so,' but my suspicions about bond market weakness being the result of institutional capital moving to international equities are being confirmed by recent price action. It is interesting that just as the bond markets' pullback from the April highs coincided so strongly with the flow of capital into international equities, their recovery phase has coincided directly with international equities declines. Bonds also received a boost with the trading range test last week for domestic equities. High quality bonds have led the way higher, while high yield and convertible bond sectors continue to represent relative value opportunities. Municipal bonds have quickly moved back near their yearly highs. The U.S. Dollar has also been demonstrating positive price action versus foreign currencies. It appears that once again U.S. financials are leading the way globally as domestic equities, domestic bonds, and the U.S. Dollar are all topping the year-to-date performance charts in 2015.

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Sources: Bloomberg, Marketwatch.com, StockCharts.com.