Monthly Commentary

February 17, 2015

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

As rough as January proved to be for equities, the first two weeks of February have smoothed out the wrinkles. The S&P 500 Index rose in seven of the first ten trading sessions of February, advancing to new all-time highs the last two days. Granted, the net gain for the year has been marginal but it bears repeating, "Trend trumps all." You have to respect the markets' positive long term trend, especially when hitting new highs.

Another positive has been the expansion of market breadth. In addition to the S&P 500 Index hitting new highs last week, the NASDAQ Composite Index, the Russell 2000 Small Cap Index, the S&P 400 MidCap Index, and the Russell 1000 Index went to new highs. In general, the broader the market front the more sustainable the advances, and expansion across the different market capitalization indexes is encouraging.

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From a divergent perspective, utilities and real estate indexes pulled back rather sharply the past two weeks. Both of these sectors are traditionally more defensive, so their decline in the face of the advance of more growth oriented sectors is an indication of institutional rotation. This rotation is another bullish indicator because broad institutional moves tend to play out over several months. The analogy is that it takes a considerable amount of energy and space to turn a battleship, so you plan on executing the move pretty far in advance. Usually, institutional investors try to camouflage their tactics as much as possible, but this rotation was just too obvious to miss. Both utilities and real estate indexes had made strong moves higher in January, so they had room to correct and still maintain their positive long-term trends.

A more subtle but even more intriguing February development occurred in the European equities markets. Sparked by the initiation of their own brand of Quantitative Easing and successful completion of Russia/ Ukraine peace talks, European equities decisively broke a long-term downtrend. As much fun as it is to follow a positive long-term uptrend, the break of a long-term downtrend can present specific opportunities. This break on the part of European equities was properly set up by a double bottom in the fourth quarter of 2014. All it needed was a downtrend break and a successful test, both of which occurred the first two weeks of February. This is very important from a global perspective, as it doesn't leave the U.S. equity markets all alone on the offensive. While the U.S. is still very clearly in the leadership role, reinforcements on a global perspective represent a distinct positive for both markets.

Just as we saw the rotation from defensive equity to offensive equity sectors the past two weeks, there was a similar rotation in bond markets. In January the high quality bond sectors were king, while the high yield sectors declined with their equity market cousins. In February the high quality bond markets pulled back to make room for high yield and convertible bonds. High yield bond sectors had actually hit their high water marks at mid-year of 2014. Now we are seeing constructive basing activity, fueled by the rotation from high quality bonds. As a group, high yield bonds remain in either downtrends or trading ranges and are attractive solely for their above-market dividends. Like utilities and real estate equities, high quality bonds were hitting new highs in January and had plenty of room to pull back and still maintain their positive uptrends.

It is still very early in the year, but we like the fact that bonds surged in January and equities surged in February. Total returns year-to-date are not remarkable but it appears that financial markets are flexing in preparation for more sustained action down the road. The U.S. economy is plugging along and the U.S. Dollar remains strong. Commodities markets, including gold, oil and other inflation predictors are so soft they are totally off the radar. Interest rate forecasts continue to be for more of the same, very low and very stable. If you want to make money, it looks like the U.S. equity and bond markets are the best play on the planet. It could get even better if the European financial markets continue their push and we get a resurgence of a global bull market.

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