Monthly Commentary

January 19, 2016

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

The historically positive November-December-January sequence is just not working out this time around. Although there are nine trading days left in January, the technical breakdowns in domestic equity prices thus far this year are going to require some major reconstruction. There are a number of historical precedents for equity markets when January starts off so weak and they are much more than coincidence. It looks like we are going to have to manage our expectations lower until institutional investors are once again comfortable with price-to-valuation ratios.

Working back to the good news/bad news scenario, the bad news is that thanks to computer-driven algo-trading, equity markets have the potential to trade to the downside with great drama. The good news is that equity markets trade much faster on both ends of the spectrum these days, so once the drama is exposed the recovery potentials can be equally as exciting. This is not just an attempt to put lipstick on the pig. The last two moderate to severe corrections, in August of 2014 and in October of 2013, were followed by very sharp recovery rallies that took domestic equity indexes right back to fresh all-time high prices.

Those dramatic recovery rallies made mockeries of attempts to effectively trade away from the volatility. While best intentions and traditionally best practices may have been to sell equities into those corrections in the hopes of preserving capital and protecting against further losses, the rebounds were so quick and so strong that overall performance was handicapped by taking defensive action. In essence, the best defense required that action be taken in advance of traditional sell signals, deferring instead to more 'early-warning' indicators. We are working within those parameters now, which does involve certain adaptations, including being prepared to 'ride out' the sharp sell programs that we are currently seeing.

This has been a global sell-off, meaning that thus far we have not seen any rotation into international equities. As rough as it has been in U.S. equity markets, it has been equally rough or worse overseas, especially in emerging markets that are more sensitive to oil and basic materials commodities prices. Case in point, Brazil, which is a huge exporter of natural resources, saw their equity prices decline by more than -40% in 2015, followed with a drop of -13% year-to-date. Not one single country index that we follow is in positive territory year-to-date, which is very unusual and an indication of the across-the-board selling taking place this year.

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With such broad selling in equity markets, one would expect that bond markets have to be demonstrating relative strength. In spite of the Federal Reserve's actions to finally increase short-term interest rates for the first time in nine years, U.S. Government bonds have seen significant in-flows of capital this year. High quality corporate bonds have also benefited from the flight from equity volatility and are netting positive returns YTD. The big question is what will happen if/when equity prices begin to rebound. Each of the last two sharp recoveries in equity prices have proven to be quite difficult for high quality bond market markets, which rapidly surrendered their gains.

As long as our economy continues to plod ahead, it is very difficult to bet against domestic equities, although the volatility can be unsettling. While we are seeing rotation into more defensive large cap domestic equities, we are not seeing rotation into international equities. Recent history has made us quite suspicious of following the rotation into bonds. For now we are sitting tight, anticipating another sharp recovery rally.

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Sources: Bloomberg, Marketwatch.com, StockCharts.com