Monthly Commentary

October 19, 2015

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

The 'Miracle Recovery of 2014' failed to reappear after our first correction of 2015, as equity indexes pushed south the end of September to test those August lows. The good news is that aside from the 'algo-trade' price points on August 24th, those lows have held thus far. The bad news is that from a technical perspective considerable damage occurred the last 60 days and the reconstruction appears to be selective and limited in scope thus far.

There has been a marked shift away from the historically riskier equity sectors towards more conservative sectors by institutional investors. From a capitalization perspective, small cap equities have been particularly impacted. From an international perspective, emerging markets equities have experienced sharper declines. And from a sector perspective, industrials, basic materials, and energy sectors have suffered. The positive exceptions from a sector perspective have been technology and consumer discretionary equities, which have been buoyed by positive price action among the large cap equities. On this positive note, large cap equities have endured this correction with relative strength, as have mid cap equities to a lesser degree. From a sector perspective, the defensive sectors of real estate, utilities and consumer staples have propped themselves up the past few weeks, after suffering poor relative price action for most of the year.

The health care sector has been carefully dissected the past few weeks. Biotechnology and pharmaceutical segments of the health care equity sector have demonstrated particularly poor price action, giving up a substantial chunk of their recent gains. Both of these sectors had been the 'darlings' of the health care industry for the past few years. But the bloom quickly fell from the rose bush during the August correction, and again during the September test. While it stands to reason that some profit-taking should present itself after such dramatic price increases over the past two years, it never ceases to surprise as to the degree of selling that persists, even in the absence of any fundamental corporate developments.

On the international front, European equities actually descended to 'lower lows' during the price test that occurred in late September, raising doubts as to their near-term contributions to diversified portfolios. While they did rebound somewhat in October, as a group they have experienced more technical damage than their domestic equity cousins. Emerging markets also participated in the October bounce, but coming off of even more pronounced lows during the August declines. Their technical picture is even more negative than developed international equities. The U.S. Dollar has stabilized into a trading range during all of the equity market drama, which should be more of an impedance to both developed and international equities versus domestic equities.

Bond markets, on the other hand, have welcomed the outflows of capital from equity market. Every single bond sector that we monitor has registered significant gains in the last month, and especially during the month of October. High quality to high yield, short-term to long-term, municipal to convertible, bonds have seen significant inflows as institutional investors have moved away from the volatility of equities to the relative safety of bonds. This is precisely what we have been doing as well.

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We continue to believe that we are experiencing a technical, albeit a major equity market correction within the context of a long-term domestic Bull Market. Economic evidence of a slowly expanding economy is still stacked up on the side of the Bulls. Developed international equity markets, which benefitted initially from Europe's and Japan's versions of quantitative easing, still appear to be in 'work-out' situations that we prefer to watch from the sidelines, especially after taking a brief licking the past few months with European equities. Emerging markets remain the more speculative characters, at the mercy of the very weak demand for basic materials, and are unattractive. Which leaves us with domestic equities, especially the large caps that are demonstrating the most consistent relative strength. The prices action of the Volatility Index supports this observation. It is certainly not our intent to wait until there are no clouds in the sky, as we carefully and conservatively monitor both equity and bond markets for opportunities. But at this juncture, equity market instability remains significant and we feel more comfortable holding proportionate levels of bonds.

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Sources: Bloomberg, Marketwatch.com, StockCharts.com