Monday, October 19, 2015

THE DAMAGE DONE

- The evidence has become convincing that the correction lows have been put in place and that the risk of another decline breaking those lows has dropped sufficiently enough to broaden equity allocation across sectors and asset classes.
- The market now is positioned for a year-end rally and further market strength into 2016.
- Mid-2016 may see a significant market struggle as it presses on against the headwinds of Presidential election jitters as well as the Federal Reserve normalizing interest rates against the backdrop of reaching their targets of inflation and full employment.

There is Good News, and Bad News

Up until the third quarter of 2015, the broader US stock market had gone nearly four years without a ten percent correction. Given that a decline of that magnitude happens, on average, almost once per year, it can be argued not-so-cavalierly that the thirteen percent decline in the third quarter was overdue. Though that was likely of little solace to equity investors as they had grown accustomed to the dearth of volatility in the previous seven months. Adding to investor concerns, it was the third consecutive negative quarter for the Dow Jones Industrial Average, which was only the third such streak in nearly forty years. That grind weighs on you.

Prior to the July 2015 high, the S&P 500 endured two such ten-percent-plus declines in the previous six years; from April to July in 2010, and April to October 2011. The rally from the September 24th low has attracted a lot of attention as possibly being the start of a new move higher. And while we generally agree with this, the clamoring of consensus makes us nervous.

We realize that since we hold ourselves out to be, at times, contrarians, we could be suffering an initial and biased assessment of the situation by being overly skeptical, and thus too conservative. Given our recognition of our own possible personal biases, we thought it prudent to look more closely at the rally thus far. We find that a bottom has been put in, and that a new move higher is the most likely scenario. But the analysis of the move suggests to us that the move may not be multi-year; the rally may struggle and experience a larger loss in the second half of 2016.

Because the bottom line is that we find it most opportunistic to allocate toward equity exposure, we'll spend some time on that assessment. But first, to keep our view honest, we will offer some brief comments regarding our concerns. Without getting overly technical or mired in numbers, the breadth of stock performance prior to the 2010 and 2011 peaks was very bullish, but the breadth prior to the 2015 high was waning, with fewer and fewer stocks holding up the price level of the broader indices. This is a sign of a changing market, one where the downtrend is stronger than the uptrend. Similarly, the rally from the 2010 and 2011 lows were much stronger than this rally, thus far, as measured by aggregate buying and selling. This is a sign that buying is less enthusiastic, leaving the rally more vulnerable to negative surprises.

Because the buying is less enthusiastic, we are seeing weaker breadth, meaning increasingly selective strength is supporting the price of the broader indices. This is not bad news if you are careful with your sector, asset class, or regional selection, but it does argue for the careful consideration of portfolio rebalancing. Whereas broad large cap indices like the S&P 500 were the number one performing indices over the last few years, investors saw no performance benefit in the safety of diversification toward other regions, sectors, asset classes, etc. New and increasing selectivity means that more diversification is likely warranted for the year ahead.

The good news is that selling and buying can easily be changed in a short period of time and breadth can become much more bullish. Our concerns for a limited rally in terms of time (again, one year instead of many years) include Presidential-election jitters in November 2016 as well as concerns that the pace of monetary tightening might begin to pick up as the economy reaches full employment and the Fed's target inflation rate.

Now For the Good News

For the marking of a new rally, we like to see signs of climactic selling followed by vigorous buying. And in late September, like at the 2010 and 2011 lows, we saw signs of this as measured by what we call a 90% downside day, followed by a 90% upside day (where 90% of company stocks move in one direction, as measured by both price and volume). Also, last week broad indices moved above their mid-September highs, which was their first attempt at a rally following the August low. These new highs (higher highs than mid-September, that is) help build the case of a bottoming process and argues for more room to run to the upside. The (extremely) short term concern is that the stock market has had a good run in a short period and it may go down a tick, if only to revert the longer term pace back to a mean. However, we've seen a bit of that attempt in the previous week and given the absence of heavy selling, it appears unlikely that the market would have to get down to previous recent lows to create a new oversold level that the market might need to extend its advance. Said less technically, it looks as if the bottom is in.

Offering further evidence that the bottom is in beyond the aforementioned 90%-days is that in the last couple of weeks consensus earnings estimates have come down considerably for the year ahead period (though estimates for Q4 2015 still seem uncomfortably high). The earnings gloom may provide a positive surprise and a buying catalyst. The market is now positioned for a year-end rally and further market strength into 2016.

The damage seems to have already been done. In our September 25th commentary "The Volatility of Coin Tosses" we wrote:

"On the subject of global recessions, as you gather a number of leading economic indicators meant to tell the story of a global slowdown, those indicators are beginning to tilt more and more toward that possibility. But, even if a global recession does happen (or is happening), most of the damage to US equity markets has likely already been realized. It is no surprise that equity prices tend to perform worse going into a global recession. But when the US did not accompany the global economy into recession, the impact on prices was far less. And the indicators just do not argue that the US economy is close to recession. In the stock market, there are far fewer statistical samples than we'd generally like

to have, but going back to 1987 there have been three cases where the US avoided slipping into a global recession: 2012, 1998, and 1995. Of course each instance saw a correction during or around the time of global recession, but the US market was always higher by the end of the economic downturn. The average correction was 13.6%, close to the 13.1% decline we saw from the May high to the August 24 low. Assuming that we actually do experience a global recession which does not include a contraction in the U.S. (seemingly a concern of the Federal Reserve), this suggests that most of the damage to the market has already been done."

Three weeks after that commentary, there is further evidence that the US consumer is stepping up to keep the US out of a recession. Low gasoline prices have helped boost vehicle sales to record levels (outside of a few heavily incentivized months). And even beyond vehicles sales, total real consumer spending is growing at a consistently healthy three percent per annum pace, with solid increases in everything from clothing to jewelry to home improvement and to healthcare.

Underpinning the spending gains is a strong job market. Job growth may have slowed in recent months, but even at that slower pace the economy is approaching full employment. As full employment levels are approached wage growth should pick up over its current pace of two percent annual growth (the rate of full employment tends to be stated in an opined range, given that there are different metrics to use during different demographic conditions, but the current ranges seem to be around 4.7% to 5.2%, with the unemployment rate now at 5.1%). Using history as a guide for our back-of-the-envelope projections, the current record number of job openings argues for wage growth closer to 3.5%, which is roughly what wage growth has been in a full-employment economy (equal to the sum of two percent inflation plus one-and-a-half percent productivity growth). Combine acceleration of wage growth with household balance sheets that are already almost as good as they have ever been, and we just cannot forecast a US recession at this time. And this further supports our stance that for the stock market, the damage has been done.

Bottom Line

Although the stock market has had much, much worse years in terms of loss magnitude, this one has been particularly uneasy given its long grind. While we do not rule out consideration of a number of negatives, we believe that the damage to prices of broader US equity indices has been done. This positions stocks for a year-end rally and strength into 2016, supported by a still accommodative Federal Reserve and a moderately strong US economy.

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The Knowledge and Experience to Build Your Wealth

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