BakerAvenue Market Insights

Running to Stay in Place

"My dear, here we must run as fast as we can, just to stay in place. And if you wish to go anywhere you must run twice as fast as that." - The Red Queen, Through the Looking Glass

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The Red Queen is a fictional character in Lewis Carroll’s Alice in Wonderland sequel. In this amusingly trippy book, Alice enters a brand new world by stepping through the mirror in her room. It’s in this confusing new world where Alice meets the brazen Red Queen who is very proud of her ability to run at “breathe-taking speeds.” The Red Queen tells Alice that she too can be anointed a queen if she can make it to the end of the garden which, appropriately, is a chessboard, by running as fast as she can. She tells Alice it won’t be easy and should she not run fast enough, she will end up in the same place. To save you from the mind-bending analogy, it wasn’t easy; she had to overcome some conspicuous obstacles, but she eventually makes it.

Sounds familiar. There are plenty of words to describe the stock market’s performance in 2015 but “easy” wasn’t one of them. Violently flat, brutally resilient, running just to stay in place - these descriptions all seem fitting to us. To earn a decent return, investors had to own the fastest of the fast. Essentially this meant investing in, and sticking with, a small group of high-flying stocks. In fact, outside of the “FANG” stocks (Facebook, Amazon, Netflix and Google) - all of which posted outstanding returns - the market was quite weak with the “average stock” closing the year down more than 11%.

Asset allocation was just as challenging as security selection. Usually there are portions of the capital markets to turn to (there’s always a bull market somewhere, right?). However, with corporate profits stalling out, commodity prices falling, and the Fed withdrawing stimulus via its first interest-rate hike in nine years, all major asset classes had a tough time
posting positive returns. In fact, looking at the four major asset classes with the longest histories (stocks, bonds, commodities and cash), 2015 ranks as the worst total return year since 1937. Overall, it ranks as the third worst year since 1926 (Chart 1).

While our baseline views about the year (low return expectations, macro unpredictability, etc.) played out nicely, the volatility associated with our core thesis made for a challenging second half of the year. Coming off the first 10% correction in four years, stocks were held hostage to a host of macro headlines that led to an increasingly volatile backdrop. Our pragmatic investment approach leans heavily on disciplined technical, fundamental and macro views. Each was tested last year and we often felt as if we were running fast just to stay in place.

Let’s begin with the technicals. Coming out of the correction, stocks put up their best monthly return of the year - October was +8%. Unfortunately, this bounce seemed to borrow heavily from November and December as those months bucked traditionally positive seasonal trends and posted negative returns. For the year, the average intraday S&P 500 move was 28 points (historically a wide margin) while the market crossed the “flat line” thirty times - a record (Chart 2). Investor indecision led to frequent short-term trend changes, all occurring in the context of a range-bound longer-term trend.

With leadership so narrow, it was one of those years where diversification didn’t seem to matter (the broader the index, the worse the return). With only a few stocks doing the heavy lifting (Chart 3), trends were vulnerable to whiplash and indeed, that’s what we got. The S&P 500 crossed its 200-day moving average (a traditional longer-term trend factor) twenty-two times in 2015. Our own trend indicators bounced between neutral and positive for most of the year. The divergence between breadth and price in equity markets was one of the most pronounced in history and reflected the overreliance on just a few large cap issues. Some key technical indices like transports (-25%) and small caps (-6.9%) more accurately reflected the underlying softness last year. The year closed out with over half of the stocks in the broadest indices (Russell 3000) -20% or more off their 2015 highs.

The fundamental picture was mixed last year. Earnings and sales trends were flat to slightly down (2015 is forecasted to be the first year with down earnings since 2008), with the energy sector driving most of that
weakness. Of course, revenues, earnings, the dollar and stocks are inexorably linked. The trade-weighted US dollar jump of 13% over the last year became a strong headwind.

The softening sales trends (and low interest rates) led to a record year for global M&A. Global M&A volume at $4.9 trillion in 2015 was the highest on record for any year, surpassing the previous record of $4.6 trillion in 2007 and was 33% higher than 2014’s volume. Add in stock buybacks (over $1 trillion) and it’s clear that corporate transactions were a stabilizing force last year.

The sector picture has been muddled for much of the past year and was defined by sudden, vicious rotations. The energy and materials sectors were the clear losers while healthcare, consumer discretionary and technology outperformed. The industrial economy seemed to weaken further as the year progressed. The ISM purchasing managers’ index dropped below 50 in the fourth quarter for the first time in three years (indicating some level of manufacturing inventory correction is occurring). However, and arguably most importantly, employment continued to grow steadily and the unemployment rate hit a new cycle low. Automobile sales hit an all-time record. In many ways, 2015 reflected front-end strength (consumer-driven) offset by back-end weakness (industrial-driven).

Macro influences were significant last year and the growth-slowdown-scare permeating from China and other emerging markets was the defining characteristic for 2015. Throughout the year we used the four “C’s” (China, currencies, credit and crude) to highlight the macro-exposed risk factors facing stocks (Chart 4). It certainly felt like each week one of those factors played a defining role in trading.

Oil prices posted some of the fastest declines on record and finished the year well below the great recession levels. The collapse of the commodity complex reverberated through the markets and economies around the world, and despite the many economic benefits of lower commodities, it turned out to be too much of a good thing. Risk and uncertainty took center stage instead of the traditionally positive boost for consumers. The first rate hike in nine years came and went and while sovereign yields ended up not far from their levels to start the year, corporate credit spreads hit multiyear highs (borrowing became more expensive last year). In total, these macro overhangs...
created unprecedented uncertainty and pushed investors to establish a more defensive posture.

It was a busy year (Chart 5) with little to show for the effort. The rise of algorithmic trading models coupled with last year’s many headlines led to some violent market moves. While 2016 is certainly starting off on the wrong foot, we, like Alice, stand ready to see what lies on the other side of the looking glass.

Outlook

The negative performance in 2015, turmoil in China, continued slide in oil prices and a rocky start to 2016 are making investors wonder if this is the end of the nearly seven-year bull market. Market volatility is on the rise just as the Fed is raising interest rates, further increasing the probability of a bear market.

We will start by saying up front that a repeat of 2000 or 2008 is not our base case. More volatility? Sure. Painful pullbacks? Absolutely. Macro instability? You bet. But outright recession or a prolonged bear market? Our models just don’t forecast it. In our view, stocks seem poised for more volatility as they grapple with higher interest rates, questionable growth and uncertainty surrounding the presidential election - but no recessionary-driven bear market.

There are still gains to be had in stocks, it just won’t come easy. Though we currently are at levels few anticipated so early in the year, we do see developed markets grinding higher over the next twelve months. Of course, we will do our best to add some alpha on top of that while seeking to avoid the heaviest downdrafts. If the start of the year is any indication, now is not the time to be overly optimistic. We will continue to use our “quantamental” approach that utilizes a comprehensive analysis of the technical, fundamental and macro landscape to manage positioning. Though this backdrop is anything but conducive to giving forecasts, this is what we currently see when we look through the looking glass.

Regarding the macros, first and foremost a turn of the calendar does not require a change in focus. Or, more specifically, a change in the variables we think are shaping the markets - we continue to focus on the “C’s”. From a big-picture perspective, we do not anticipate any groundbreaking changes in the market’s underlying trends. So, in that sense we expect another similarly volatile year for the macro environment. We believe global growth concerns will persist and deflationary pressures will continue. The best explanation for this increasingly global-deflationary trend is the rising global debt burden (Chart 6).

Total public and private non-financial sector debt was estimated at 265% of GDP for the advanced economies and 167% for emerging markets at the end of 2014. That debt load is now being felt more acutely in the emerging markets. However, we do believe economic activity in the US (and the Eurozone and Japan) will move forward in 2016, but obviously there’s downside risk. Due to its persistent subpar growth rate, this economic recovery is universally considered “disappointing.” However, if the recovery continues until the end of this quarter, it will represent the fourth longest in US history.

There is a genuine fear of a policy mistake by the Fed.
After all, they are set to raise rates four times this year. We doubt they will. Regardless, many believe since the Fed has begun to raise interest rates while most other foreign policy officials remain highly accommodative by lowering interest rates, the US dollar can only rise.

Investors should remember that in contrast to conventional wisdom, the US dollar typically declines after the Fed fund’s interest rate increases (Chart 7). Also, we wouldn’t be surprised to see a global economic bounce that closes the foreign growth gap (relative to the US) - ultimately forcing the US dollar lower. A topping dollar is necessary (in our view) for earnings to grow in 2016. This view is clearly out of favor - bullish sentiment on the US dollar is probably the most crowded trade on the planet, but it represents a potential source of upside.

Of course, the most important currency discussion right now centers on China. Quite simply, it’s a mess over there. Years of growth has led to overinvestment and high debt levels which are now being worked down. In the midst of an economic slowdown, China has undertaken large-scale reform of its monetary system by liberalizing interest rates, relaxing capital controls and free-floating the exchange rate. As they look to revive exports, they have devalued their currency. This, in turn, has led to closed markets, capital controls and imprisoned executives (those who wanted to sell). So much for capitalism.

Anyway, here is what is important: over the last decade, China’s share of global growth has risen from 13% to 29% - the world’s largest. But China only accounts for about 13% of US GDP and around 3% of the combined profits of the S&P 500. Remember, the world’s second-largest economy is in the middle of its long-sought transition away from investment and manufacturing toward consumption and services. We expect the change to be volatile. In sum, at least as it relates to China, we are in the “bumpy slowdown but not global depression-inducing” camp.

The fundamentals underpinning the market are mixed and we expect them to stay that way. Again, 2015 is expected to be the first time since 2008 that company earnings contracted. The strong dollar and commodity collapse are responsible for the majority of that decline, but even demand trends are shaky. The industrial complex is much weaker than the consumer or service-exposed portions of the market but there is fear the weakness will spread. We do expect growth this year but
recognize it will be back-end loaded.

To us, valuations are neither excessive (trading at 15x forward estimates is not egregious, particularly in light of the low interest rate and inflation backdrop) nor overly supportive. While the recent selloff has made several companies and sub-industries look attractive, we are sticking with the higher quality issues in the technology, healthcare and financial sectors for now (these are our slight sector overweights).

Credit is front and center for us. The 300 basis point surge in high-yield spreads since last May has many investors dusting off the credit crisis playbook of 2008. We think it’s way too early to make that analogy. Most of the pain is felt within the energy patch and corporate balance sheets remain quite strong. The credit market remains open for business (2016 is off to the best start ever). Though the US economy is probably not as strong as the 5% unemployment rate is telling us, it’s likely not as weak as credit spreads are suggesting either. Also, there are several examples of equity market rallies that lasted far beyond high-yield tights; in 1997 for example, spreads began to widen and the equity market still rallied until March of 2000.

Oil prices will play a major role this year – quite possibly the defining role. The 75% selloff in crude affected everything from input costs (good) to credit (bad). We see 2016 as an evolution of the quest to restore balance in the wake of overcapacity, uncertain demand and strong dollar headwinds. We think the widening gap between production and capacity should close this year (Chart 8). We aren’t crude bulls just yet, but think the rebalancing process is well underway.

The bottom line on fundamentals is: expect more of the same. If a recession is coming, it will be the most widely anticipated economic downturn of all time. Contrary to most outlooks, we believe the risks for a downside shock and an upside surprise are roughly equal. We place the highest odds on a continuation of the less-than-stellar economic expansion we have been experiencing for the last few years yielding earnings growth that surprises investors to the upside. Since 1960, after every “flat” year for the S&P 500, like 2015, it has rallied between +11% and +34% the following year with +17% on average (there have been seven such instances since 1970). So even though the market is off to a rocky start this year, if earnings increase in 2016, the S&P 500 is also likely to increase.

The technicals are the discipline that will need to see the most healing, especially given the start of this year. We expect it will take time. After going four years without a 10% correction, we have had two in six months, clouding the short-term technical picture and pressuring long-term trends. Market breadth has deteriorated with the market depending increasingly on a few large stocks (in 2015, 301 S&P 500 issues were down 10% or more and 175 stocks were down 20%). Breadth needs to improve soon or our long-term signals will quickly turn negative.

Faltering uptrends after multi-year advances, widening group dispersion, and narrowing participation are reflective of a tired market. Key to our technical outlook is the long-term trend we believe is still within the constructs of a multi-year bull market. The 2015-2016 range would mark a normal consolidation within that trend should key levels hold (Chart 9). However, should
they crack with further deterioration in our disciplines, we will follow our models and disengage.

Currently, the litany of pessimism is probably the greatest technical positive. Extreme investor bullishness, which often coincides with market tops, is certainly not present. In fact, bearish sentiment is at extremes. Therefore, our conclusion from the rather convoluted technical picture is that, while we cannot forecast a bear market with any confidence, the weight of evidence suggests that the risks are high enough to take seriously. Short-term trends are currently negative (nearly oversold) while longer-term trends are trying to hold support.

There will be other factors affecting performance this year. ISIS and terrorist threats are real, but we believe the main market-relevant geopolitical risk over the next twelve months is the deterioration of economic and political fundamentals in emerging markets (social costs are rising - we are keeping a watchful eye on Saudi Arabia). Our own presidential election will surely play a role but we have long felt that the impact of American politics has been massively overstated by investors over the past three years (the economy has continued to grow and the market has reached new highs despite Washington’s best efforts). We will have more to say on this as November approaches.

We believe it is prudent for investors to prepare for a structurally higher volatility environment and importantly, higher market tail risk. 2015 perplexed some of the best Wall Street minds and we expect more of the same in 2016.

Just as Alice wondered what the world was like on the other side of that mirror, investors are left wondering what lies on the other side of the first rate hike in almost a decade, collapsing commodity markets and volatile global growth. We will endeavor to stay nimble and quick as the backdrop warrants decisive action. Our views on investment strategy will continue to evolve during the year in response to shifts in asset prices and the various market indicators and models that we follow.

Growing principal while adhering to prudent capital preservation remains at the forefront of our strategies. Given the volatile and ever-changing backdrop, we believe a strategy that combines disciplined fundamental, technical, and macro analysis has the best chance to generate superior risk-adjusted returns.

We are happy to share our thoughts in greater detail, and welcome any questions or comments you may have. Thank you for your continued support.