Market Commentary - February 2016

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CLEARVIEW WEALTH SOLUTIONS

Volatility Has Returned

Hold on to your hats! Volatility was the order of the day in January. The first 12 trading days of the new year saw the broad market averages decline about 9% while the remainder of January showed a 4% rise (7% above the January 20 intraday low). Will the volatility continue? We believe elevated price action will remain for the next several months. There are many factors spooking investors and some are likely to persist further into the year (see our January 20 Market Commentary).

Does the aforementioned spike in prices since January 20 mean the correction is over? Not necessarily. A few market developments give us pause. For example: established bear markets often see sharp, violent counter trend moves upward similar to last week. And three out of the four leading sectors during last week's surge were telecom, utilities, and consumer staples–hardly what you would expect in a bull market rally.

The damage done to stocks has already been significant. The average stock is in bear market territory–down 23% from its April 2015 peak even though the S&P 500 stock index is down only 9% during the same time period (sources: *Value Line, Merrill Lynch, Bloomberg*).
Why not step aside until the market looks healthy again? We have stated many times that market timing doesn't work and that staying fully invested maximizes returns over a cycle. Here is more proof: The Hulbert Financial Digest, a well-respected firm that surveys and tracks market advisors, recently published this study in *Barron's*. Here is what they found:

- Less than 25% of market timers had higher stock exposure on March 9, 2009, (the bottom) than on October 9, 2007 (the top). This shows that most timers are bearish when they should be bullish, and vice versa.
- Only 6% of timers called **both** the 2007 top and 2009 bottom. This shows that even if you make the correct call to get out, it is difficult to know when to get back in.
- Fewer than half of successful timers in 2007-2009 were also successful in 2000-2002. The few lucky timers weren't able to repeat their success.

Market timing may seem appealing during a period like early January when stocks seemed to cascade lower every day, but timing the market has an extremely low likelihood of beating a fully invested strategy over time.

Rate Normalization Frays Investors' Nerves

In late December, the Federal Reserve increased short-term interest rates from near zero to .25 percent. This widely anticipated move had been advertised as the first of many small rate hikes that will eventually normalize rates (or restore interest rates to a level more consistent with the past). The rate hike occurred after nearly a decade of historically low rates the result of quantitative easing (QE) introduced to offset the effects of the great recession. QE is an unusual method of increasing liquidity as it uses high quality bond buying in lieu of rate declines. It has been used extensively of late in the U.S., Japan and Europe.

While the rate hike had been telegraphed by Fed officials and was widely expected by all, anticipation of a rate rise has not stopped or even limited the stormy reaction from market participants in its aftermath. The fact that investors have become jittery few would now argue. And growing negative sentiment could become a problem if it were to spread.

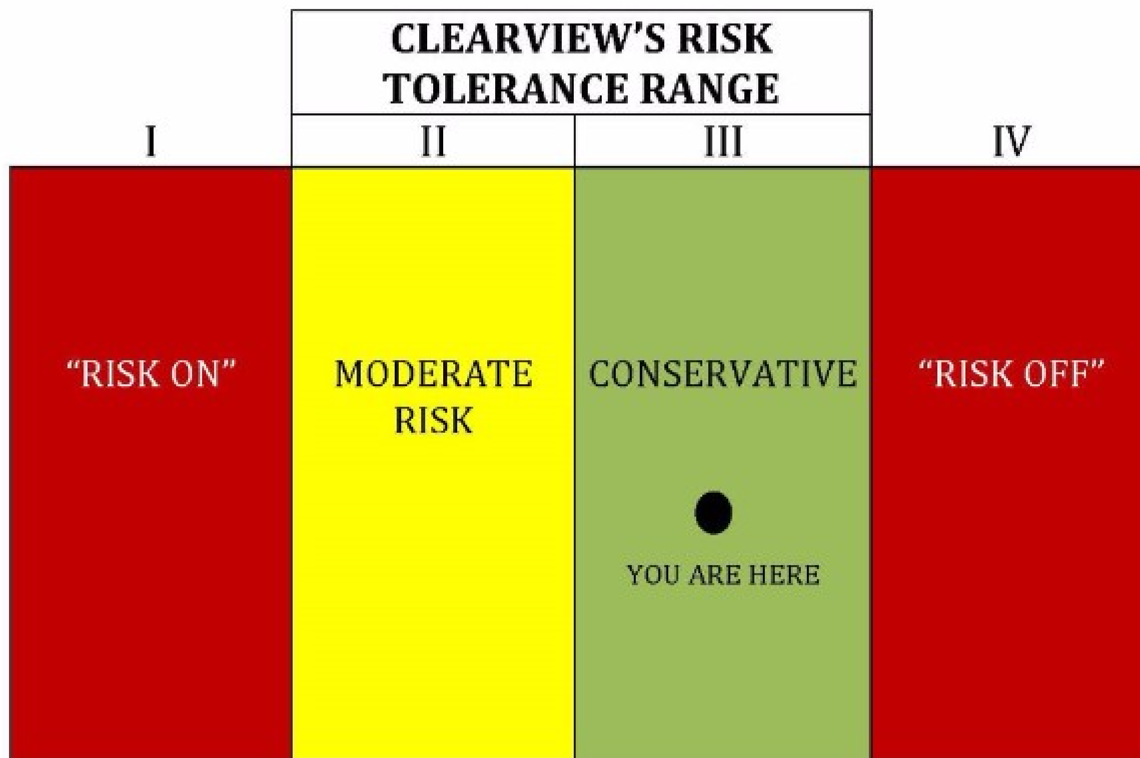
Last month we published a piece entitled **"China, Oil and the Fed"** to describe how these three factors were responsible for the meaningful decline in 2016 markets. We would argue that much of the damage done by these factors has been the result of anticipated rate normalization. For example, the abundance of liquidity over the past decade has allowed emerging market countries (both sovereigns and corporations) to raise debt to fund an enormous commodity/materials/energy infrastructure build the likes of which we have not seen before.

These infrastructure assets are now operational and contributing to the overabundance of oil, iron ore, steel and literally everything else that emerging markets countries provide; further aggravating an already stressed commodities market. The tapering of QE (about 14% of it runs off this year alone by our estimates) along with rising rates is causing a "taper tantrum" among anxious emerging market investors who now question if these entities will be able to service their debt loads. And if the Fed stays the course with rate hikes going forward investor sentiment may grow worse, further stressing these countries and contributing to additional market corrections and the possibility of defaults.

While temporarily on hold, Fed policy makers seem resolved to continue with rate normalization and investors are feeling vulnerable. They had developed a reliance on QE to drive investment prices higher even embracing high risk assets such as high yield bonds. Will the Fed reverse course and return to QE or other forms of easing to prop up the markets and end the tantrums? Only time will tell but it now appears that the commodity super cycle has ended. High debt levels and falling commodity prices may create deflationary pressures. Finally, the recent decline in U.S. high yield (energy related) bonds, in sympathy with the emerging markets, would suggest that the U.S. may have rolled-over into a credit downturn.

You have probably heard the phrases "risk on" and "risk off." These all in or all out positions are often applied to traders. Long term investors buy to hold and stay fully invested. We manage

portfolios between these two extreme positions. When we are more cautious in our outlook (like now), we manage portfolios in the more conservative mode (III) and are overweight in consumer staples and health care stocks. When the market cycle is young and valuations are low, we will overweight technology, industrials, and consumer discretionary stocks. This represents II on our diagram (see below).



DEFINITIONS:

RISK ON: engaging in speculative behavior under the guise that the risk/reward equation is skewed towards the higher risk/higher short-term returns.

RISK OFF: embracing a decidedly defensive series of investments believing that the risks of significant short term loss far outweigh the potential rewards.

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