Market Perspectives | A Glance at How the World Affects You

Eyes on Washington; Volatility Ahead

March 6, 2017

When economic data is good and consumer confidence reaches its highest level since 2001, U.S. equities have momentum on their side. Last week the S&P 500 Index climbed 0.7% as the ISM non-manufacturing index showed that business activity and employment trends are improving. As the economy improves, the Federal Reserve will likely move interest rates higher later this month. Investors are cheering this environment but we believe equity markets have gotten ahead of themselves.

When things get overly optimistic, we turn to a number of technical indicators which help us monitor and better understand the strengths and weaknesses in the stock market. At this point, positives outweigh negatives, however, you should not construe this as a forecast of things to come for stock prices. Instead, it is simply our way of saying that we interpret these signals as increasing near-term enthusiasm. For example, stock based exchange traded funds have seen increasing inflows. This may imply broad support for stocks among institutions, retirement planners, wealth managers and retail investors. Another example is the 20-day simple moving average of the S&P 500 shifting up and away from the 50-day. Breadth across the broad market has reached healthy levels that argue in favor of more upside.

Another useful indicator is the Exposure Index (EI) published by the National Association of Active Investment Managers (NAAIM). Considered a "sentiment" indicator, it quantifies how professionals have deployed their assets. The idea behind this indicator is identifying extreme bullishness or bearishness. When indicators such as this reach extreme levels, contrarians anticipate the next move to be in the opposite direction. Currently, the Exposure Index is elevated and leaves us with the question, have we reached a price top?

In our opinion, no one really knows if we are witnessing a market top. So, how should we interpret the recent period of high readings as measured by the Exposure Index? In short, we believe the evidence favors more upside for stock prices with bouts of selling along the way. The S&P 500 is trading well above its 200-day moving average and conditions of this nature generally resolve to the downside. These conditions suggest the possibility of some corrective selling or consolidating in the short-term. Nevertheless, we are in a strong bullish trend that appears to be well anchored based on improving economic data, for example, corporate earnings.

Our interpretation of technical indicators is not limited to a view of eternal optimism. In fact, we are acutely aware of how fast and far stocks have moved since the U.S. election last November. Indeed, any deterioration in the percentage of stocks trading above their support lines would create some concern. Our long-term indicator, which looks at stocks trading above their 200-day moving average, is currently 83.60% (source: StockCharts). In contrast, intermediate-term indicators are not strong, but they are not deteriorating, either. We are cautiously optimistic and expect moderately positive U.S. equity returns in 2017, joined by increased volatility.

No matter how you slice it, a pattern of low volatility, low correlations and moderate dispersion in the world's major equity markets has been a continuing theme since emerging late last year. February's daily volatility of the S&P 500 was the second lowest since the 2008 financial crisis, while average stock-to-stock correlation was below any other monthly reading since the turn of the century. Similar extreme lows in correlation and volatility may be observed in the S&P Global 1200 and its other regional sub-indices for Europe, the U.K. and Australia. Clearly, we have a trading environment of bullishness behavior, but is this a sustainable trend?

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It is plausible that stock prices have been rallying on political expectations, along with improving corporate earnings. Investors are relying on President Trump and Congress to implement tax reform, fiscal spending and regulatory changes that will boost growth. However, there may be too much confidence in a political fix. President Trump's legislative agenda will likely take longer than expected and that unknown could bring disappointment. For example, the repeal of Obamacare seems imminent. Infrastructure spending, on the other hand, and historically speaking, is a slow process that may not come to fruition in 2017. President Trump delivered a poignant speech last week on prioritizing his agenda and provided a lucid view of how he will get it done. As a result, investors cheered last Wednesday morning as major indexes advanced to new records.

Without question, equity markets are moving higher on expectations for economic growth and progress in Washington. Said another way, the rally appears dependent on assumptions of political actions. Conversely, bond yields rose quickly following the election but retreated in recent weeks. The current landscape of stocks going up, bonds yields vacillating and the new administration in Washington D.C., brings out optimism and conflict among leaders and followers. Many are calling this a conundrum, which creates more confusion and consternation among investors, and frankly, the American public. Nevertheless, what we are dealing with is not enigmatic, but the forces are very unbalanced; high United States' debt, low Gross Domestic Product (GDP), trade imbalances, and the list goes on. Exacerbating these issues are extreme levels of unfunded liabilities which are mostly ignored or misunderstood, conditions that happened over many years of intemperate spending, which created the appearance of prosperity and good fortune. Perhaps today, a disillusioned America may be recognizing the need to fix some of these problematic issues.

Challenges abound along with opportunities. With this in mind, investors are asking "how are you (OmniStar) managing portfolios and strategies?" First, we expect equity prices and bond yields to grind unevenly higher over the coming months, which supports our belief that equities will continue to outperform bonds and cash. Government bond yields should continue to produce rising economic improvements, thus placing bond prices and bond proxies at risk. Moreover, very low short-term interest rates mean cash will provide little return. Our expectation is that economic growth and corporate earnings will continue to improve, providing the needed confidence to stay fully invested. Furthermore, we continue to believe U.S. stocks are better positioned than most non-U.S. markets. Looking ahead, emerging markets appear to offer better long-term growth and international equities, in general, appear more attractively valued. Eventually, market leadership will shift and foreign investments will have their day. Until then, U.S. stocks should continue benefiting from stronger growth tailwinds.

Bottom Line: Making changes is never easy and human nature tends to fight the unfamiliar. Still, we believe the economy is poised for more acceleration while the Federal Reserve remains accommodative with a slow and steady tightening of monetary policy. Consumer spending and business investment are also rising, which should be a positive for near-term economic growth. Nevertheless, the pace at which equities have been growing will be next nearly impossible to maintain. Therefore, we think some kind of pullback, consolidation or correction is looming in the shorter term.

Conditions remain supportive for risk, though risk management is the key. The global economic expansion is halfway through its eighth year, providing a supportive backdrop for equities. In our opinion, the Trump administration's pro-growth plan for deregulation and tax reform could help unleash confidence and a greater willingness to invest. This in turn could result in increased differentiation across sectors and individual companies. We think approaches that go beyond "beta" or broad market exposure are worth the consideration of investors who seek to blunt the effects of market volatility.