Insights: May 2015

Market Overview and Performance

For the most part, the month of April was a plodding month with stocks gradually moving upward in the same "treadmill market" pattern that has been in place since the start of the year. The S&P 500 Index even quietly marked a new all time high on April 27th. However, on the morning of May 1st, following a sharp sell-off on the very last day of the month, investors woke up to headlines like those of the Wall Street Journal proclaiming, "May Day! May Day!" It seems curious that this would be the case given that U.S. stocks were actually higher in the month, non-U.S. stocks were solidly positive and volatility in general was on the decline. However, the real reason these attention grabbing sound-bites should have been published on May 1st was not because of the gyrations of varied index levels, but rather, due to the fact that a number of consensus positions reversed in April - most notably, the U.S. dollar weakened, commodity (oil) prices moved higher and global bond yields increased. Whether these trends will continue remains to be seen.

On another note, May also brings some important milestones for Litvak & Co. May 5th marked the one year anniversary of our firm and we sincerely thank all of our clients for your continued support. Additionally, our new blog, "Bread & Circus" is now live on our webpage. We encourage you to visit the Insights section of our site where articles influencing our current thinking will be posted on the blog frequently. As always, thank you for reading our monthly Insights.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	0.85	1.29
Russell 2000 Index	-2.55	1.65
MSCI EAFE Index	**4.08**	**9.16**
MSCI Emerging Markets Index	**7.69**	**10.10**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.36	1.24
Barclay's U.S. Credit Index	-0.59	1.30
Barclay's Corporate High Yield Index	0.66	3.76
Barclay's Municipal Bond Index	-0.52	0.48
Macro Measures		
Gold	-0.07	-0.14
Crude Oil	**25.27**	**11.94**
CBOE Volatility Index	-4.84	**-24.22**
USD Dollar Index	3.29	4.91

April Themes – Month of May not the Time to Sell, Earnings Better than Expected, Consensus Positioning Reverses: Weak U.S. Dollar, Commodities and Bond Yields Higher, Inflation on the Rise

Seasonality and Earnings

As we said at the open, from a numbers perspectives, April was a decent month for investors with large cap U.S. equities moving roughly one percent higher and bonds ending relatively flat. This pattern echoes the market behavior we have witnessed throughout 2015. The S&P 500 Index is up 1.29 percent over the first four months of the year and the Barclay's U.S. Aggregate Bond Index has returned 1.24 percent over the same period - uninspiring, but positive nonetheless. This is why some refer to it as a "treadmill market" – you are making progress and doing something positive, but you don't feel like you are getting anywhere. According to Bespoke Investment Group, the April 30th S&P 500 close was also the same close as April 17th, March 30th, February 12th and December 24th. However as we noted earlier, volatility at the very end of the month began to rattle some widely held beliefs about where one should be invested at the moment.

S&P 500 Index in April – Trend Higher Until the End

Source: Thomson One; S&P Dow Jones

Focusing for now on just stock market behavior, one cannot be questioned for suggesting that the sell-off at the end of the month could perhaps be attributed to profit taking and re-positioning as we head into the seasonal pattern commonly referred to as "Sell in May and Go Away". The adage is based on roughly 100 years of historical data which suggest that the summer period is typically a weaker one for stocks. A few things are worth pointing out. As Navellier & Associates and others have noted, historical returns in the summer months are not negative they are simply more muted. Additionally, according to work done by Barclay's Capital, years in which "Sell in May" has worked are typically distinguished by two factors: first, it has been preceded by negative returns in the winter months; and second, economic data has only started to soften as the month of May begins.

Importantly, these conditions are not in place today nor have they existed for the last two summers. As the table below illustrates, in 2013 and 2014 the May through October period returns have actually been ***higher*** than the November through April period; and in fact, this tendency has only been accentuated in the technology sector, an area which we currently view as attractive.

"Sell In May" Has not Worked For the Last Two Years

Six Months Ending	S&P 500	NASDAQ
October 31, 2013	+9.95%	17.75%
April 30, 2014	+7.25%	+4.97%
October 31, 2014	+7.12%	12.55%
April 30, 2015	+3.34%	+6.71%

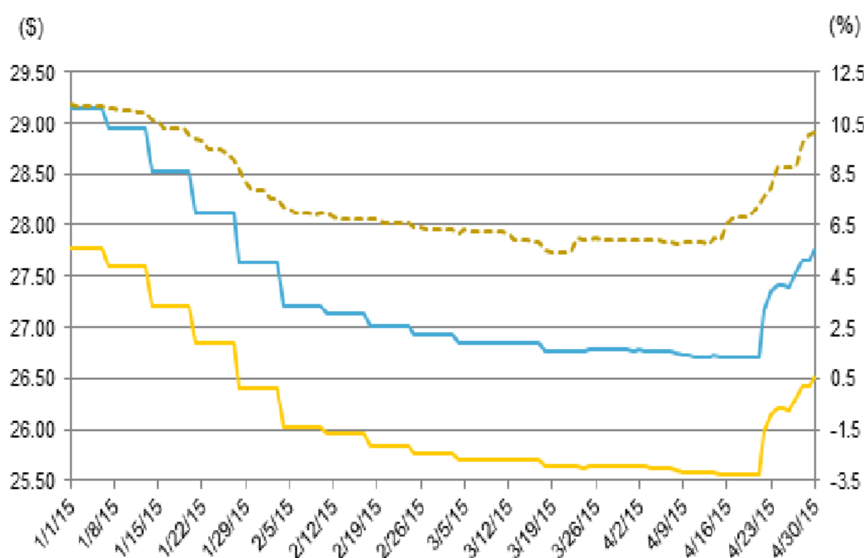
Source: Navellier &Associates

So if seasonal patterns are not to blame for the selling pressure late in the month, what was? One obvious answer in April of any year would be disappointing earnings reports from the first quarter.

As we indicated in earlier Insights, coming into this reporting season we believed that that the downward revisions to estimates were largely overdone. This in fact proved to be the case as 71 percent of companies beat their earnings targets and 46 percent beat their revenue estimates according to Factset Research Systems. In fact, not only have results beat expectations, but what was once thought to be the first negative growth quarter since Q3 2012, managed to produce positive results. The actual reported growth level moved from an anticipated -3.3 percent to a positive 0.6 percent according to S&P Capital IQ. Furthermore, if you strip away the drag attributed to the energy sector, first quarter growth would have been a very robust 10.1 percent!

Q1 Earnings Growth Turns from Negative to Positive

Earnings per share (left axis) — First-quarter year-over-year growth (right axis) — First-quarter growth excluding energy (right axis)



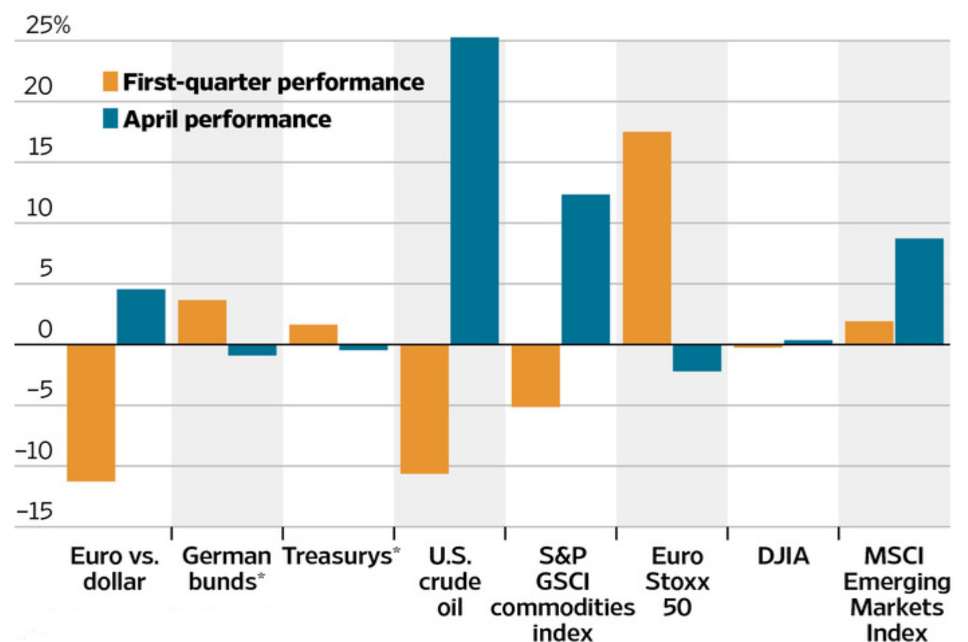
Source: S&P Capital IQ

Consensus Positioning Reverses and No Longer Just in Equities

So if stock market trading patterns seem solid and earnings came in much better than expected and returns were positive for the month, why did so many investors come away from the month with the feeling that all is not well? Of course, there is more than one answer to that question - which we will discuss -but much of the reasoning can be explained by looking at the following chart.

Without even looking at the labels, it is clear that the directional trend of year to date performance (orange bars) have by and large completely reversed in April (blue bars.)

Q1 Trends Reverse Across Asset Classes in April



Source: Wall Street Journal

The real significant change this month is that this reversal was across asset classes. In last month's Insight we discussed how stocks outside the U.S. were performing better than their U.S. counterparts and the reasoning behind those moves. In April however, the real foundation of positioning coming into the year – a strong dollar and weak commodities in particular – were flipped on their head; even interest rates on bonds went up across the globe. While these shifts might have proved surprising, they can perhaps be dismissed as part of the ebb and flow of markets. The real reason April left such a bad taste in the mouth of many investors is because there was no clearly identifiable trigger for these pivots. This observation is disconcerting to many.

The real catalyst for the combined moves is likely a confluence of things, but the point we would like to emphasize is that nothing has fundamentally changed in the global economic narrative, and the bulk of the reversals can be explained in fundamental terms.

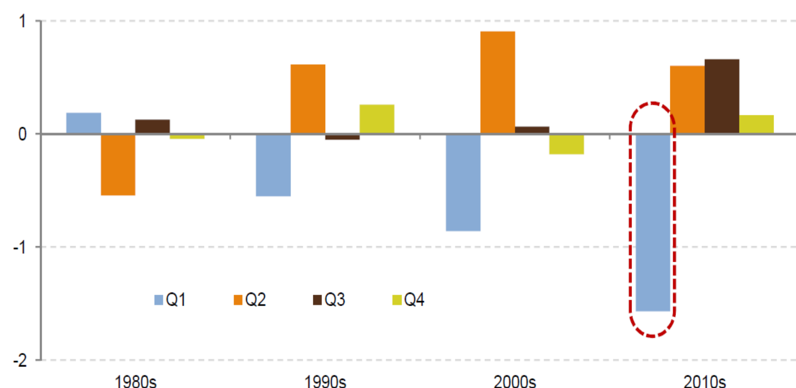
The point being, that whether the assets revert back to the longer term trend lines or not, a rapid shift away from very crowded trade positions creates discomfort. As always we prefer to be on the lookout for things that actually do represent fundamental change and therefore opportunity.

Inflation and Oil

Given the amount of movement across asset classes that we have witnessed, perhaps the one thread that most easily ties the shifting currents together is inflation expectations. This is the one area where there has been some change in the storyline. Several things happened this month that caused this change.

April started and ended with disappointing economic data (employment report of 126,000 jobs versus 248,000 expected and Q1 GDP of just 0.2% versus 1.0%) that perhaps gave pause to the notion that the U.S. was steadily on the path to a strong recovery. Somewhat troubling, the ISM manufacturing index also failed to produce an anticipated bounce from a lower reading in March, perhaps indicating a slowdown in economic activity. While the GDP number in particular was surprising, temporary factors such as a severe winter and a port closure on the West Coast were at play. Additionally, as the chart below from J.P. Morgan Asset Management illustrates, weak first quarter readings are not at all unusual.

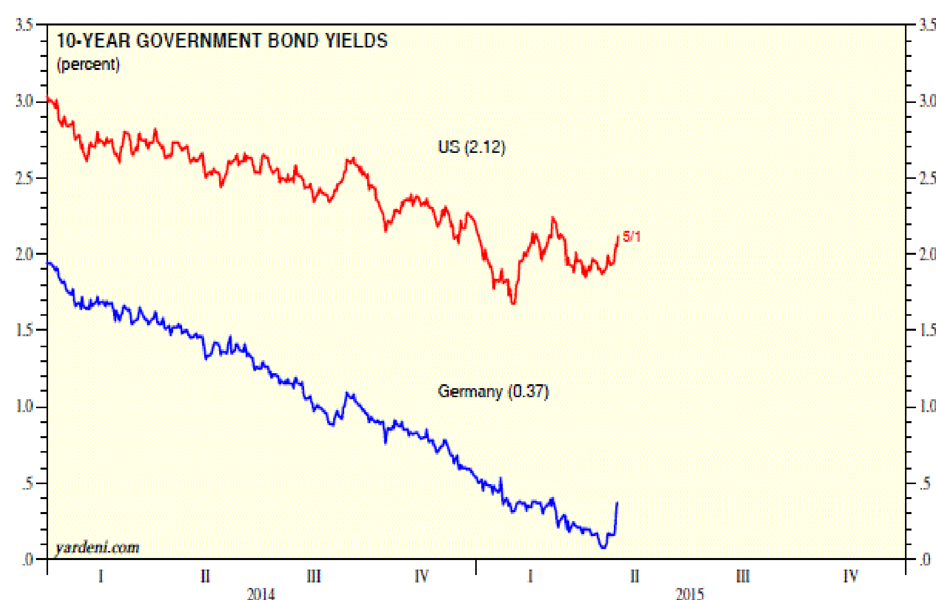
Weak Q1 GDP Numbers Have Become More Common



Source: J.P. Morgan Asset Management

In a soft economic data environment one might expect investors to flee to the perceived safety of bonds. But that didn't happen this time. Instead, bonds were sold aggressively on a global basis, driving yields higher. This was a global phenomenon as highlighted in the chart below showing the move in the U.S. 10 Year Bond and the German Bund. The move was sharp. In fact, the yield on the German Bund moved from an incredibly low .03 percent on April 17th to .37 percent on the last day of the month.

Sharp Reversal in Global Bond Yields in April



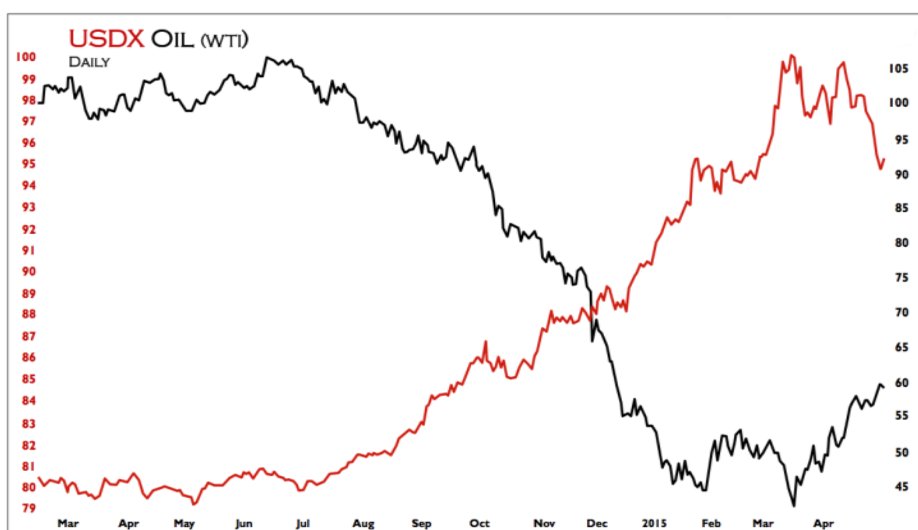
Source: www.yardeni.com

Outwardly, this seems surprising and unwarranted. However in hindsight, it appears that global yields simply fell to an unnaturally low level at the start of the year based on the concern that the precipitous fall in the price of oil would spur deflation especially in Europe.

What actually occurred was the uninspiring economic data coming out of the U.S. had the follow-on effect of creating uncertainty around the timing of a Fed rate hike. If the U.S. economy was indeed slowing, it seems unlikely that Fed would raise rates in June and perhaps not even in September either. This belief allowed for a back-up in the dollar which had been on a relentless tear higher since the middle part of last year. There is no reason to believe that the dollar will not remain strong throughout the rest of this year.

But as we have discussed in earlier Insights, long dollar positions had risen to an extreme level, so some retracement is not unexpected. What happens when the dollar moves lower? Commodity prices move higher as seen in the chart below from Market Anthropology.

Sharp Reversal in Global Bond Yields in April



Source: Market Anthropology

The stabilization and subsequent rebound in the price of oil has been both surprising in its robustness (up over 30 percent since late March) and helpful in normalizing yields. With rising commodity prices fears of that deflation scenario have abated and yield levels have conceivably moved away from previous extremes, particularly in the Eurozone where many countries had been experiencing negative yields earlier in the year.

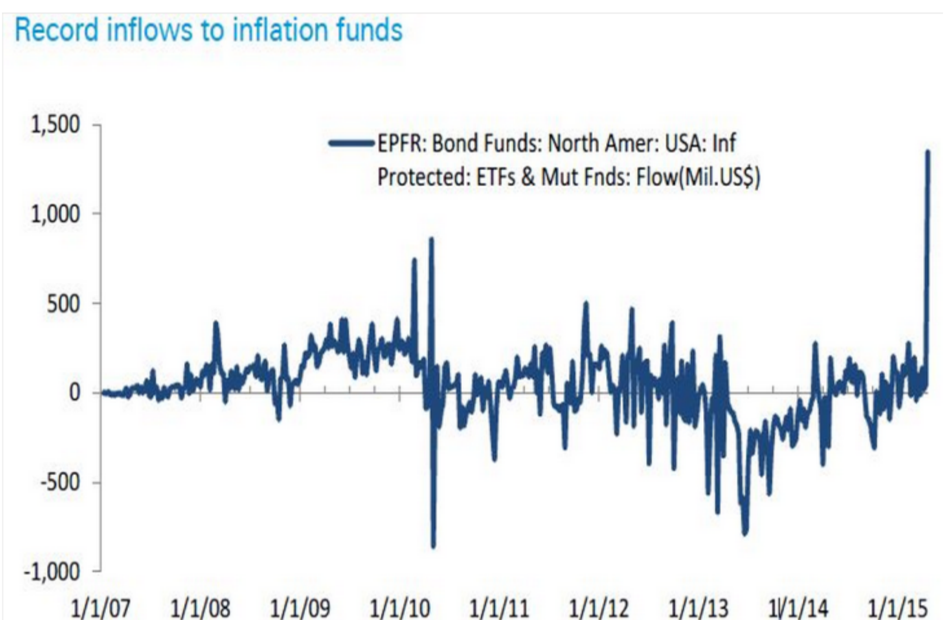
Not only is the fear of deflation waning, but expectations of inflation moving higher are becoming more pronounced both here and abroad. This is a notable change and one that helps complete the picture of what happened this month since higher inflation is bearish for bonds, thus adding fuel to the selling pressure seen in global bond markets.

Inflation Expectations Continue the Move Upward

Source: Charlie Bilello; Bloomberg

In the U.S., inflation expectations continued their march upward as seen in the previous chart, and also highlighted by the fact that a record level of inflows moved into inflation protection funds during the month.

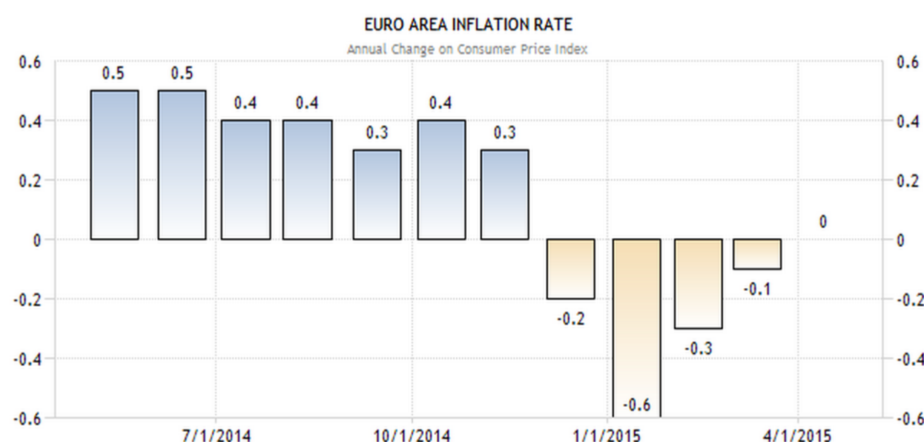
Flows Into Inflation Funds at a Record Level



Source: www.soberlook.com; Duetsche Bank; EPFR

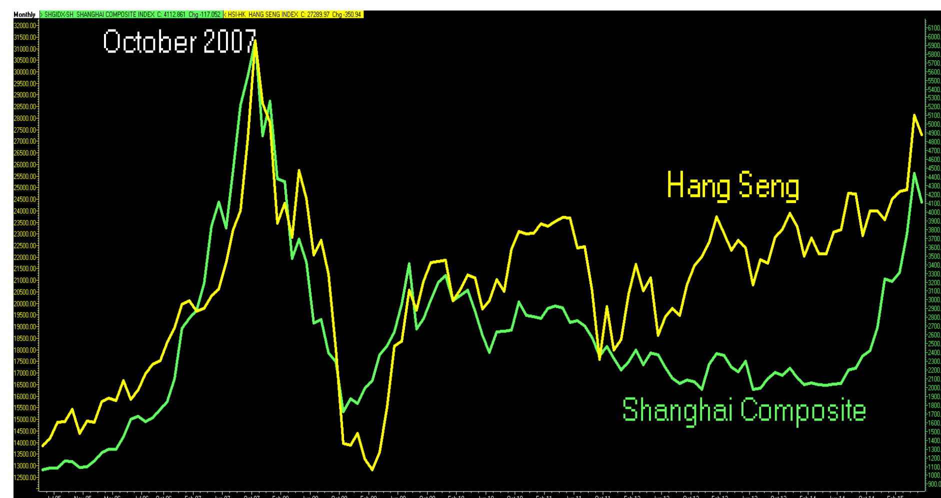
And the inflation story is taking hold in Europe as well, a welcome development for the area challenged by negative rates since the end of last year.

Eurozone Inflation Turning Positive Again



Source: TradingEconomics; EuroStat

Chinese Stocks Looking Vulnerable



Source: Thomson One

The one consequence of all of this that bears watching is emerging markets. The weaker dollar and specter of rising inflation not only allowed the price of oil to float higher, but also other commodities like copper and aluminum rose as well. Emerging markets generally are the beneficiaries of these conditions, and predictably, countries like Russia and Brazil saw returns of over 15 percent during the month. More importantly however, Chinese stocks (traded both locally and in Hong Kong) continued to rip higher despite the fact that economic data seemed to confirm a slowing growth scenario. Stocks are being pumped higher on the basis that the Chinese government will be forced to enact simulative measures, hence the run up in commodities. However as we warned in our blog on April 9th, the 100 percent increase in Chinese stocks since July 2014 is an unsustainable rally built largely on retail investor speculation. Selling did begin at the end of April and if you are hunting for popping bubbles, this is a good place to start.

Going Forward

As we said last month, 2015 has been a wonderful reminder that diversification plays a large role in prudent portfolio management. Monthly returns of 7 percent for emerging markets and 4 percent for developed non-U.S. stocks versus a virtually flat U.S. market emphasize this point.

Within equities we continue to favor the large cap segment of the U.S. market. Of note, small cap stocks fell by -2.5 percent this month while large cap gained 1 percent. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar. We did reduce our exposure in the biotech sector in late March and will continue that process. We are locking in strong gains experienced in the sector and seek to apply those funds to better opportunities elsewhere. A new area of focus for us is the financial sector. We think this group is well positioned to benefit from a weaker dollar, higher bond yields and improving global growth and we will be looking to add to our exposure.

Our non-U.S. developed markets exposure has served us well this year. While we are still believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular will allow us to participate in improving economic conditions globally.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate most likely coming in September, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus.

Although they had a strong month, commodities still face structural headwinds. With the apparent stabilization in the price of oil in the short-term, we are carefully looking at entry points for long-term investments. For oil in particular, at around $65 a barrel, stagnant production in the U.S. will come back online creating downward pressure. On the other hand, we now have U.S. military ships making their presence felt near the Strait of Hormuz as well as on the ground conflicts in Yemen. Negative events in the area could quickly cause the price of oil to spike higher. We continue to cautiously monitor the sector before increasing exposure.

Thank you for taking the time to read some of our thoughts this month. We hope you found our ideas valuable and insightful. We would be happy to discuss any items in greater detail with you in the future.

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