TIME FOR CAUTION IN MARKETS?

The first trading day of 2016 saw a very sharp drop in Chinese equities that served as a major catalyst for lower stock prices in Europe and North America. A sharp one day decline in equities is insufficient cause for me to change my positive longer-term view on US equities. However, a number of factors taken together suggest that the current risk/reward environment for equities is unattractive short term. I think it likely that we will see a pullback in equities in the first half of the year that will produce a buying opportunity later in 2016.

I had written last summer that I expected a traditional pullback in equities in the fall that would produce a buying point. The market subsequently declined and produced a circa 12% rally from the fall low. The rally in US equities was even better for foreign buyers because of the ongoing strength of the US dollar. I also wrote last summer that I believed that the best performing assets over the next five years would be US denominated, particularly equities. I still believe that this will be the case, but suggest that the current situation favours short term caution for the following reasons.

The market breadth of the US market has been narrowing for some time; the market has been propelled by an ever smaller group of large companies such as Amazon and Google. This phenomenon can exist for some time but never ends well. It is far healthier for the market to incur a pullback that produces more attractive valuations to prepare the ground for the next market advance with broader leadership. I believe

leadership narrowed as valuations became stretched in a slowing earnings environment. It is not coincidental that the recent market leaders exhibit very strong growth in revenues and/or earnings.

The chart posted above illustrating volatility in the US equity market (VIX index) demonstrates that the market last exhibited sharply increased volatility in late August in conjunction with the fall pullback. The VIX almost reached 55 at that time while it failed to reach even 25 on January 4th before pulling back. I believe this demonstrates a degree of complacency that needs to be addressed before the market can resume an uptrend. A new buy point will likely be produced when we see a spike in the VIX similar to that of late August, and ideally a multi-day event.

An expectation of lacklustre fourth quarter earnings, which will begin to emerge in the next several weeks, has also contributed to recent market action. Obviously, results below expectations will contribute downward pressure on stock prices. The recent trend in quarterly results suggests that any surprises will likely be unpleasant ones.

The strength of the US dollar has had a negative effect on earnings of American firms operating in foreign jurisdictions. However, my thesis remains that the ongoing attractiveness of the US dollar will prove to be a net positive for US assets through positive capital flows. The global macro situation suggests that the greenback remains the best choice among major currencies.

The Fed decided in December to begin an attempt to raise interest rates to more normal levels. I do not believe rising rates will have a negative effect on equity markets until we see multiple rate increases that clearly establish a trend. The Fed will be very quick to halt and/or reverse its policy on rates on indications of economic weakness.

In conclusion, I believe that current market action, combined with breadth, valuation, and complacency, suggests a correction in the first half of 2016. I continue to believe that US stocks will likely be the best asset class for the balance of the decade, albeit with pullbacks along the way.

By Jonathan Baird CFA

NOTICE AND DISCLAMER: This material is sourced from the Globalinvestmentletter.com website and is subject to the terms of use and privacy policy of that site. The comments are for informational purposes only and represent the opinions of the writer, which can change at any time as additional information becomes available. They do not constitute an offer to buy or sell a security at any price. The information contained is believed to be reliable at time of writing but cannot be guaranteed. No liability is accepted for any loss or damage arising from the use of the material presented.

All rights reserved. This material is strictly for viewing by specified recipients and may not be reproduced, distributed or forwarded in any manner without the permission of the publisher.