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Volatility examined

As the third quarter came to a close, equity markets were a stumble away from panic. Bankruptcy concerns were playing havoc in the commodity space while technicians nervously watched for a Dow sell signal. If the Dow had closed below the August trough of 15666: a blood bath. I wrote that I was comfortable with my equity allocation and would just wait and see, ignoble action possibly resembling chicken excrement. Of course, my reluctance to do anything was a reliable buy signal. Don Hayes, the longstanding strategist at fondly remembered Wheat First Securities, used to say the markets will do whatever they can to confound the most. The rebound this month certainly qualifies. Not only has the market staged a striking rebound, but also sector leadership completely reversed. Energy and commodities – hated a few weeks ago – have led while healthcare has lagged.

The violence of this reversal is impressive but the message isn't especially controversial. It could be the first sign that the global commodity recession is moderating. Emerging-market equities – most geared to the commodity cycle – also have perked up. That isn't a coincidence but it's not confirmation either. Generally speaking, stocks rebound prior to the actual business-cycle nadir. It's not prescience but it can look that way. Simply explained, unrelenting bad news and constant downward pressure eventually exhaust the sellers. The only holders left are value players and the brain-dead. And typically, more blood in the water attracts more short-sellers, crows and vultures – important, but unpleasant, carrion-eaters – betting on continued pain. With no sellers left, a change in the wind can cause a buying panic as short-sellers and intrepid investors compete for scarce shares, forcing prices up. However, if – over the ensuing few months – the news gets worse, the selling will resume and perhaps make a new leg down. Most investment busts involve several legs down interrupted by violent buying panics until the news doesn't get any worse. The last buying panic will look like market prescience but it's really just part of the cycle.

If I had to guess, I'd say that wasn't the last leg down of the commodity bust but that's just a guess. However, in the context of disappointing-but-positive global economic growth, I'm inclined to make a distinction between energy (excluding coal) and industrial commodities. Global energy demand is slowly growing along with the global economy. Where the latter goes, the former reliably follows. However, for some important industrial commodities, the growth paradigm is upended. China represented until very recently as much as 40 percent of total global demand for materials such as copper and concrete. According to a recent op-ed penned by former U.S. Treasury Secretary Larry Summers, China

“poured more concrete between 2010 and 2013 than the U.S. did in the entire 20th century.” That historic investment orgy is over. As Summers says, “A reading of the recent history of investment-driven economies ... tells us that growth does not fall off gently.” Chinese demand won't evaporate but it could decline for years, leaving the globe in an oversupply situation for the foreseeable future. Given the amount of malinvestment and debt employed, I expect the adjustment process to be exceptionally painful and lengthy. And, in my mind, this episode doesn't yet feel exceptional. This analysis may lack thoroughness and it's tainted with bias but I did manage to quote Summers, the brilliant former Treasury secretary.

Dark thoughts for Halloween

Staying in that vein, his Oct. 7 piece, “The Global Economy is in Serious Danger,” left no quarter for happy talk. In the spirit of Halloween, I'll quote again: “The problem of secular stagnation – the inability of the industrial world to grow at satisfactory rates even with loose monetary policies – is growing worse in the wake of problems in most big emerging markets, starting with China,” Summers wrote. He follows with, “This raises the specter of a global vicious cycle in which slow growth in industrial countries hurts emerging markets, thereby slowing Western growth further.”

Summers argues we're in a new “macroeconomic epoc” (secular stagnation) where the propensity to save rises while the propensity to invest and take on risk withers, resulting in exceptionally low rates of interest, both real and nominal. That condition leaves authorities with no conventional tools to confront inevitable problems. And this is where it gets a little scary. Summers believes the only way out of this trap is a debt-financed combination of fiscal expansion and corporate-bond quantitative easing (QE) until growth improves enough to raise rates. Can you imagine fiscal conservatives ever agreeing to this? If that is truly the only remedy, I'm absolutely certain we will have to be on death's door before we take that medicine.

Fortunately, global growth is still positive so this day of reckoning is in the future. However, because growth is slow, margins are very high, valuations are full and rates are already extraordinarily low, I still believe we should expect lower-than-average returns and higher volatility from domestic financial assets. Frankly, I worry that the signal to change course on asset allocation could be dim.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

Strategic Return Portfolio	
Equities	69%
Bonds	13%
Gold	2%
Cash & similar	16%
Total	100%

as of Oct. 28, 2015

Richard, an investment professional with more than two decades of experience, manages Eagle's Strategic Return Portfolio. His views are his own and may not reflect those of other Eagle portfolio managers.