April 15, 2016
First Quarter 2016 Commentary

As 2015 drew to a close, the markets were still recovering from the volatility that was ushered in with the precipitous decline on August 24. The low on the NASDAQ that session was 4292.15. But at the close of the week the composite was up over 544 points near the 5-session high. The next few weeks the index was turned back at the ten-week moving average line and then rallying more than 20% through early December. As the year ended, the markets were in a confirmed uptrend.

That buoyant condition did not last long. On the first trading day of 2016 the markets fell into a correction. The July/August correction sliced nearly 18% off the averages and the December to February decline was slightly worse at -18.7%, just shy of the 20% mark that characterizes a bear market. While there was not a 20% drop, the early 2016 felt worse perhaps because the decline wasn't stopped in short order. No single session seemed to be able to contain the selling. The technical pattern that foreshadowed the decline was a head-and-shoulders pattern. The left shoulder high was 5163.47 on November 4. The head, or middle portion of the pattern, poked just above the left shoulder at 5176.77. The right shoulder began forming on December 14 and finished on December 29 at 5116. What's going on is that the market is trying and failing to make new highs, but stops short three times with the right shoulder topping out below the left. In this classic bearish pattern, when the neckline is broken, which it was decisively on January 4, sellers are in control. That session opened with a gap-down, a lower open than any price in the prior session's range, definitive evidence that trouble lay ahead. And troubling it was until the February 11 low of 4209.76. Going back to the July 2015 high, that was a drop of 19.5%. Many blamed the steep fall in the price of oil which reached a low of $24/bbl. Of course that led to a tremendous selloff in oil-related stocks. Some thought the drop in oil was a consequence of slackening demand which suggested a slowing economy or perhaps a recession. That befuddled many since the Fed had just raised rates for the first time in years, suggesting that the economy was robust.

Market history and metrics served as warnings. In addition to the bearish head-and-shoulders pattern, the put-call volume ratio reached the 1.3 five times between December and mid-February, an indication of heightened fear among investors. A high put-call ratio, is a contrary indicator, signaling an end to the selling. However, this time it was not until the fifth spike in the ratio in mid-February that the selling abated. Often one elevated level is enough but not this time. The NASDAQ put in a low on February 11and followed through on February 15, confirming a new uptrend. Historically, a crack like the 1,000 decline on August 24 takes six months to resolve. By mid-February, investors were rattled and disinclined to believe in a rally. Who could blame them in the wake of the volatility and short/sharp rallies? To say that investors were dispirited would be putting it mildly. However, since the market's job is to confound, which is to say, make them fearful when they should be optimistic and cheerful when they should be afraid, the market had succeeded. Compounding the problem, the NASDAQ had risen 313% over the past six-plus years and established an all-time new high of 5231.94. The timing of the turnabout during the last two sessions of 2015 punctuated by the gap down on January 4, undoubtedly caught investors off guard. Since the February 11 low, the NASDAQ has rallied 15.7% through the end of the quarter. To add to the confusion, in the first quarter, defensive names from the utility, consumer staples, tobacco and food processors led the markets. That's a clear sign that risk is out of favor. The good news is that after more than six months of difficulty, investors have been very slow to push growth names to the fore. Very few real growth companies have outperformed—yet. Many reset their base counts clearing the way for outperformance in the current cycle.

As we head into the second quarter and earnings season, many remain cautious as indicated by the below-average volume on most trading days. Recent comments by prognosticators opine that first quarter earnings will be down as much as 7 ½% and that tech and banks will fare worse. As noted before, markets look ahead, so perhaps the low bar for earnings will create conditions that will make for easy comparisons. Nevertheless, market conditions appear favorable if you set aside the glum outlook offered by economists and strategists. If you have seen the movie version of Michael Lewis' book, The Big Short, you probably remember the quote that accompanies the opening scene picturing a man and his child blithely romping in a field of wild flowers: "It ain't so much what you don't know that gets you into trouble, it's what you know that just ain't so." Yesterday I stumbled across a quotation by Abraham Lincoln which contrasts with the way many on Wall Street think. It says: "I shall try to correct errors when shown to be errors, and I shall adopt views so fast as they shall appear to be true."

Those two quotations highlight another problem the market has been contending with, the Presidential election campaign and especially the attacks on enterprise and capitalism. Many of the candidates claim to know what's best when so much of what they know "just ain't so." Fortunately, this source of uncertainty will likely disappear with the November elections. But well before a single vote is cast, the markets will have moved past the uncertainty. After all, markets showcase every day the success that is capitalism.

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