Navigating A Summer Correction

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All of our portfolios, even those that have shorter time horizons, have allowed for both corrections and bear markets in the calculations that set their strategic benchmarks.

Using our three tactical rules (Don't Fight The Fed, Don't Fight The Trend, and Beware The Crowd At Extremes) to gauge the shorter term outlook supports our decision to raise some cash.

As of Friday, global stocks are down more than 9% from the all-time high they posted in May, and they are now down for the year. Last week, some important technical levels were broken on the S&P 500 and the Dow Jones Industrial Average. The catalyst, as it was in the summers of 2010, 2011, and 2012, when major indices also wiped out their year-to-date gains, appears to be a fear about the sustainability of economic and earnings growth. In the previous cases, fears of a global recession proved unwarranted and stocks resumed their uptrend. We believe this summer will be similar. Thus we do not advocate a strategic change in client portfolios. The price of the higher returns that stocks have delivered over time is the uncertainty of when those returns will come through and the volatility of the journey.

At RiverFront, we have risk management processes to help us navigate volatility, and those processes have been active in the last two months in response to both our fundamental views and a breakdown in price momentum. Starting in early July, we reduced our already low exposure to the energy sector as oil prices fell below $50 per barrel. Two weeks ago, we reduced exposure to emerging Asia. In both cases, we re-invested the proceeds. Also in July, we reduced our exposure to short duration high-yield bonds and moved to a cash equivalent. Last week, we reduced overall stock exposure — we now have between 7–11% cash/cash equivalents; the shorter time-frame portfolios have the highest allocations.

To put this in context, we have gone from a long-held position of being tactically overweight our strategic benchmarks to being much more neutral. Please recognize that all of our portfolios, even those that have shorter time horizons, have allowed for both corrections and bear markets in the calculations that set their strategic benchmarks.

The catalyst for the sell-off in stocks and the rally in bonds appears to be fears surrounding decelerating economic growth, with these fears fueled by weak data coming out of China and the mixed data coming out of the United States, Europe, and Japan. However, as with the US in the early stages of economic recovery, the earnings from Europe and Japan have been encouraging, in our view, despite the mixed economic data. It is in the US that the dollar's strength has hurt earnings. We think it is wrong to believe that the global bull market in stocks might be ending, and that weaker data will likely prolong the cycle of easy money and lead to a slower, longer economic cycle. Following weaker data such as we have seen, we would expect to see policymakers respond. The Fed will likely be at pains to say that it will only raise rates in response to better growth. With no inflationary pressures, the Europeans and Japanese could easily accelerate their bond-buying programs, and China has already responded. As we wrote last week, China's move to loosen its currency's peg to the dollar is recognition that it needs a more aggressive monetary policy than the US.

Finally, we believe the fall in oil prices is good news for consumers and businesses outside the oil industry, and that it has been driven more by the increase in supply than by a fall-off in demand. We expect oil prices to stay lower for longer, and to find a sustainable trading range where supply and demand come into balance. Up until now, consumers have mostly been saving the benefits of cheaper fuel, but we believe they will spend more as the low prices are no longer viewed as temporary. Supply-driven oil price declines have historically been a good thing and have not been the precursor of recessions.

Using our three tactical rules to gauge the shorter term outlook supports our decision to raise some cash, in our view. **Don't Fight The Fed** — central banks, as we have said, are promoters of global growth, especially those in the major economies outside the US. The Fed has taken great pains to say that its goal is to encourage continued improvement in the US economy and labor market. Thus, this rule is emphatically encouraging investors to remain invested. **Don't Fight The Trend,** and **Beware The Crowd At Extremes** — these rules suggest that the correction may last a while longer. The primary trend (we like to use the one-year moving average) for the US and overseas developed markets is best described as flat, and those markets broke down through the trend decisively last week. Emerging markets broke down through major support levels and are firmly in a downtrend. We have no exposure to emerging markets in our more conservative portfolios, and we have less than two percentage points in our other portfolios following last week's sales. Finally, weekly crowd sentiment, as measured by Ned Davis Research, is not yet at a pessimistic extreme (top chart), though daily sentiment (bottom chart), which responds to market moves more quickly, is now at levels that have produced a bounce.

THE WEEKLY CHART: SENTIMENT SUGGESTS CORRECTION NOT QUITE OVER