Daniel Wildermuth's
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March Moves Mostly Sideways Driven by Good and Bad News

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In March, the S&P 500 has managed to eek out gains after a rough start, leaving the index up more than 12 % on the year. Recent gains put the broader markets in about the same place as they were in mid-July last year.

During the past few weeks, sharp short-term sell-offs threatened to break recent upward momentum. Yet, serious losses have never materialized, and recoveries have consistently clawed back most or all of temporary declines. While this equity market bears little resemblance to the incredibly calm and near perfect run-up of 2017, recent trading patterns and investor behavior seem a bit more normal. Both good and bad news is impacting markets as investors seek to extrapolate recent events into longer-term trends. Bottom line, this market looks a lot more normal.

Many factors seem to be balancing optimism and pessimism, with nearly all good news having an opposing dark side. The U.S. economy continues to look solid, but growth is slowing with GDP forecasts dropping below 2% for the year. Consumer confidence, key to ongoing U.S. strength, remains solid, but has dropped significantly from last October's post-recession peak. Similarly, consumers describing business conditions as "good" fell in March, and the perception that jobs are plentiful is also dropping. Spending on services slowed sharply in fourth quarter, and employees added a very disappointing 20,000 jobs in February, down from 311,000 the previous month. Very simply, nearly every growth, expectation, perception, projection, or activity data point measured across businesses and consumers continues to soften, pointing to moderating economic growth.

More recently, during the last week of March, the yield curve inverted as the yield on the 10-year government bond dropped below the yield of the 3-month treasury bill. Initially, markets predictively dropped as some believe this event portends a near-term recession, but since data supporting this theory tends to be fairly sketchy, and little evidence exists predicting a near-term recession, the market's quick recovery seems appropriate. Investors appear to be intelligently interpreting the event as another cautionary issue likely indicating only slowing growth rather than a clear sign of major problems.

Hopes of a China-US trade deal have also lifted stocks recently as investors are assuming some sort of deal will be reached. China has been driven to the negotiating table by a fairly severe slowdown in their economy led by a more than 20% drop in exports, largely resulting from recent U.S. trade pressure.

Optimism about a trade agreement is helping to offset concerns about global growth. Germany's Markit manufacturing index fell to its lowest level since July 2012. France's manufacturing and services data also fell sharply. Italy is already in its second quarter of a recession. In early March, the European Central Bank (ECB) cut its 2019 growth forecast from 1.7% to 1.1%, and also dropped its 2019 inflation forecast from 1.6% to 1.2%. While ECB representatives sought to assure the press that borrowing conditions remain favorable, their comments were really meant to mask the lack of demand for credit and the ECB's shrinking ability to spur growth. The bad data from key eurozone economies combined with the dovish tone of a concerned U.S. Federal Reserve indicate growing U.S. and eurozone angst about conditions outside of the U.S.

In this environment, an area of opportunity could be emerging markets. Since the financial meltdown, emerging markets in

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general have lagged U.S. markets substantially, rising by only about a third as much. Yet, despite the last decade's poor performance, emerging markets have still outperformed U.S. markets over longer timeframes. Various indicators suggest that emerging markets might be poised to once again outperform the U.S. Valuations appear more attractive by many measures despite growth expectations that are roughly double those of the U.S.

Mispricing of risk also appears to be rampant. As an example, the differences in yields between emerging market and developed country high yield debt (higher risk debt) assumes that default rates and inflation in emerging market countries are much higher than in the U.S. Yet, this is simply untrue, and emerging market debt prices seem to clearly indicate a misallocation of capital. The same pattern likely exists within equity markets suggesting that emerging market securities offer better opportunity than U.S. markets.

Trading strategies may also help investors. Over the past decade, markets have been buoyed by floods of money pouring into low cost exchange traded funds (ETFs) that blindly track indexes. The phenomenon has been accused of creating a bubble, because passive investing pays no attention to the intrinsic value of a company but simply invests in companies according to their weights in an index.

One particularly cautionary voice is Ned Davis Research, the Florida-based investment advisory firm. They claim, "We are in the last phases of a passive index bubble. I think over the next five years there will be great opportunity for active managers to outperform passive managers." Davis notes that passive investing's indiscriminate purchasing of securities distorts prices as it mandates buying more of what has gone up and less of companies that have short-term underperformance. Notably, growth stocks have outperformed value stocks over the last decade, which is extremely uncommon historically. Simply, the approach seems completely contrary to buying low and selling high.

Concerns abound that passive investing could backfire when investors inevitably all run for the exits simultaneously during a downturn. Since the growth of indexing is relatively new and its large presence has not previously existed during a bear market, no one knows what its impact will be during a down market. However, last year's market pullbacks provided a possible preview when problems with some of the market's high fliers such as Apple and Amazon, which had recently helped drive the market up during good times also disproportionately drove indices down when their prices plunged on perceived problems.

If these pundits are correct, a portfolio less exposed to indices through passive ETFs may be able to better weather future storms. Notably, a 2018 Blackrock questionnaire (Truths and the Future of Active Equity Investing) of 225 institutional managers across the globe found that these sophisticated investors were increasingly allocating their equity holdings to active management with those devoting 70% of the assets to active management rising from 28% five years ago to 33% today and projected to increase to 44% over the next five years.

With markets appearing to have factored in much good news and becoming increasingly concerned about potential growth challenges, we believe markets still offer an attractive opportunity, but we also believe that investors can benefit from seeking out specific opportunities, possibly in emerging markets, while also employing optimum investment approaches wherever possible.

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