Election 2016: Year End Setup

As we approach the election and markets are finally pricing in a little bit of anxiety around the outcome, should investors batten down the hatches for more potential downside or use the opportunity to take advantage of lower prices?

The first thing that I like to do is assess whether or not the correction and sell off is driven by growth concerns or if it is driven by some other factor. The reason I do this is that a growth concern is one that can be sharp, painful, and in some instances become self-fulfilling and turn into an outright bear market. If the selloff is driven by some other factor than it should be viewed as a potential buying opportunity.

The first thing to look for is how safe haven assets are performing. If growth is a concern then safety assets would be expected to do well. Here I will use the yield on the 10yr treasury as a proxy for safe haven assets. As you can see by the following chart, in January and June we had yields fall significantly, which in turn means that prices rose. Each of these downturns in yields coincided with a market correction that was predicated around potential growth concerns. The January fall was based on the potential for low oil prices driving the United States into a recession. Conversely, the June selloff was around the “Brexit” vote causing the UK and potentially Europe to enter a recession. As you can see in the chart, yields have been rising pretty significantly as we enter this most recent market pull back. While this is only one indicator, and the markets can change quickly, it currently is pointing towards election concerns and not growth concerns being the driver of the market downturn.

Source: Bloomberg, LP

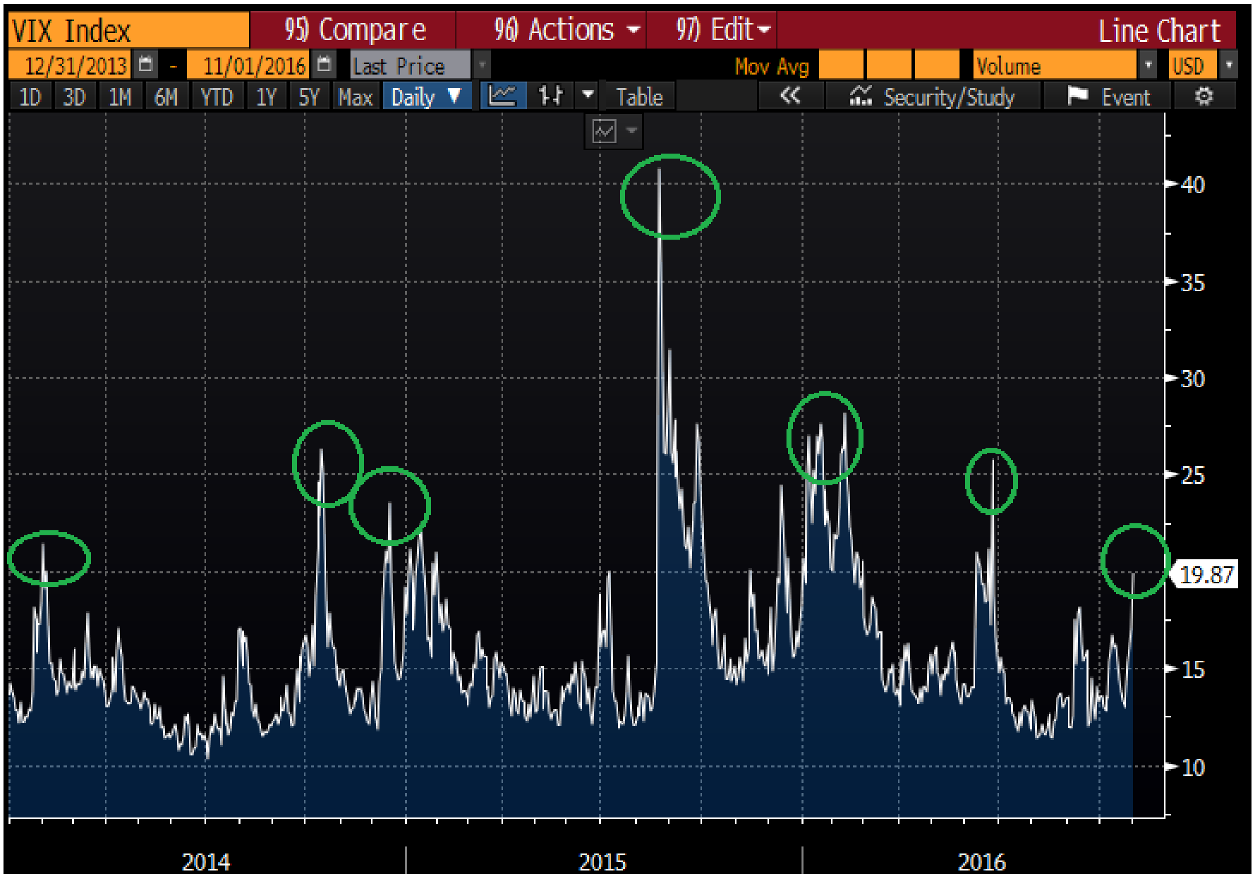
Another source of concern for future growth would be the shape of the yield curve. The below chart uses the 2yr vs. 10yr treasury spread to illustrate the shape of the curve. There had been a lot of talk this year about the flattening of the yield curve and how this was forecasting slower growth and a future recession. The interesting thing is that while the curve is flatter than it was to begin the year, we are actually seeing steepening for the last few months. I would take this as further evidence the credit markets are telling us that forward economic growth is not the cause of the selloff, but rather the election uncertainty is.

Source: Bloomberg, LP

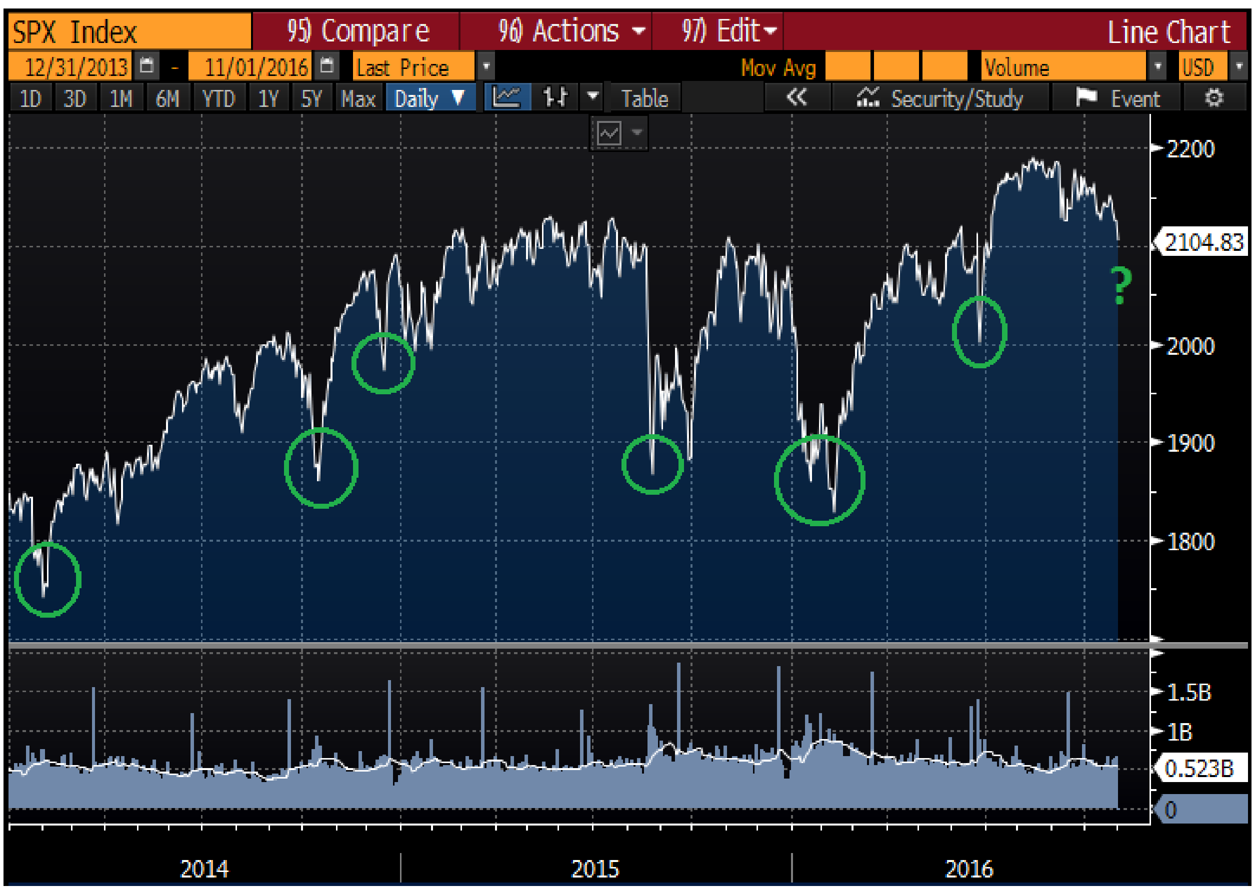
Next I take a look and see how the market is positioned from a sentiment standpoint. The idea behind this is to try and see how people are positioned and extrapolate where the surprise risk is. In this instance I will look at two different indicators. The first of which is the AAII US Investor Sentiment reading which should be viewed as a contrarian indicator. In other words, if everyone is bullish then it would take a lot of upside surprise to make them more bullish. Alternatively, if there is not a lot of bullish sentiment, then even less bad news should make them put money to work and thus could move the market higher. As you can see in the following chart, this is not an outright “buy” signal which I would characterize as a reading at 20 or below, but it is very close and could hit there as soon as this week before the election.

Source: Bloomberg, LP

Next I want to take a look at volatility as another contrarian indicator. The tricky part with volatility is that it can move rather quickly. Additionally, even if you have a hard and set rule, like buying when it spikes over 20, there are many instances when it continues to move higher and the market selloff accelerates. Instead, I like to use this indicator in conjunction with other indicators in order to find opportunities. In the following charts, I chose 6 instances since 2014 when volatility spiked over 20 and the corresponding S&P 500 chart of those 6 instances. As you can see, these spikes in volatility have tended to be good buying opportunities in the past.



Source: Bloomberg, LP



Source: Bloomberg, LP

In summary, the concerns of the market have coincided with the increased uncertainty of the upcoming election and the additional FBI probe into Hillary Clinton emails and not the current expectations of future growth. With sentiment near lows, volatility approaching the panic area, and safe assets not pointing to an imminent growth scare I think it is time to get the shopping list ready. Within the next week I expect that we will see the market find a bottom and begin to move higher into yearend as the now highly contested election is in the rear view mirror.

If you have any questions, do not hesitate to contact me at 908-376-3041.

Sincerely,

Mark R. Painter, CFA

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