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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Disconnected – adjective 2. Not coherent; seemingly irrational: a disconnected argument. This seems to sum up the last several weeks in the market. On Wednesday of last week, S&P 500 touched 1825, it had fallen 9% from its high of 2010 on Sept. 19th. It all seemed to be about Europe. European stock markets where declining and even Germany was showing signs of an economic slowdown. The markets started to panic. Meanwhile, somebody forgot to tell the European bond markets all was not well.

The first sign of trouble usually shows up in the debt markets. Investors start demanding higher interest rates from debtors they believe are less credit worthy. In the case of Europe; Italy, Portugal, and Spain are considered the weak nations. A few years ago investors were starting to speculate these countries might even default. A year ago, the five year bonds of Italy, Portugal, and Spain where at 2.991%, 5.482% and 3.19% respectively. At the height of the recent selloff last Wednesday, these three countries had five year bond yields of 1.13%, 1.94%, and .91%. These are hardly yields that show any economic stress, and they had barely moved off their recent lows. It seemed apparent that the markets had become very disconnected. We now know, at least for the moment, it was stock investors who were wrong.

Since 1980, there have been at least one 5% market correction in every year but one, and that was 1995. In that same period, the market advanced by 11% per year. The challenging part is that the best days tend to be very close to the worst days. This is why market timing is nearly impossible. In the depths of the Wednesday selloff, the 10 year Treasury bond paid 1.85%, and they were considered a safe investment. Well, it only took two days to lose an entire year's interest. Since the bond was back to a yield of 2.2% by Friday, that increase in yield is all it takes for the bond to decline in value by 1.8% which wipes out one year's interest. So much for safe.

It is understandable why volatility rose somewhat suddenly when you consider that nobody wants to give back the gains that have been made in the last few years - especially when the worst recession in fifty years is a recent memory. However, price alone really means nothing, it has to be taken in context with everything else. Low interest rates and low inflation do justify higher prices. Falling oil prices do stimulate the economy. Earnings of $120 means that at the low on Wednesday, we were back to the long-term trend of 15 for a P/E valuation. Fortunately, Europe represents a small part of S&P 500 sales, however, the risk is contagion. Europe has been struggling for years, so there is nothing that suggests now is the time for us to worry about Europe.

It is in our nature to try and predict the future, and we tend to focus on data that supports our view. In the world of instant news, there is never a shortage of opinions. But if you could pick only one data point to watch that would predict if the market is in real trouble, pick the yields of Italian, Spanish, and Portuguese five year debt. If these rates widen significantly then we have a major problem to contend with. Central banks have little resources left to bail a sinking ship. Fortunately, the skies are clear on the horizon. Just remember that there is never just one canary in the mine, and if you believe that, you probably shouldn't be investing.