



“May You Live in Interesting Times”

SYNOPSIS

- Everyday investors are panicking over this most recent wave of volatility, but professional investors seem to be remaining calm for the time being.
- Three key indicators tell us a lot about the mindset of professional investors, which matters because of their dominance in the U.S. equity market.
- The market appears as if it may remain decoupled from fundamentals for the time being, but that in of itself will not shift the direction of the U.S. economy.



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Interesting Times Indeed

The title above is reputed to be a legendary Chinese curse, and it is often used in English-speaking countries during times of disorder and despair. Despite the intended irony of using a Chinese proverb during a period when China is to blame for much investor angst, it's safe to say that everyday investors certainly feel like they are living in “interesting times.”

The real question is if the institutional investors feel the same. The U.S. stock market is dominated by institutional investors, such as banks, insurance companies, and endowments, which consist of professional investors with long time horizons.

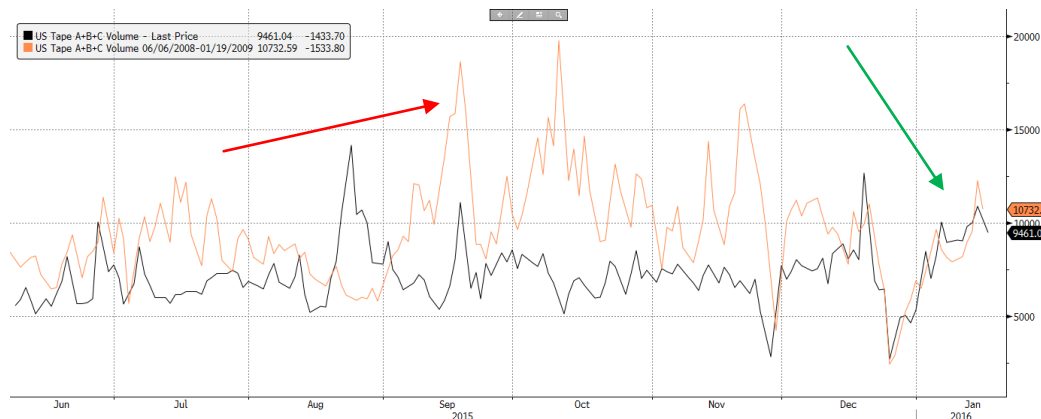
If this cohort is scared, running to cash, liquidating holdings, and engaging in other acts of panic, then their force is almost always felt because they control the majority of market movements.

Hence, during “interesting times,” I often check three indicators that have proven to be reliable gauges of professional investor sentiment: (1) trading volumes, (2) the VIX, and (3) the yield curve.

NOTE: *These indicators by no means give any insight into the future direction of the stock market. They simply shed light into the activity and behavior of professionals as a whole. Hence, I use them as a way to get a sense of which way they are leaning, and nothing more.*

Let's walk through each to explain why I do not believe that professionals are signaling that they are ready to throw in the towel or expect a recession in the next several months.

The chart below shows the total daily trading volume on US exchanges over two time periods.



Source: Bloomberg, Aviance Capital Management analysis

The black line is the total daily volume from June 2015 to Jan 2016, and the orange line is from June 2008 to Jan 2009. During times of panic, academic studies confirm that volumes tend to spike dramatically because large blocks of stock are frantically traded.

For example, the red arrow indicates the point when the financial crisis really exploded. Trading volume quadrupled in one month, and professional investors are the only ones that can cause this level of activity in our stock market.

The green arrow points to present day, and the volume level does not indicate any significant rise. Hence, it leads me to believe that professionals have not started to panic sell just yet.

The second indicator is The Volatility Index (VIX), which is computed by the Chicago Board of Options Exchange (CBOE). This gauge is the de facto standard for measuring and tracking volatility, and many consider it to be the “fear gauge” for stocks.

The index tracks a specific tool that professional investors use to protect against the downside. A higher value indicates more use of this tool due to fear of near-term market weakness.

VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets.

The VIX hit an all-time high of 89 during the peak of the financial crisis. Currently, the VIX is elevated but still below 30 and less than a third of its rise back in October 2008. Therefore, the VIX’s recent rise does not indicate rampant fear just yet.

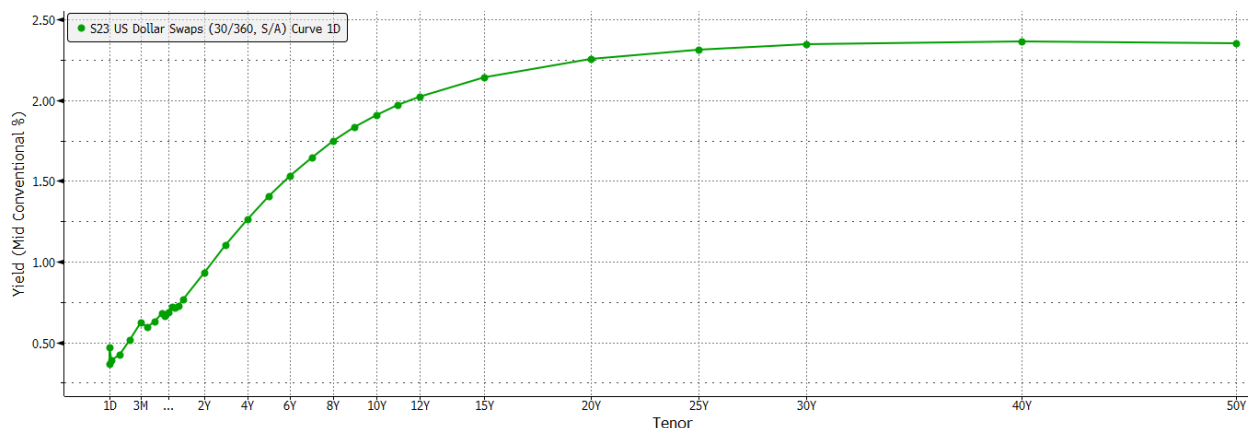
The third indicator involves the yield curve and is one of the most reliable and accurate gauges of not only professional investor sentiment but also their view of the future direction of the U.S. economy.

The yield curve is a plot of current interest rates on specific government bonds, ranging from 0 – 30 years. In a normal economic environment, this curve slopes upward



because investors typically demand more return from bonds that have longer investment time periods.

For example, the yield of a 2-year government bond should be lower than a 30-year bond because any rational investor should demand more return for locking up her principal for longer. The chart below shows the current yield curve for the U.S., which indicates this very relationship.



Source: Bloomberg, Aviance Capital Management analysis

Since economies tend to grow more frequently than shrink, an upward sloping curve is normal and indicates that professional investors believe that a recession does not seem probable in the near future.

However, there are times when the yield curve becomes inverted and slopes downward, and this rare event has predicted every recession over the last several decades. The reason the curve inverts has to do with professional investors flocking to the safety of longer term bonds.

NOTE: A detailed discussion of the yield curve is beyond the scope of this conversation, but the mechanics of this indicator are incredibly important to global finance and have been studied extensively for decades.

The chart below shows the slope of the yield curve over time and the accuracy of an inverted yield curve calling past recessions.



Source: Bloomberg, Aviance Capital Analysis

When the yield curve inverts, the black line drops below zero, which is indicated by the red horizontal line. The shaded regions represent each U.S. economic recession since 1977. Notice how the shaded regions appear shortly after each time the slope of the yield curve falls below zero.

Currently, the black line is far away from becoming inverted, which leads me to believe that the professionals do not expect a recession in the near future.

Simply put, if professional investors were truly worried, I would expect to see trading volume and the VIX significantly higher and a flat to inverted yield curve.

Implications for Investors

The S&P 500 has been in a “drawdown,” which is failing to recover from a drop of over 10% from a previous high, for the last eight months. Although this reality may sound frightening, since 1928, stocks have been in a 10% drawdown 55% of the time!

It would be logical to assume that since these are the norm, we should be used to them by now. The reason why drawdowns never seem to feel any better is because of the fear that one could lead to the start of a bear market.

There is no question that our economy currently faces real economic headwinds. However, the reason why we continue to grow at a slow and steady pace is because the economic tailwinds are stronger and will last longer than headwinds.

In the short-term, the stock market will most likely continue to be dominated by the price of oil. The correlation of the oil price to the stock market has been elevated for some time (the actual value exceeds 0.40 for those skilled in statistical analysis).

Meaning, if oil is up one day, then the market rises, and when oil drops, equities get whacked. I don't see this pattern changing anytime soon. Stock prices have completely decoupled from fundamentals, but this is not the first time it's happened, and I am supremely confident that it won't be the last.



The bottom line is that stock prices don't always behave rationally, but it's interesting to note that the professional investors are remaining calm. For now, it's best to do the same.



Sincerely,

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