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Market Outlook:

Poised...but which way?

The employment and consumer spending data that the Federal Reserve says it uses to determine future interest rate policy is recovering so well, in all industries except for oil, that the FOMC interest rate committee last week deemed it probable that we will see an interest rate hike before the end of the year. Although the energy space had accounted for a significant portion of jobs created early during the recovery, its current demise has been more than offset by jobs increases in healthcare, manufacturing and technology.

The one sticking point that might delay/prevent immediate monetary action is the unfortunate market deceleration (crash) in China. Paper losses in Chinese companies and their resultant influences abroad are in the billions of dollars. Continued financial disruption in the globe's second largest economy will surely have policymakers second-guessing about any net pain that might be inflicted worldwide.

But here at home, there is a strong shift from defensive investing towards accelerating trends in cyclical businesses, financials, industrials, and technology shares. An interest rate rise seems already to have been factored into our thinking and trading patterns.

My biggest concern, at present, is that investor's expectations have become highly unrealistic because of the massive returns generated in the course of the current bull recovery. We have become so accustomed to seeing consistent increases in our monthly account statements (as if they were passbook saving accounts) that when an inevitable cyclical market correction occurs, we act "shocked", "panicked", or "angry".

The truth is that we have been peaking in equity valuations for the past 7 months, traversing a zigzag pattern around a very inflexible upside resistance point, roughly 2100 on the S&P. Despite a steady drumbeat of "new highs", each one of those has been swiftly offset by inter-day lows or selloffs that net zero sum return. Patterns which used to take weeks are now transpiring over days with great regularity. Obviously, the key to market performance in the long-term is to be allocated into sectors with high probability of earnings acceleration, and to underweight exposure to those sectors and stocks with negative trends.

Although that sounds simple, and highly logical, it is not how most retail investment portfolios look. Typically, one finds portfolios constructed of one-off ideas, and highly concentrated in one sector that might happen to hold their attention. Failure to diversify risk exacerbates the probability of something going wrong, and exaggerating emotional stress levels in the process.

Multiple choice

Even the most well balanced portfolios suffer setbacks during volatile times like this because of the staccato-like pace of peaks and troughs. Our numbers indicate that we are close to exhausting the dramatic bottom-left to top-right configuration of the current uptrend, and settling more into a short range trend of lateral consolidation. That does not imply that I think a "crash" is imminent. To the contrary, as we reboot valuation expectations for the next quarter, the probabilities of sector shifts and price acceleration in specific sectors heightens. But the laggards are more likely to recede at the same time. That bears careful responsibility to watch out for any "accidents" or slips.

Any analysis is subject to healthy caveats, but those equities that indicate the highest probability of earnings acceleration and stochastic (relative strength) durability are likely to continue to offer capital gains opportunity despite the macro overlay or current events.

We will caution, however, that earnings patterns *across the board* are likely not to increase at the same pace as in the past five years. **Corporations have mostly consolidated or merged, laid off employees, manipulated their accounting practices, or bought back sufficient quantities of their outstanding shares that their growth now depends upon good old-fashioned consumer demand for revenue and sales increases**. Examples of such shift include biotech and biopharmaceuticals, alternative energy, investment banking, industrial machinery, and computer technology. Those who have built, or are in the process of building, a better mousetrap will flourish. We are now at the cusp of an important inflection point in our analysis. *Demand-driven success* is the art of bringing customers into the store and having them leave happy, with a new purchase under their arm.

Be forewarned: the next decade in the stock market will not look like the go-go past half-decade.

But you already knew that, right?