

Market Outlook:

High hopes

Last week's basket of data was full of clues about the future of the financial markets. We observe, for example, that the hangover effect of the long-running stock price expansion was dramatically harmed by a slowdown in the rate of acceleration of earnings reported during the December period. This created uncertainty and the biggest decline in equities for any December in almost a century. The uncertainty might have continued into the new year, but valuations were just too compelling not to be a motivating factor for January's (also) historic rise. My concern is that expectations are once more becoming unrealistic, setting the stage for these disequilibrium events to become commonplace.

It goes without saying that since the US S&P hit its all-time high in October of last year, global and domestic markets have been in a disappointing correction. The question has shifted from "*how long can the markets sustain an intermediate upside advance?*" to "*for how long and to what magnitude will the contraction last?*" Clearly, the veneer of confidence has been pierced.

Metaphysical certitude is never achievable, so the next best thing is to refer to a process of execution disciplines from which to divine the appropriate answers. And even there we have no guarantees. You know the old joke: if you gather 9 economists in one room, you walk away with 10 different opinions!!

Perhaps the best way to attack this analysis is to look at what is happening around the kitchen table....

Even though employment numbers are improving, discretionary spending and household savings rates are advancing less robustly. Historically, full employment emboldens the consumer and corporations to spend more money. But in today's instance inventories are flat, savings are low, and liquidity, where it exists, is being hoarded. The rise in interest rates during the past year has added a marginal burden to those who borrow, affecting the potential of future corporate and personal capital expenditures. In other words, there exists a threat to earnings patterns which could slowly slip into the performance of consumer and financial markets later this year.

Strangely, the consumer has not even been the primary engine of this latest economic expansion. Since the Great Recession(2008), a significant portion of the recovery in the economy had been artificially manufactured in the accounting departments of corporations and financial institutions: stock buybacks, balance sheet manipulation, personnel layoffs, cessation of hiring and research. The retail investor had been tapped out and exhausted long before the rally even began. To this day, a great debate rages about whether or not corporate emoluments have served the best interest of the economy.

Given that we have achieved over eight years of tangible recovery, we must thus look at the recent past few months of economic and market activity as the "right hand side of the parabola", an extension of a market capitulation that I predicted months ago.

Going forward, I would expect the financial markets to take on a more "technical" staccato orientation, yielding to short-term profit taking when valuations rise too quickly, and using declining profit or price projections as an opportunity to buy recognizable names at discounted valuations. The Fed has already eliminated its impact upon interest rates with a declaration of patience for the foreseeable future, so our focus now turns to inventory expansion and production numbers which, thus far, have been non-compelling.

While fundamental analysts tend to see things as either black or white, supported by data or not, quantitative strategists always refer to things in a *relative context*. That is, data is merely a snapshot of events in transition, up or down. I look at numbers in directional frames of reference, not as an absolute performance integer. So, a "quant" would say that when events are getting bad, they one day must get "better". Similarly, as things reach an apex of performance they must ultimately recede. Shocking, I know. But that is how statisticians think.

I remain fully invested, within the range of risk tolerance our clients prefer. The news is benign, if not lukewarm. The Fed has done its job for now. As evidenced by the mighty swings in market valuation between December and January, a "strategy" of trying to time the market (selling when it goes down, buying back in as it goes up) is futile. An important question remains whether corporations will step up and address issues beyond merely returning earnings to their stakeholders, and take aim at doing good for the long-term. In spite of record market highs, there still remains a gap in the breadth and diversity of successes at all strata of the populace.

Before we place an unconditional bet on this market, that there are no lingering doubts about the upside sustainability of stocks going forward, I would have to see greater confirmation that the "relative strength" integers of the current cycle have receded enough to make the probabilities of advance nearly certain. Until then, we proceed with caution.

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