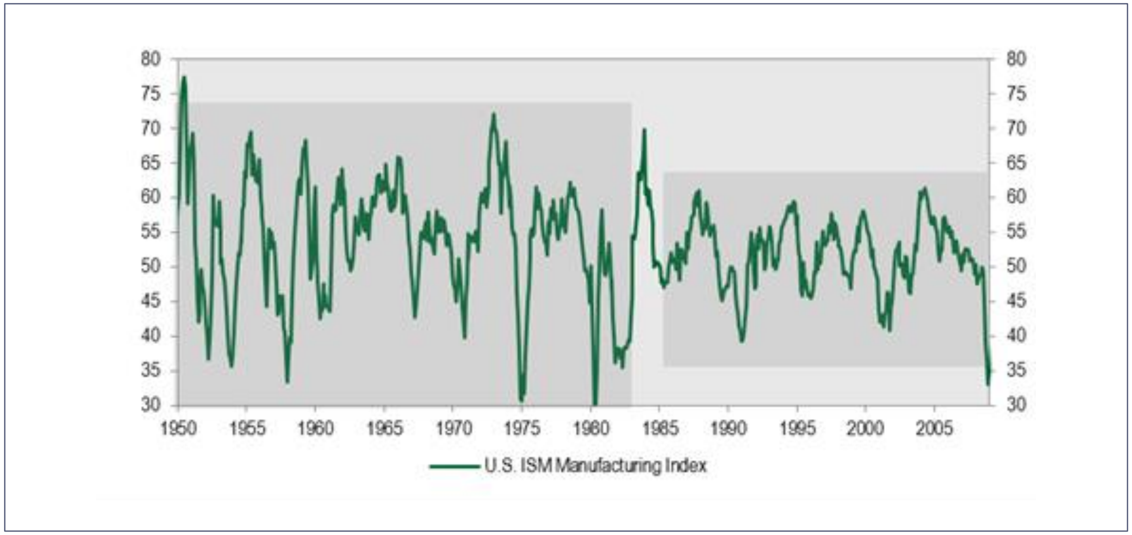
Market Recap

Unwind of 'Great Moderation' is Causing Market Cycles to Shorten



Source: Cornerstone Macro

Mega-Cap, Mega-Profits

Source: JP Morgan

'The Great Moderation' refers to the 30-year period between 1985 and 2005 marked by changes in the composition of the economy, alongside financial innovation, fewer worldwide economic 'shocks', and more effective and transparent monetary policy, all of which combined to increase visibility into markets and shape the investor mindset. During this time, company fundamentals and earnings drove investment decisions. In recent years, however, increased uncertainty and reduced visibility has impacted the way investors interpret macro news and pick stocks, leading markets to trade more on sentiment. Now, P/E's, rather than earnings, are driving price movement. At the same time, stock correlations have risen significantly, causing market returns to be driven predominantly by macro news and trends rather than by company fundamentals. These two factors have combined to increase volatility and shorten the market cycle.

Corporate profit margins have continued to rise since the financial crisis, and now stand above their long-term average (around 6%). Historically speaking, profit margins have reverted to their average over time as competition, rising interest rates, and higher labor costs gradually eat into profits during the latter stages of a bull market. Today, however, higher margins may be sustainable due to a structural shift in the S&P 500. The so-called "mega-cap" stocks (the ~50 companies with a market capitalization exceeding $100 billion) have distanced themselves from smaller rivals due to superior economies of scale and greater exposure to overseas markets (not only increasing their addressable market, but also allowing them to shift operations to low-cost countries). Another factor buoying the mega cap cohort is a growing weight towards the technology sector, which tends to have relatively lower overhead costs leading to higher margins.

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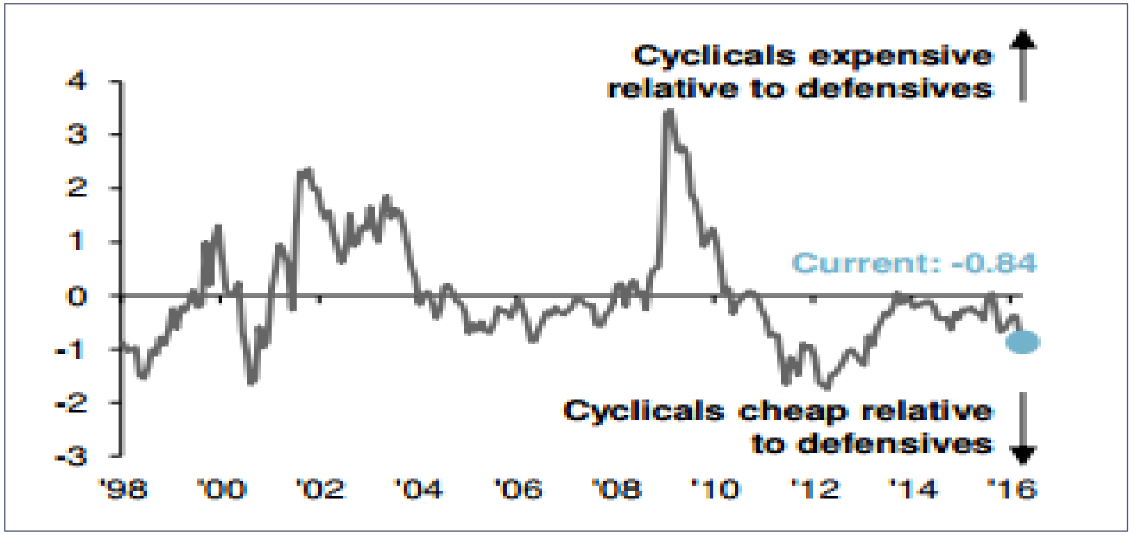
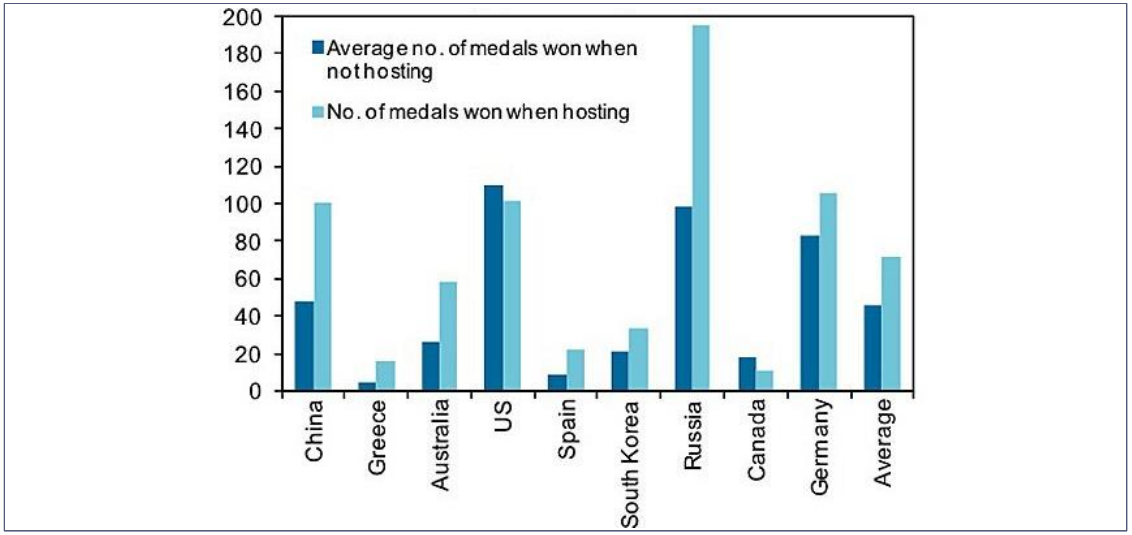
Ex Energy, Cyclicals Look Cheap Against Defensives



Source: JP Morgan

Olympic Games Hosts' Medal Success



Source: Goldman Sachs

Defensive stocks paying healthy dividends were strongly preferred by investors to their more cyclical counterparts through the early part of the year as macro fears and headline risks served to dampen market sentiment. While these are considered 'safe haven' stocks, especially in volatile markets, elevated valuations are making these stocks less attractive now. As the economic outlook continues to improve, there is an argument that defensive stocks may fall out of favor and investors will flock towards undervalued cyclical investments. While Energy is considered to be a cyclical sector, the decline in the price of oil – and the related drop in energy company profitability - has made it difficult to value these companies on an earnings-to-price basis. Ignoring energy stocks, however, cyclicals are inexpensive relative to defensive stocks today. Given that valuation has been the best predictor of returns in the long run, it appears that the cyclical areas of today's U.S. equity market may offer good opportunity for investors.

The Olympic Games often bring mixed economic returns to their host country – the increased tourism can be offset by the disruption of transportation and cost of day-to-day operations. A more consistent benefit of hosting the Olympics may be the host nation's performance in the Games themselves. Data compiled in 2012 suggest an interesting, albeit unexplained, correlation between the Olympic host nation and the improved performance of its native athletes. In the Summer Games between 1972 and 2008, a country earned, on average, 54% more medals in the year that it hosted the Olympics. (Note: This data may be skewed by Russia's host-year medal count, which was likely inflated due to a lack of competition, as 66 nations boycotted the 1980 Soviet Union Games.) The trend may be set to continue this summer, as Brazil has already surpassed its average Games medal count (4.7) with 9 days left in this year's Olympics.

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