The Rise of the Equity Market "Vigilantes"

Markets are becoming increasingly uneasy about the political situation in Washington. Beware the equity market "vigilantes", a deal and a potential market rally.

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

The Fiscal Cliff Lingers….

The "fiscal cliff" is the story that just won't die. While we'd love to discuss other topics this remains the primary market moving event currently confronted by investors. It's likely to remain an important event until there are signs of a resolution.

It's interesting to note the recent development of equity market "vigilantes". We often hear about the mythical "bond vigilantes" in the USA and those of you who are familiar with my work know that I've spilled quite a bit of ink trying to explain why this thinking is wrong when applied to the bond markets. But what we're seeing in the equity markets can now be applied to the political sphere. In essence, the uncertainty created by the fiscal cliff is creating a downside bias in equity markets as investors are unwilling to put their money on the line in the face of such uncertainty.

Long Story Short—We think equity market "vigilantes" are forcing Washington's hand….

This is somewhat reminiscent of 2008/9 when repeated waterfall declines in the equity markets forced politicians to cobble deals together in a hurried manner. If you recall John Paulson's ridiculous 3 page "fix" to the financial crisis you remember just how quickly US politicians pieced together policy. The current environment is nothing like 2008, but the equity market is once again imposing its will over the political arena. And that's probably good news.

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The face-off in Washington is becoming quite political. On the one side you have the Democrats who are largely in favor of letting the Bush tax cuts expire in a strategy that is the equivalent of “driving over the fiscal cliff” by waiting until after January 1st to agree to a deal. This would put the Democrats directly in the driver’s seat as they’d likely come back to the negotiating table hoping to cut taxes of equivalent size for the middle class. In other words, the tax cuts would simply be swapped for Bush’s upper class cuts to the middle class.

The alternative is putting together a deal in the meantime that would likely involve greater compromise from both sides. The equity market vigilantes are likely playing an increasingly important role in forcing compromise. There are few things that old, rich politicians hate more than seeing their net worths decline due to their own lack of action. And that’s essentially what the current declines in the equity markets come down to—a lack of political compromise.

As we write, President Obama is appearing in his first press conference since being re-elected and he has stated in clear language that he is open to compromise and says he has no intention of letting the economy go over the fiscal cliff. This is progress. He says:

> "We should not hold the middle-class hostage while we debate tax cuts for the wealthy."

I believe the continued market worries and the pressure by equity market vigilantes will force Congress to act before the middle of December. The timing of an agreement is important, but I believe we’re likely to see a potentially substantial rally in the equity markets once this uncertainty is lifted. This creates three potentially very positive catalysts for a year-end rally:

1. A lifting of the fiscal cliff uncertainty.
2. Strong seasonal patterns as markets enter a “quiet period”.
3. Underperforming money managers will likely chase year-end upside.

As we noted late last week, we have yet to receive a buy confirmation in our primary equity indicators, but the risk/reward has shifted to the buy side on the back of the –8% decline since the S&P’s 1475 top in September. As always, we’ll keep you updated.

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