ORCAM ALTERNATIVE PERSPECTIVES

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Welcome Back, Volatility

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

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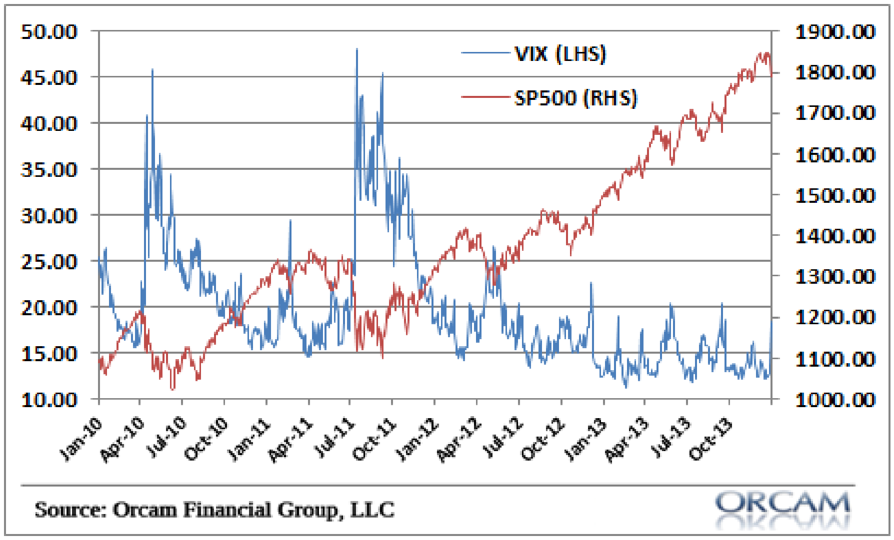
Welcome back, volatility! 2014 sure started with a bang. Despite our tendency to focus on the near past, 2014 is proving to be a vastly different animal than 2013. The S&P 500 is -3.1% in the first three weeks of the year. Emerging market equities are –8.5%. Japan's Nikkei Index is –5.5%. US Treasuries are +5.5%. The VIX is +32%. The Yen/USD is +3%. In a lot of ways the new year is proving to be the exact opposite asset performance of 2013. But is this year really that different?

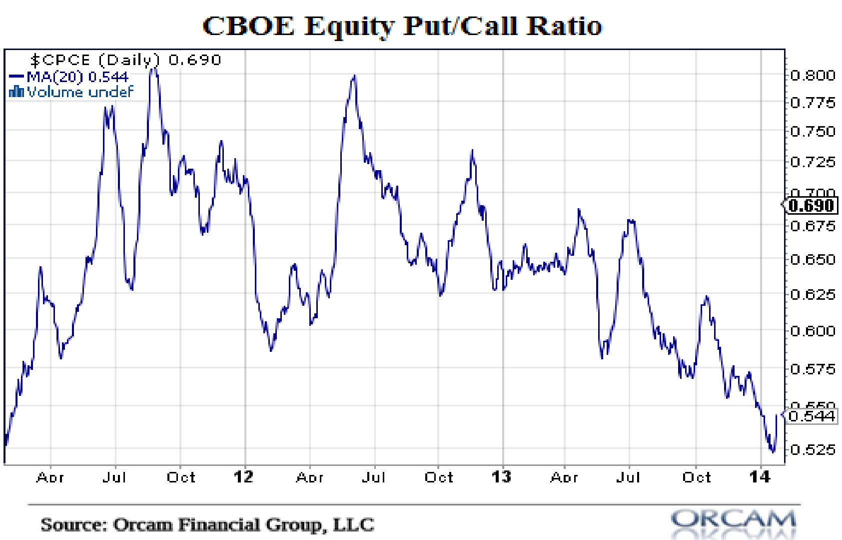
First of all, I think it's important to maintain some perspective during the course of violent near-term market moves like the ones in recent weeks. I prefer to approach the markets in a multi-temporal manner so as to avoid falling victim to overly dramatic emotional swings that doom so many market practitioners. That said, there is little news or evidence that changes my overall cyclical view of the markets. Instead, this looks like a bit of normalization and perhaps digestion of excessively bullish perspectives that had become so common in 2013. Therefore, I am inclined to call this a correction inside of a continuing cyclical bull market. The question then is, how concerned should we be about the current correction?

Continuing concerns about the effects of the "taper" are hanging over the market and could remain a substantial psychological hurdle for quite some time. This week's FOMC meeting is likely to be result in another $10B taper announcement bringing the level of monthly purchases down to $65B. That means we could see some more near-term volatility.

Speaking of volatility—the VIX has proven a relatively good near-term indicator of excessive pessimism during the course of this bull market. On Friday the VIX surged to 18.1, a level not seen since last October during the S&P 500's brief decline. During the last four years every move over 20 in the VIX has proven to be a buying opportunity in equities.



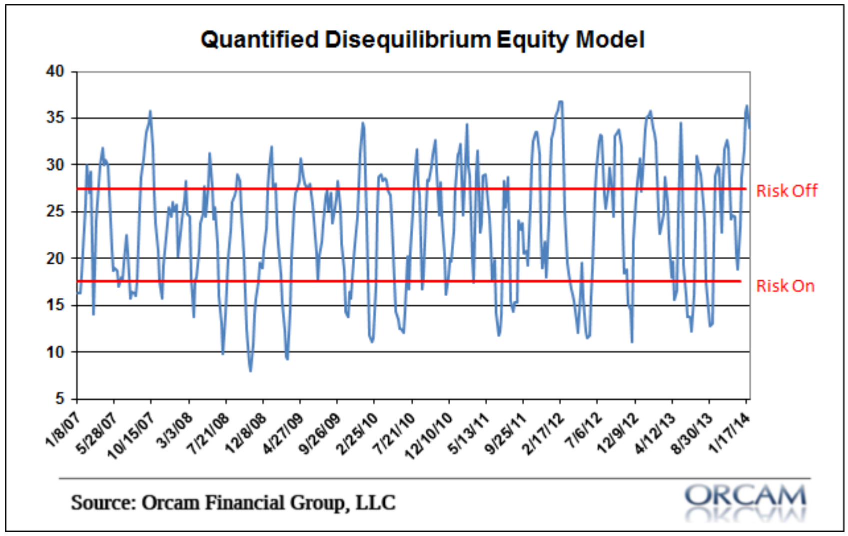
But this doesn't tell us everything we need to know without more context. If we look at the CBOE put/call ratio we can see that the level of complacency with regards to hedging equity exposure, was substantially lower in recent weeks than at any point during the 2013 corrections. The last time we saw this level of complacency was in 2011 just prior to the market's last 10% decline.



This is one data point among many that leads me to believe that this correction could turn into something more substantial than the few minor hiccups we saw in 2013. And yes, 3% is nothing more than a hiccup thus far.

A broader measure of complacency in the market is the Orcam QD model which remains highly elevated even after the –3% move in the S&P 500. As you can see on the chart on the following page, the indicator hasn't given a strong buy signal since last September due to the extremely complacent short-term view of the equity market. This leaves me to believe that the broader equity market indices likely have some room to move to the downside as investors continue to digest the effects of the "Taper" and play 2014

In a more cautious manner than they did in 2013.



While much of the attention has been focused on equity markets this years it's also extremely interesting to see fixed income acting a bit more rationally. Yields are no longer rising on taper fears. Instead, yields are falling as investors realize that inflation is likely to remain low and that tapering isn't necessarily tightening. In addition, this change in market action makes me think that this is more a case of equity markets realizing that multiple expansion can't drive prices higher all alone and that the current pace of moderating earnings growth (Q4 earnings have a blended growth rate of 6.5% thus far) won't justify permanently high multiples.

This doesn't mean we need to panic and move entirely out of equities though. As I stated at the start of this letter I view this as a correction within a cyclical bull market. So I would continue to approach the markets in the manner that I stated in the 2014 Q1 outlook—I would remain extremely negative about emerging markets for now, hopeful that a developed market pullback creates a better entry point and focus on fixed income as a source of portfolio stabilization and hedging.

I'll keep you updated in the coming months about the equity market positioning as I suspect we're likely to see a relatively attractive buying opportunity at some point during the first quarter of this year.