ORCAM
ALTERNATIVE PERSPECTIVES

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Market Turbulence—is it Different this Time?

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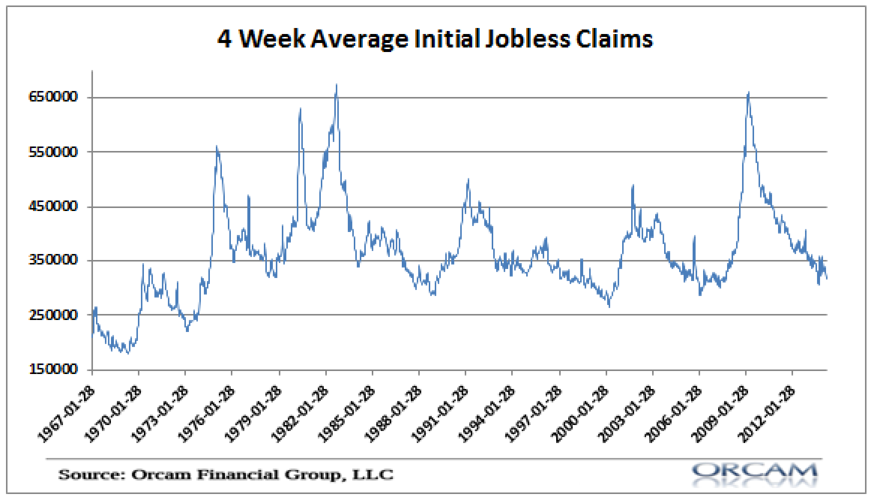
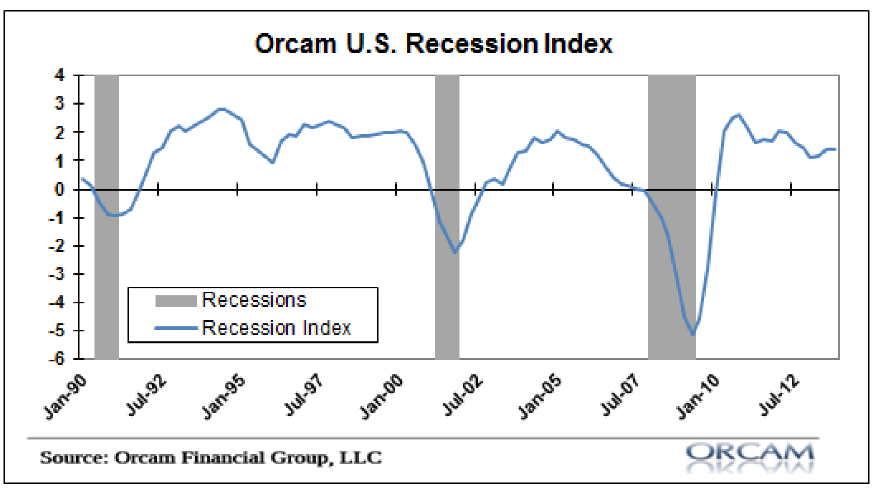
As expected, the start of the Q1 earnings season has investors on edge. The realization of flat or negative earnings growth puts serious doubts in the minds of those who have been willing to own stocks with higher multiples. Of course, the process of multiple expansion is sustainable so long as there's some underlying earnings growth, but it becomes a dicey situation when the earnings are suddenly no longer there or deteriorating. And that's where we sit at the present as Q1 earnings begin and it looks like we might register negative growth.

But the more important question is whether the current market downturn is different. Is this the start of a more cyclical downturn and potentially the peak in the bull market? I am inclined to argue no given the vast macro data that I follow.

My macro portfolio framework is constructed around the concept of probabilistic risk management. That is, I don't expect to be able to predict the future of price movements at all times, but we can construct portfolios that are likely to generate positive risk adjusted returns given an understanding of market history, the monetary system, the macroeconomic landscape and the capital structure. In particular, one of the biggest risks to our portfolios is tail risk, the risk of an outlier event. Years like 2002 & 2008 are not just emotionally devastating, but they are financial devastating. A 50% loss requires a full 100% return just to break-even. The problem is, no one knows when a 2008 is going to occur. On the other hand, we do know that these outlier events tend to occur around unstable market environments. In particular, outlier events tend to occur inside of recessions. This makes perfect sense since recessions tend to coincide with profit declines and behavioral changes. What we know about the current macro environment is that recession looks highly unlikely.



One of the very best real-time indicators of the macro landscape over the last 40 years has been initial jobless claims. The latest claims data is overwhelmingly positive. This week's reading came in at 300K which brought the 4 week average down to its lowest reading since September of last year. This is consistent with an expanding labor force and economic expansion. In fact, initial claims have ALWAYS spiked prior to recession so I find no evidence here of a deterioration in macro data even though it's hardly robust.



In addition, the Orcam Recession Index continues to point towards low potential for recession. The latest estimate of 1.39 is down marginally from the Q4 reading of 1.4 and continues to project economic growth. This index has been our primary cyclical expansion/contraction index over the last 20 years and is nowhere near levels that make me concerned about the current macro landscape.

Based on this broad evidence I continue to see low risk of recession and that means that the risk of a serious outlier event is unlikely. It doesn't mean that the S&P 500 can't undergo a 5%, 10% or 15% decline, but I do think it would be a mistake to become aggressively bearish at this juncture. As I like to say macro investing is all about knowing which way the current is headed. After all, if we know which way the current is headed we don't have to be great swimmers and we don't have to try to outguess anyone else. In fact, we can just jump in the water in an innertube and crack a few beers as the macro current takes us where we need to go. Odds are, we'll get there just as fast as everyone else involved in the same river. And that's the thing—anyone can move fast in the water if they know the direction of the current and based on my macro evidence, I remain confident that the macro current is moving in a positive direction.