BUTLER, LANZ & WAGLER

For the discerning,
risk-conscious investor.

April Newsletter 2014

Most of March was a disappointing month for stock markets around the world. The S&P 500 would have finished the month in the red had it not been for a dramatic stick save on the last two days of the month. As it turns out, the S&P 500 finished up a little less than 1% on the month, but not without some trouble. The worst the S&P 500 got was down a little more than 1% at the lows on March 14.

It was not the absolute performance of stocks in March that troubled investors. It was a repeating pattern of big morning jumps followed by afternoon weakness. For a while, it appeared that the market couldn't hold any gains. For six straight days in late March, stocks got a bounce from the currency markets in overnight trading; that overnight momentum was successfully carried into the US stock market open; stocks opened up big; stocks then sold off throughout the course of the trading day. That behavior is called the ol' "pump and dump." Smart money allowed retail investors to drive stocks up in the morning, only to use those higher prices as an opportunity to sell stocks for the rest of the day.

Amidst all that, the damage done to the stock market in March was nothing but a little red coloring splashed into a chart which shows a sideways market.

But, if we look under the hood of the market, we find that some significant changes were taking place amidst a relatively quiet equity market landscape. Market technicians use the word "rotation" to define the investment behavior of "rotating" out of the riskiest, most volatile stocks and stock sectors into those perceived to be "safer." That's the subject of this month's newsletter - market rotation.

Rotation

Perhaps the most notable points of weakness during the six-day pump-and-dump were in the biotech sector and a few of the momentum stock favorites - Facebook, Tesla, Netflix and LinkedIn.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

This was classic defensive rotation. And, by the way, even though the word "rotation" is often reserved for moving out of riskier assets and into less risky ones, the opposite is also true. Rotation can mean that less risky assets are being sold as more risky assets are being bought.

The Biotechnology Index, Facebook, Tesla, Netflix, and LinkedIn have had tremendous runs over the previous 18 months, so they were ripe for a pullback. Not coincidentally, all of these securities were extremely overvalued on a price-to-earnings basis vs. the rest of the Nasdaq.

There are different ways we can measure rotation: (1) value stocks vs. growth stocks, (2) consumer staples stocks vs. consumer discretionary stocks, and (3) utilities stocks vs. the broad stock market. The theory here is fairly straightforward: value stocks, consumer staples stocks and utilities stocks are viewed as less risky stock selections than growth stocks, consumer discretionary stocks and the broad market, respectively. When investors are concerned about any number of risk factors present in the markets, they move from risky assets to less risky assets.

We should point out that at market tops, we often see a defensive sector rotation first, then an asset class shift. In other words, we see investors taking less risk when they are concerned about the future of the stock market. But they still choose to be in stocks - just less risky ones. If their concerns persist, they get out of stocks altogether, and go into bonds or cash. That mass exodus from stocks is a self-reinforcing bearish vicious circle. The former behavior is defensive rotation; the latter is defensive asset re-allocation. We need to be clear about this. Further, we should make perfectly clear that while most stock market tops exhibit defensive sector rotation, there are many examples of this rotation without a corresponding stock market top and bear market. It's almost as if a defensive stock sector rotation is a necessary, but not sufficient, condition for a stock market top.

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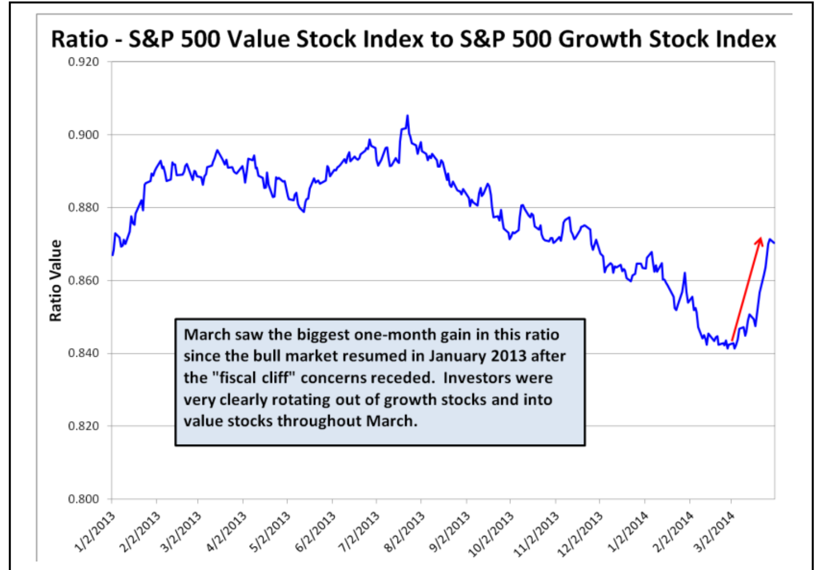
Value Stocks vs. Growth Stocks

Why do people rotate into value stocks, and out of growth stocks, when concern hits the stock market? Because by definition, value stocks are less overvalued than growth stocks. That's the definition of a value stock - based on price-to-earnings, price-to-book, enterprise value, and other fundamental criteria, the stock is either cheaper than its peers, cheaper than its own historical averages, or both. The logic behind a defensive rotation into value stocks is that if a bear market develops, value stocks will be hammered less than growth stocks, which are relatively overvalued.

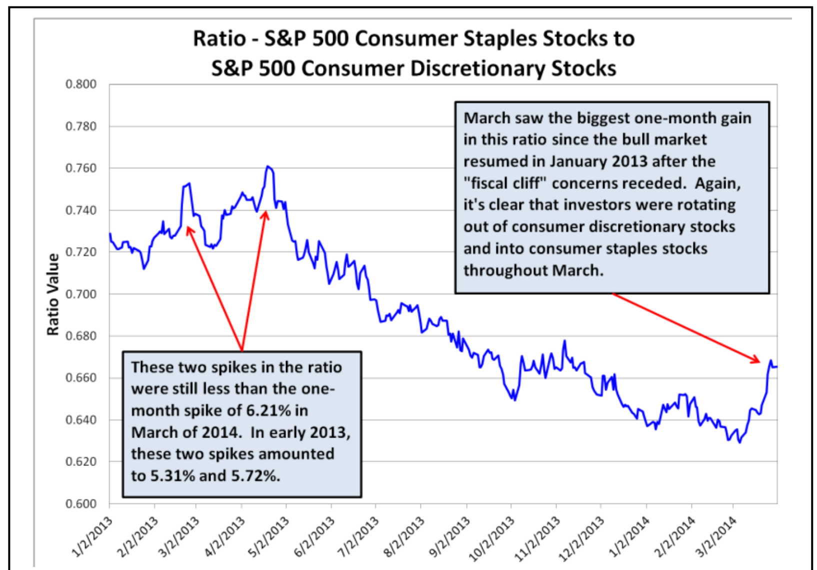
This is one of the clearest signs of a recent defensive stock rotation. March saw the largest one-month gain in the ratio of value stocks to growth stocks in 15 months.



Consumer Staples Stocks vs. Consumer Discretionary Stocks

First, let's understand what these two sectors are. Consumer staples stocks are the stocks from companies providing services thought to be relatively immune from economic weakness. Staples are the things people will need to buy in economic bad times as well as good. It should therefore come as no surprise that the largest holdings in the index of consumer staples stocks are Proctor & Gamble, Coca-Cola, Phillip Morris, Wal-Mart and CVS Caremark. These companies either manufacture or sell recession-resistant products like soft drinks, tobacco and pharmaceuticals.

On the other side of the spectrum are consumer discretionary stocks. These are the stocks of companies that manufacture or sell products that consumers tend to demand more of when the economy is doing well. Consumers cut back on "discretionary" purchases when the economy is bad, so the stocks of the companies selling discretionary products or services will typically suffer in bad times. Given that explanation, we see that the top holdings in the index of consumer discretionary stocks make sense - amazon.com, Disney, Ford, priceline.com and 21st Century Fox. All of these companies sell products or services that are considered non-essential, and thus, are the first items struck from a budget when the economy suffers.

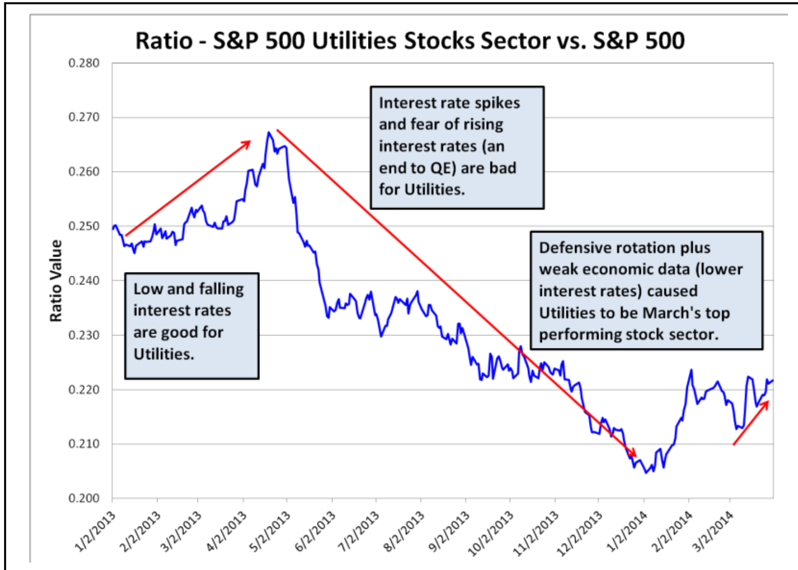


Now it can be seen why, when investors have concerns about the stock market, another typical defensive stock rotation is money flowing out of consumer discretionary and into consumer staples.

Just like the ratio of value stocks to growth stocks, the ratio of consumer staples to discretionary set a 15-month high in March as money rotated out of the riskier discretionary stocks into staples.

Utilities vs. S&P 500

One final sign of defensive stock rotation is the performance of utilities relative to the broad stock market. Admittedly, this is the least clear of all three. The reason for this is that many things drive utilities stock performance versus that of stocks in general other than a lack of "animal spirits" in the market. For example, interest rates are probably the biggest factor affecting utilities performance. Utilities may be outperforming the broad stock market simply because interest rates are falling. Conversely, when we see utilities falling relative to the broad market, we cannot simply conclude that investors prefer more risky stocks. It could be that interest rates are going up, or it is widely believed that they soon will.



But utilities also outperform the broad market when animal spirits evaporate from the market - when risk-taking wanes among market participants. Why? Because utilities are thought to be safe equity investments due to their geographical monopolies and relatively high level of dividend payout.

As you can see, utilities have ebbed and flowed inversely to interest rate expectations over the last 15 months. But in March, worry over the stock market's future, as well as lower interest rates, helped utilities to be the best absolute performing sector for the month.

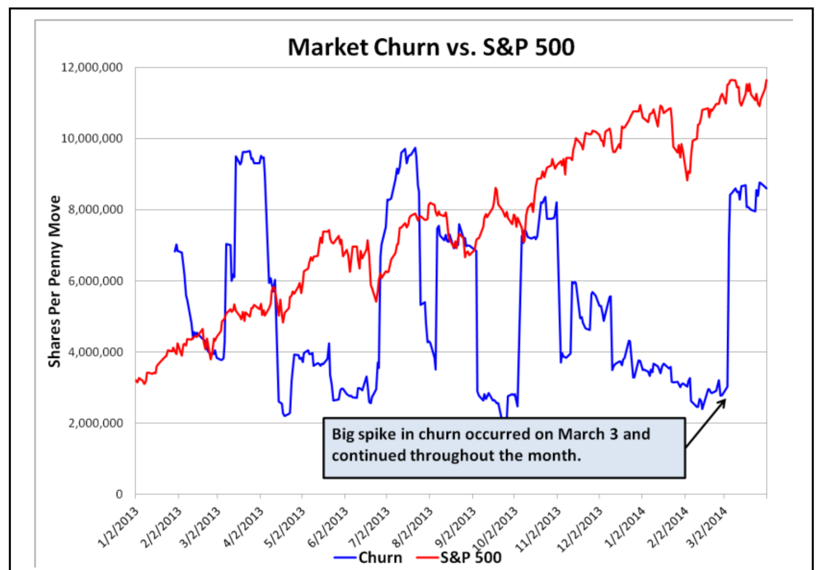
Market Churn

One additional way to see market rotation, although it could be offensive or defensive, is to look at market churn. We describe market churn as high levels of trading volume resulting in very little price movement. This occurs when shares of some stocks in an index are sold, with the proceeds going to purchase other stocks in that index. Because the rotation is occurring within sectors of the same broad index, the net result is not much movement in the broad index.

The difference in market churn and the other three indicators is that the type of rotation is not known with market churn - it could be offensive or defensive. The three other indicators are specific examples of defensive stock rotation.

When levels of churn are high, there is some rebalancing going on in the stock market. That can be seen in the chart.

As mentioned above, market churn tells you that there is rebalancing - rotation - within the stocks market, but will not give you any indication as to what type - offensive or defensive. But the first three indicators discussed all point to defensive rotation.



What it Means

As we mentioned earlier, significant market tops are almost always preceded by defensive stock rotation. But not all cases of such rotation precede a significant top. We could very well see a complete reversal of the rotation in April. However, it is significant that this is the first, and only, instance of meaningful risk aversion in 15 months.

If this rotation ultimately does lead to a market top, it's unlikely that it's on the immediate horizon. Usually, but not always, the top is made months after the first defensive rotation. Still, when investors see that the market is playing defense, it's probably a good idea to pay attention. An alert has been issued. That alert, much like a tornado watch, should remain in effect until the defensive positioning is unwound. We saw this earlier in 2013 in response to concerns over the Fed's tapering its quantitative easing program. Market participants rebalanced their portfolios defensively but were not willing to give up on stocks entirely. When the Fed announced in early September that it would delay any tapering until the economy looked better, defense turned into offense again.

We are of the opinion that this Teflon market has reacted remarkably well to external risks (China's slowing economy and quivering financial system, Russia's invasion of the Ukraine, Cypress' banking system jolt, slowing economies of Europe, the emerging market melt-down, etc.). It has not responded well to any talk of the Fed tightening monetary conditions. In addition, the weakness is the US economy acts as both good news and bad news, depending on the sentiment over whether the Fed can or will taper an extremely loose monetary policy.

It would therefore seem that stock market risk is centered around Fed policy. Those are the shocks that will likely matter to stocks in this environment, as many participants are already playing defense, but unwilling to exit stocks entirely.

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