KIM: Increased uncertainty leading to extreme volatility

Mickey Kim
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Volatility returned with a vengeance in the first quarter of 2015, as investors grappled with increasing uncertainty associated with Federal Reserve ("Fed") policy, signs the U.S. economy has hit a soft patch and lowered expectations for corporate earnings.

The S&P 500 dropped 3.1% in January, rose 5.5% in February and fell 1.7% in March. The S&P 500 experienced nine swings of 3.5% or more during the quarter. From mid-February to late-March, the S&P 500 failed to put together back-to-back gains for 28 consecutive trading days. This rare circumstance happened only twice since World War II—in May 1970 and April 1994.

Stocks aren't cheap on an absolute, historical basis, but still remain attractive relative to bonds. Given the U.S. economy has been recovering for several years since the depths of the "Great Recession," there is no reason to fear the gradual lifting of the emergency measures implemented by the Fed. The recent weakness in economic readings is indicative of a temporary soft patch, not the start of a trend. Corporate earnings remain a wild card, but expectations have been lowered to the point surprises could be to the upside.

The U.S. economy encountered significant challenges in the first quarter, leading to weaker-than-expected manufacturing activity and employment.

Falling oil prices have had an immediate negative impact on earnings, capital spending and employment in the energy sector. Strategas Research Partners estimates if oil remains at its first quarter average of $48/barrel for the rest of 2015 (vs. $93/barrel in 2014), this will translate to ***$200 billion in savings*** for consumers. This will be a boon to the economy, but the boost to consumer spending has been slower to materialize than expected.

Our economy was also negatively impacted by the brutal winter in the Midwest and Northeast and the massive West Coast dock strike, all of which are seasonal/transitory. In January, the European Central Bank (ECB) finally decided to act on its pledge to start its own brand of quantitative easing to jumpstart the European economy.

Combined with the Fed indicating its intention to raise rates at some point, the U.S. Dollar surged in value vs. the Euro. Last May, 1 Euro cost about $1.39. Today, 1 Euro costs about $1.07. While this is fantastic news for Americans visiting Europe, this has made it tough for American companies doing business in Europe. The rise in the dollar makes American goods more expensive vs. those from European competitors. Similarly, an American multi-national corporation translating its earnings from Euros to dollars also takes a hit.

On the positive side, the European economy finally appears to be emerging from the doldrums. The ECB was far less aggressive than the Fed in taking extreme, emergency measures to shore-up the European economy. As a result, "green shoots" of economic recovery began appearing in the U.S. much sooner than in Europe. Improving economic data as well as signs of increased lending activity could be indications of a European recovery, which could be a nice bonus most investors are not anticipating.

With uncertainty surrounding Fed policy, the strength of the economy and corporate earnings likely to persist, we expect the stock market to remain "choppy" and volatile. It's always important to keep focus on the long-term, never more so than in times like these.

Kim is the chief operating officer and chief compliance officer for Kirr Marbach & Co. LLC, an investment adviser based in Columbus, Ind. He can be reached at (812) 376-9444 or mickey@kirrmar.com.