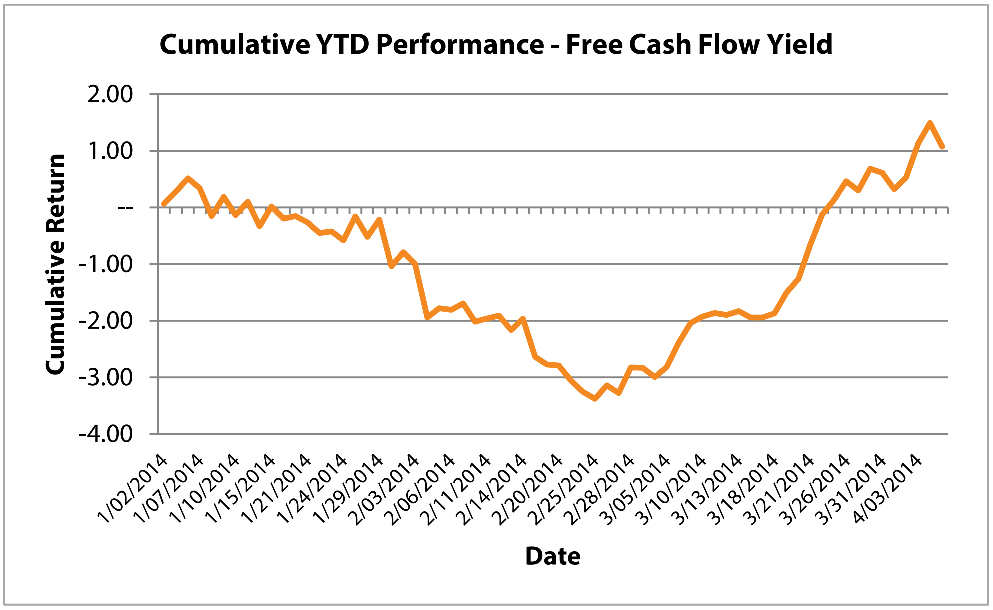
"Beta Earthquake"

One of the things I like to keep my eye on when I'm puzzling out what's going on in the market are the specific company factors that loosely define concepts like Momentum and Value. I do this because any sort of big market move, like we've seen over the past week, is inherently over-determined and over-explained. That is, there are dozens of "reasons" trotted out by the financial media and various experts, ALL of which are probably right to a certain degree. The trick is to see if you can identify an *underlying* explanation that both accounts for a large chunk of the various rationales AND distinguishes or predicts unexpected nuances between the rationales. Here's an example of what I mean.

We all know that momentum-driven, high-beta stocks have been particularly slammed of late. Even as the overall market maintained its highs (until last Friday, anyway), particular sub-sectors like Internet stocks or biotech stocks have been crushed. What we'd like to know is whether this is somehow specific to a certain group of stocks – call them Momentum stocks – or whether these stocks are just the canary in the coal mine due to their high-beta nature for a more broadly based market dislocation. So let's not look just at Momentum factors over the year to date (which we know have been slammed), but also factors connected with Value and Quality. If high Value and high Quality stocks have done well as high Momentum stocks have done poorly, then there's no need to look deeper than that. Momentum is the culprit, and maybe this market trauma will be contained there. On the other hand, if there are weirdnesses or distinctions between the three broad categories, then something deeper is probably at work.

For Value I'll use free cash flow (FCF) yield as a quick-and-dirty indicator of the concept, and for Quality I'll use cash flow return on invested capital (Cash ROIC). We can argue about alternative measures of these categories, and there's certainly some conceptual overlap between Value and Quality, but I think these are pretty well-acknowledged, if not standard, operationalizations of what Value and Quality *mean*. For both, I'll chart the isolated performance of each factor against the MSCI US large-cap universe. Again, maybe you'll get different results if you look at different universes of stocks or different operationalizations of Value and Quality. Knock yourself out.

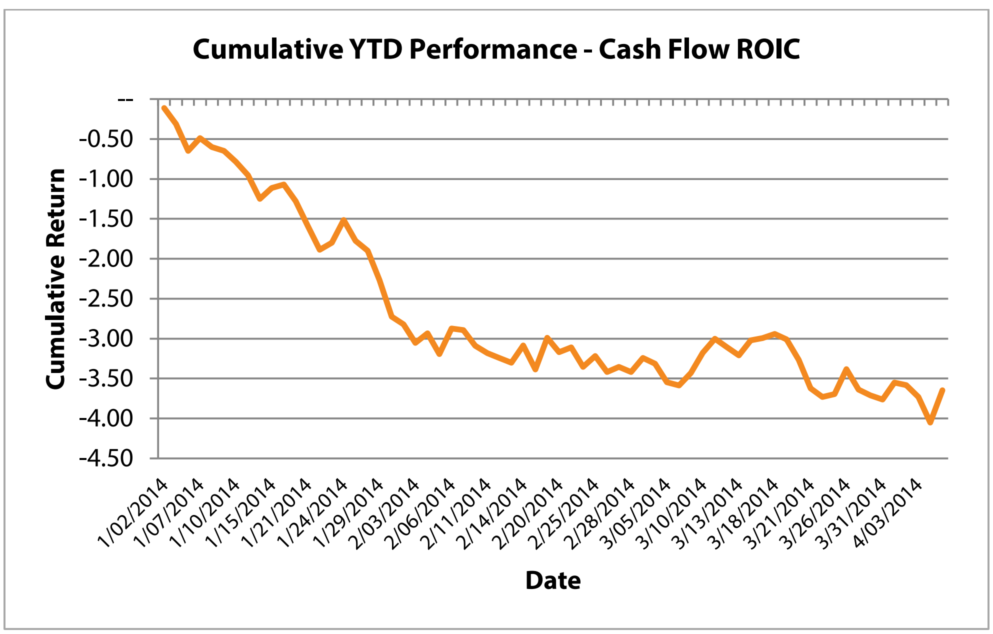
Here's the year-to-date performance chart for my Value factor, FCF yield:



Source: FactSet, Salient Capital Advisors, LLC, April 2014.

Pretty much what you'd expect if the answer to our puzzle were simply: Momentum Is Bad. FCF yield turned on a dime the last week in February, just as Momentum stocks started to tank, and hasn't really looked back since.

But here's the year-to-date performance chart for my Quality factor, cash flow ROIC:



Source: FactSet, Salient Capital Advisors, LLC, April 2014.

Unlike Value, Quality did not turn up at all as Momentum collapsed. Instead, it has continued to drift down along with Momentum.

What does this mean? What is an underlying explanation that can account for Momentum failing and Value working, but Quality NOT working? When one of my colleagues here at Salient saw these charts he said, "looks to me like **the market is trading on a narrative of risk appetites and fear rather than toward some notion of seeking fundamentals or selling overbought growth stocks; otherwise Quality would be working, too."** To which I replied, "Amen, brother!" The notion that this market sell-off is limited to biotech or Internet or some other high-flying sub-sector because the market "realized" that these stocks were too expensive or out of concern with earnings this quarter (both explanations that I've seen of late in the WSJ and FT), just doesn't hold water. These high-beta stocks are being hit hardest because they are at the epicenter of a broad market or beta earthquake. This is what it *means* to be high-beta…you live by the broad market sword and you die by the broad market sword.

What's the source of this beta earthquake? What tectonic plate is shifting beneath our feet? Only the bedrock bull Narrative of the past five years – "the Fed has got your back." As I wrote last week, the Common Knowledge on Fed policy is starting to shift. The crowd is sniffing the air, sensing a change in the easing/tightening Narrative and acting on that by selling – and the less fundamentally-grounded the security the more furious the selling – just as they acted on prior market-positive shifts in the easing/tightening Narrative by buying – and the less fundamentally-grounded the security the more furious the buying.

Is this the Big One? Is this the beta earthquake that sends the stock market down into correction or bear market territory? I have no idea. Or rather, if you can tell me what US growth data looks like over the next six months then I'd be happy to make a market prediction, but I certainly don't have a US growth crystal ball and I don't think you have one, either.

Anemic growth remains the Goldilocks scenario for markets, not so cold as to make for a recession but not so hot as to take the Fed out of play for "emergency" monetary policy implemented on a permanent basis. Good real-world news is bad for markets, and vice versa, because that's the dynamic that impacts Common Knowledge around the Fed. The market is in a tough spot right now, as good news will not make the market go higher (Fed stays on the tightening path) and bad news can make the market go lower if it's **really** bad news (or if the Fed gives more signals that they're tightening regardless of how bad the news gets).

This tough spot is made even tougher by both a market fatigue with Fed jawboning (excuse me… communication policy) and a growing sense, fair or not, that the Yellen Fed is kind of flailing around right now. The dominant Narrative by a mile is still Central Bank Omnipotence, where the Fed is responsible for all market outcomes, but there are definitely signs of a growing counter-Narrative, one that I call "The Incompetent Magician", that bears close watching. The Incompetent Magician Narrative is a story that's very dangerous for markets, because it's a story of *loss of control*. This is what makes private sources of liquidity dry up, this is what makes for a deep bear market, and this is what would drive gold into the stratosphere. The Incompetent Magician Narrative has been around for decades, usually resting deep in the depths of counter-cultural media and the like, sort of like a flu virus that can lay dormant for years within an animal population. Over the past few weeks, though, I've seen a few outbreaks of this virus, or at least a strain of the virus, within mainstream media. Nothing to be concerned with yet, but like I say…something that bears watching.

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All the best,
Ben

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