Gary Thayer, *Chief Macro Strategist*

Investment Strategy

A weekly overview of today's investment environment

February 24, 2014

Investors still appear to be cautious

The U.S. stock market has recovered most of its losses suffered during January and early February. However, investors now appear to favor defensive sectors rather than cyclical sectors. This suggests that investors are cautious. Consequently, sentiment is still probably fragile, and the risk of an increase in market volatility persists.

The U.S. stock market remains in an upward trend, and we remain long-term positive on the U.S. economy and the U.S. stock market. However, recent market activity continues to suggest that the U.S. stock market is vulnerable to further volatility in the weeks and months ahead after the big gains in prices during the past year and a half.

During the strong market advance this past year, many investors began to realize that the U.S. economy was getting better and the United States was leading the global economic recovery. In this positive environment, investors favored the cyclical sectors of the stock market, especially the Consumer Discretionary stocks. At the same time, investors shunned defensive sectors, particularly utility stocks. However, investor sentiment is more cautious now, and the Utility sector has done better than Consumer Discretionary sector all but a few days this year.

The defensive Health Care sector is also doing better than the overall stock market, despite all the negative news and problems implementing the Affordable Care Act. This is probably because a lot of the stocks in the Health Care sector are domestic oriented, and history shows that the Health Care stocks tend to do better than the overall stock market when the global economy is growing slowly.

In addition, investors often favor U.S. investments over foreign investments when the global economy is weak, causing the value of the dollar to strengthen against many currencies, as it has much of this past year.

Earlier this year, many forecasters raised their economic forecasts, including the International Monetary Fund (IMF). However, less than a month later, the IMF appeared to be changing its tune and warned this past week of an increased risk of deflation in the euro area and market turmoil in emerging markets.

Looking back, most major U.S. stock market indexes have outperformed global stock market indexes during the past couple of years. Investors have increasingly realized that the U.S. economy was strengthening at the same time that other economies in Europe, Asia and Latin America struggled with slow growth.

History shows that the U.S. economy often benefits from slow global growth, although the financial markets can be volatile during these periods. One clear indicator that the global economy is weak is the trend in commodity prices. When the global economy is weak and the U.S. economy is doing better than many foreign economies, commodity prices often trend lower. Thus the downward trend in commodity prices during the past two years is consistent with a period of slow global economic growth. It is also consistent with U.S. stocks doing better than foreign stocks and the dollar strengthening against many other currencies as has occurred recently. Unfortunately, the downward trend in commodity prices and upward trend in the dollar is also consistent with an increased risk of market volatility if foreign economic problems cause investors to turn cautious. That may be why the IMF warned this past week about the risks of deflation in Europe and also potential problems in emerging market economies.

The last time that the U.S. economy outperformed the global economy on a sustained basis was during the late 1990s. That was also a period when many emerging market countries were weak, leading to the Mexican currencies crisis in late 1994 and early 1995, the Asian currency crisis in mid-1997, the Russian currency crisis in late 1998 and the Brazilian currency crisis in early 1999. This was also a period when the value of the dollar trended upward and commodity markets were weak, underperforming the stronger stock market. However, it was also a period of increased stock market volatility as negative news from overseas weighed on fragile U.S. investor sentiment. Of course, past performance does not guarantee the same results. Nevertheless, the situation then and now appear to be similar in many respects.

Looking ahead, we believe that cyclical stocks will outperform defensive stocks again later this year if our long-term positive outlook on the U.S. economy and the U.S. stock market is correct. However, the recent better performance of defensive stocks suggests that investors are still cautious even though several U.S. stock market indexes are near record highs again.