MATARIN CAPITAL

Investing with Insight and Integrity

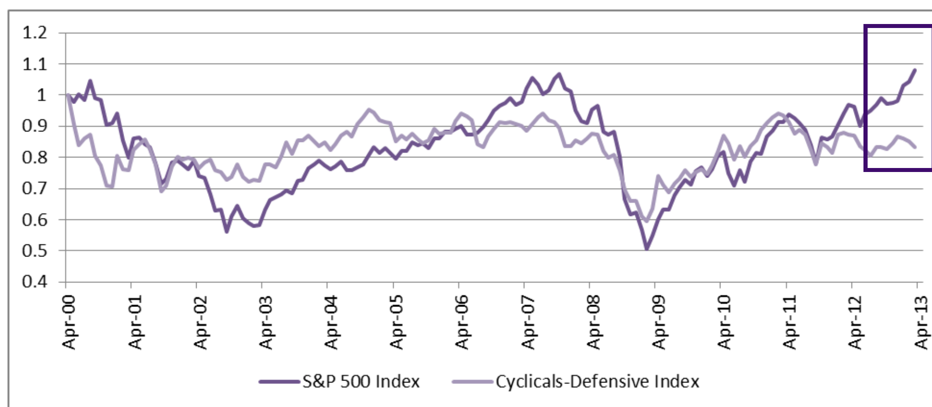
Matarin Capital Management aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards.

Commentary: U.S. Markets

The first quarter of 2013 was an excellent period to be invested in U.S. stocks. Stock market returns were strong across the capitalization spectrum and the S&P 1500 returned 10.8%. For the S&P 1500 and S&P 500, this represents the strongest first quarter since… any guesses? … last year. According to Bespoke Investment Group, the S&P 500 has only been up greater than 10% in the first quarter of a year 13 times since 1928. In the 9 months following these prior strong first quarters, the S&P 500 has returned an average of +1.4% for the remainder of the year with a median +5.8%, and returns were positive for the remainder of the year in 10 of 12 years (1930 and 1987 were the highly notable exceptions which help to make the average return so different from the median).

In periods of stock market strength such as this past quarter's, investors typically expect higher beta, more cyclical segments of the market to be leading the rally. However, in Q1 2013 the stock market did not follow the typical script. The top performing S&P 1500 sectors during this past quarter were traditionally defensive sectors such as Health Care (+16%), Consumer Staples (+15%), and Utilities (+14%), while typically cyclical sectors such as Technology (+5%) and Materials (+5%) performed the worst. Interestingly, the last time the market was up greater than 10% in a quarter, with the Consumer Staples and Health Care sectors outperforming, was 21 years ago. The strong performance of these defensive sectors during a rally is unusual, and may speak volumes about market sentiment, and the economy.

At Matarin, we perceive this anomalous sector performance to be a signal that at this stage of the stock market rally, investors remain somewhat cautious, purchasing the most defensive, stable and reliable market segments – they are not yet fully shifted into "offensive" mode. As you can see in the chart at the left, in which we plot the excess returns of cyclical stocks (defined as Consumer Discretionary, Industrials, and Materials sectors) vs. defensive stocks (defined as Utilities, Health Care, and Consumer Staples) along with the return of the market (the S&P 500), the current market rally to new highs is occurring during a period of significant cyclical stock underperformance relative to the defensive stocks. The chart clearly demonstrates that this is not the typical performance pattern, so we believe that mean reversion for cyclical vs. defensive performance should be expected, with defensive stocks poised to underperform cyclicals in the next stage of this rally.



Sources: Bloomberg & S&P Dow Jones Indices. Data as of April 1, 2013.

As it relates to the overall stock market, in Matarin's proprietary top-down forecast for the S&P 500 index, we have a bullish outlook as we enter the second quarter of 2013, with the underperformance of cyclical sectors relative to the rest of the market contributing to this positive view. With cyclical sectors lagging the rest of the market in its ascent, inflation is less likely to be an intermediate-term risk. (This is because companies in cyclical sectors such as industrials and materials tend to have pricing power, and as they pass on higher prices to their customers during market environments which are favorable to them, it places inflationary pressure on the broad economy. When cyclical sectors are underperforming the rest of the market, however, it is a signal that inflationary pressures may remain at bay). A continued period of moderate inflation in 2013 would be bullish for the stock market, because it would indicate that the Federal Reserve can continue with accommodative policy unhindered – and a further protracted period of easy money should continue to be a positive catalyst for stocks in the intermediate term.

Regarding future sector performance, we are cautioning our investors that defensive stocks may not hold up as well during the next weak period for markets as they have in past ones. These "slow and steady" names are typically relied upon for downside protection in a stock portfolio. However, given today's stretched valuations (all three sectors trade at above market 2013 P/E multiples) and unexciting growth prospects for defensive stocks, the downside risk in these names is greater than it has been in the past. Today's extended valuations could contract at the most inconvenient time.