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3rd Quarter 2014 Investment News - Choppy Waters

You could say that the markets took a breather in the third quarter of 2014, but you would come to that conclusion only if you looked at the overall returns and ignored the drama of the past 30 days. The markets experienced a difficult month of September, giving up some of the gains from the prior eight months and causing investors to worry that we're about to experience more of the same. The end of the month was especially difficult, with a general market slide starting September 22, and some indices dropping more than 1% on the final day of the month.

The Wilshire 5000--the broadest measure of U.S. stocks and bonds--rose a meagre 0.37% for the third quarter even as it lost 1.71% in September. But the index is hanging on to a 7.26% gain for the year. The comparable Russell 3000 index was essentially flat in the third quarter, which means it is still holding onto a 6.95% year-to-date gain with three months to go in 2014.

Large cap stocks were the market leaders over the past three months, but the gains were modest. The Wilshire U.S. Large Cap index gained 1.13% in the second quarter, and is now up 8.38% so far this year. The Russell 1000 large-cap index eked out a positive 0.70% return for the quarter, but is still provides 7.97% gains so far the year. The widely-quoted S&P 500 index of large company stocks posted an even smaller gain of 0.60% for the quarter. The index is up 6.7% since January 1, but it has fallen back from its record highs on September 18.

The news was less happy for smaller stocks. The Wilshire U.S. Mid-Cap index lost 3.54% in the third three months of the year, and is clinging to a 4.99% gain so far into 2014. The Russell Midcap Index fell 1.55% for the quarter (posting a 3.34% loss in the month of September), but still stands at a 6.87% gain overall since the first of the year.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, fell 4.98% in the third quarter (4.38% in September alone), but the index is hanging onto a positive 0.44% return heading into the year's home stretch. The comparable Russell 2000 Small-Cap Index fell 7.60% in the third quarter, representing its worst quarter in three years--and is now down 4.40% so far this year. Meanwhile, the technology-heavy Nasdaq Composite Index managed to gain 2.45% for the quarter, and is up 7.88% for its investors so far this year.

The rest of the world put a drag on diversified investment portfolios. The broad-based EAFE index of companies in developed economies fell 6.39% in dollar terms during the third quarter of the year, and is now down 3.63% so far in 2014. The stocks across the Eurozone economies contributed to the foreign stock slide, dropping 7.37% for the quarter, but the red ink spilled over to most of the foreign indices in Asia as well. Ironically, the emerging markets stocks of less developed countries, as represented by the EAFE EM index, represented a bright spot, losing "only" 4.33% over the last three months, and is still up 0.26% so far this year.

Looking over the other investment categories, real estate investments, as measured by the Wilshire REIT index, fell 2.54% for the quarter, but the index is standing at a robust 15.08% gain for the first three quarters of the year. Commodities, as measured by the S&P GSCI index, fell 12.46% this past quarter, and now sit at a loss of 7.46% for the year.

The expected rise in bond rates never materialized, confounding the experts yet again. The Bloomberg U.S. Corporate Bond Index now has an effective yield of 3.07%, while Treasury rates held steady. 30-year Treasuries are yielding 3.20%, and 10-year Treasuries currently yield 2.50%. At the low end, 3-month T-bills are still yielding a miniscule 0.02%; 6-month bills are only slightly more generous, at 0.04%.

Nobody seems to have a convincing explanation for the recent stock market slump. The economy still seems to be pushing along in a long slow, steady growth process, and corporate earnings are well-above historical averages. Oil prices are at their lowest level since November 2012, consumer spending has rebounded, and although the Fed will cease its bond purchases this month, there is no indication that it is going to sell its inventory back on the market, and its policymakers are projecting low interest rates well into 2015. Corporate cash at larger corporations is near an all-time high.

But pullbacks don't always reflect reality. They are also affected by the sentiment of investors--in other words, human emotions and a crowd (or herd) mentality. Investors seem to be worried that stocks are overdue for a correction, and if these things operated on a schedule, they would be right. We are in the fourth-longest bull market since 1928, without having experienced even a small 10% correction since 2011. The Conference Board reported that U.S. Consumer Confidence slipped dramatically, and unexpectedly, in September, lending some credibility to the surmise that the investing herd has been startled--and their expectations appear to be creating market reality.

The best (although imperfect) way to chart investor sentiment is via the VIX Index, which measures the volatility of the market by tracking the behavior of S&P 500 index options. When the VIX spikes, it means that investors are excited or scared--as they seem to be now.

The interesting thing about the long-term VIX chart--shown here starting in the third quarter of 2007, is the heartbeat-like rhythm of the spikes and drops, as if people get nervous in a kind of pattern. The 2008-2009 market meltdown shows up in the enormous spike toward the left, but if you let your eyes move to the right, you can see that volatility has been pretty moderate since the end of 2012. Maybe it's just time for the "heart" that represents how investors feel about the markets to give another tick.

Does that mean we should take action? Unfortunately, nobody knows whether the markets are poised to act on the good economic news and move up, or are ready for another fearful selloff that would finally deliver that long-delayed correction. History tells us that it's a fool's game to try to anticipate market corrections, and that investors usually get rewarded for sailing through choppy waters, rather than jumping off the ship when the waves get higher.

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CBOE Volatility Index (aka "the VIX Index")