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Asset Management

News or Noise: Market-Moving Headlines

By David Fisher, Chief Investment Officer

The essence of successful investing involves determining when market participants in aggregate have an expectation for future events that is not supported by evidence. Simply put, it is only when future events unfold differently than expected that markets move at all.

At SignatureFD, we are often asked for our opinions about the day's front-page stories and whether we think they are market moving. To better answer that question, we will be taking a monthly look at several recent top financial news stories and then sharing our thoughts on why they are—or are not—important to the markets. Our first installment looks at recent news involving interest rates in Europe, payroll data, new EPA regulations for the utility industry and more.

No. 1: European Central Bank Takes Bold Action

Summary: Last week, European Central Bank (ECB) President Mario Draghi announced that the bank would lower key rates in the eurozone and introduce targeted longer-term refinancing operations (TLTRO). TLTRO will focus on lending to businesses in periphery countries, especially Italy and Spain.

News or Noise? News

Our Take: The markets, in our opinion, underappreciate the long-term impact of continued ECB action. Equity and bond markets did rise slightly last week, but the euro did not fall. Two things were noteworthy to us. First, the ongoing confidence the market places in Mario Draghi was again solidified. During his press conference Draghi asked, "Are we finished?" His answer: "No." Draghi's statements gave market participants additional confidence in the ECB. Second, while the TLTRO program is somewhat modest, and may or may not be effective in materially increasing corporate lending and economic growth, the program will likely continue to attract private capital to Europe. Our team was in Europe earlier this month, and we continue to believe the market is underestimating the amount of restructuring that is occurring

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and the global flows that are moving into the region's challenged sectors—corporate and real estate assets in Italy, Spain, Portugal and Ireland.

No. 2: U.S. Payroll Numbers Surpass Old Highs

Summary: Monthly payroll data in the U.S. was released last Friday. The report itself was almost right on target and showed a solid 217,000 gain. The big headline was that payroll data finally surpassed the previous peak, which occurred in January 2008. This is a milestone, but an essentially meaningless one given that the quality of jobs remains weaker than in any other previous recovery. Moreover, the absolute number of jobs does not account for underlying population growth, and the country remains significantly underemployed.

News or Noise? Noise

Our Take: Payroll data is important and is a central focus of the Federal Reserve, so it will be widely followed. What we find so interesting about the data, however, is how consistent it has been. Trying to measure a data point as complex as payroll on a month-to-month basis is nearly impossible. The data series is subject to huge revisions and, in our opinion, causes needless volatility.

Taking a broader view, the 12-month and 36-month moving averages have been very stable over the last few quarters. Moreover, both are currently running at exactly the same level: 197,000 in monthly gains. The weekly unemployment claims data shows similar stability at around 300,000 per week. The conclusion is that unless some material change in trend occurs over a sustained period of time (at least six months), then there is very little *news* in any of the employment-related data. Month-to-month bounces are just noise.

No. 3: Auto Sales Surge in May

Summary: Auto sales were above 1.6 million units last month, hitting the highest levels since the second quarter of 2005. Gains were broad-based, with most major companies posting double-digit sales increases. The data confirm that last quarter's slowdown was likely weather related.

News or Noise? News

Our Take: Normally, we wouldn't consider a single month of auto sales numbers newsworthy. However, when combined with several other indicators, the data confirms that the economy is gaining momentum faster than many expected. The reality remains that an inflation scare remains a real market risk. The Federal Reserve has tried to provide forward guidance on the pace of removing stimulus (both bond purchase tapering and interest rate increases). Yet the market could begin to perceive the Fed as falling behind the curve. That, in turn, could box the Fed into a corner, forcing it to abandon forward guidance or risk inflation fears. We also have remained positive on the housing recovery

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and believe that auto sales confirm this thesis. Similar to housing, the decision to purchase a car is affected by both consumer confidence and attractive financing. Thus, strong auto sales could foreshadow a stronger-than-expected bounce in housing over coming months.

No. 4: Market Volatility Hits 2007 Levels

Summary: The VIX index is the market's fear indicator, as it measures the expected future volatility of the stock market. Last week, the index dropped under 11, which is nearly half its historic average of 20.09. This was the lowest level since February 2007, before hints of the coming financial crisis were even visible. The extreme complacency amongst investors has caused many analysts to raise a concern about the market's ability to continue advancing.

News or Noise? Noise

Our Take: The solid market performance over the past five years and the relatively high valuations that are now factored into most assets (broadly speaking, equities, bonds and real estate) do cause us to be on an elevated sense of alert. That said, low levels of market volatility can persist for long periods and along with valuations are not necessarily good at predicting imminent market corrections. It is important to realize, however, that some in the Federal Reserve are growing concerned that the extreme levels of stimulus could be adding to a sense of calm. There has been recent speculation that the Fed may try to increase volatility in order to reduce risks of another bubble.

No. 5: U.S. EPA Announces New Emissions Standards for Utility Industry

Summary: Last week, the EPA issued a draft ruling requiring the nation's power plants to reduce emissions by 30% by 2030. As with any major announcement related to environmental issues, the story created a major political standoff between Democrats and Republicans. The rules are focused on phasing out coal plants that currently emit large amounts of the carbon emissions for the utility industry and can't be cost effectively upgraded to more modern and clean burning systems. Coal remains the largest single source of electricity generation capacity at 39% of the U.S. total.

News or Noise? Noise

Our Take: Politically, this is a big story and will likely remain a contentious issue for the remainder of President Obama's second term. Not surprisingly, people have drawn very different conclusions about how the rules will affect the economy. Some argue that the rule will cost almost 500,000 jobs over the next 20 years, while other analysis shows only a slight reduction in cumulative economic growth and very little employment change.

When we analyze a story like this one, we first look at the market's reaction. In this case, coal stocks did not move on the news. The largest coal-focused ETF, KOL, is actually slightly higher than it was a week ago. The reality is that the changes in the utility industry are already happening and this ruling will do little to change that trajectory. The rules require a 30% drop from 2005 levels through 2030, but about half of this drop had already occurred by 2012. The most significant effect of this rule will likely be volatility in energy costs over time, given that

natural gas prices move up and down more than coal prices. In this case, the lack of market action told us the event was already priced into expectations for coal companies.

As you can see, the amount of attention that the media devotes to a particular story often has little relationship to its importance as far as markets are concerned. As we concluded in the first *News or Noise* post, for much of history access to information was a key determination of power. Today, access to information is ubiquitous, and it is therefore the analysis of that information that matters. In his excellent book, *The Signal and the Noise*, Nate Silver concludes, "Information is no longer a scarce commodity; we have more of it than we know what to do with. But relatively little of it is useful. We perceive it selectively, subjectively, and without much self-regard for the distortions that this causes. We think we want information when we really want knowledge."[1] Our goal is to help you turn the huge amount of information you're confronted with every day into that useful knowledge.

Sources

1. Silver, Nate. *The Signal and the Noise: Why So Many Predictions Fail—but Some Don't*. Page 17.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, News or Noise*, we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.*

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