Strategy Thoughts

January 2016

The expectations game

Introduction

In mid-December I concluded that month's issue of Strategy Thoughts with the comment;

> My real concern now is that the slow motion topping process, that has been unfolding for several years across asset classes and regions, will become a more homogeneous and damaging bear market.

Now, one month later, it seems that it has. After I wrote that concluding remark most markets rallied briefly before resuming their declines. Since the end of November junk bond indices have declined about 6%, the S&P500, Shanghai Composite and FTSE have all fallen 8%, the Hang Seng index 9%, the NASDAQ 10%, the Nikkei 11% and the German DAX 14%.

The blame for the decline seems to be once again being placed upon China. In this month's Strategy Thoughts I'll look at what has been the worst start to the year in decades and whether it is all about China, examine where the return, if any, has been over the last year, and then finally look at where expectations are currently and what this may mean for 2016.

The bottom line will be that preservation of capital, as I have been reiterating for a couple of years now, should remain the single most important investment goal for investors this year.

Worst start for decades, a healthy correction?

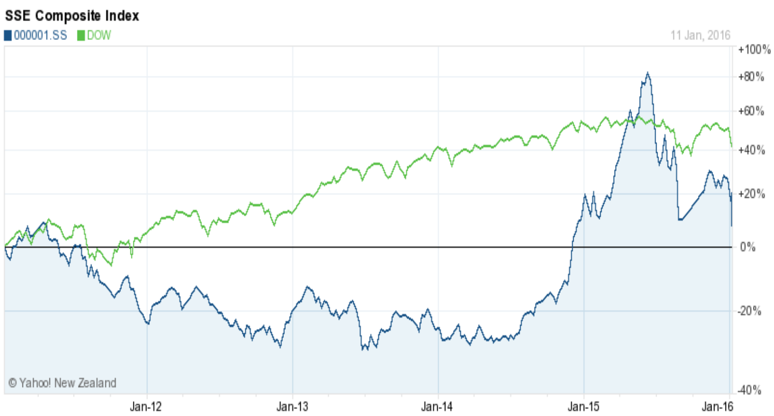
Forbes reported on January 11th;

Can Stocks Stage A Comeback After Worst Start To A Year Since 1930?

The article didn't offer any conclusions but it highlighted just how bad the first few trading days of 2016 have been, and this was coming off an ending to 2015 that had seen stock markets drifting sideways to down for the years last couple of months.

The 'blame' for this horrendous start to a trading year has been squarely placed upon China as the financial Times outlined;

> The catalyst for this week's market turmoil has been China's plunging stock market and weakening currency. Beijing's powerful influence over financial markets this week underlines for investors how the country's policy decisions reverberate across the global stage.



That it is now the Chinese market that is driving the US and other markets is an appealing explanation, however, why the relationship should occur now is less easy to explain.

The chart at the foot of the previous page shows the US Dow Jones Industrial Average compared to the Shanghai Composite over the last five years. It is a stretch to say that there is any causal link, or even a loose correlation, between the movements of the Chinese market and its US counterpart. Broadly speaking, since late 2011 the Chinese market has struggled while the US market rose, at least until mid 2014, then the US market began to plateau while the Chinese market rocketed higher. Only over the last six months, on the back of severe Chinese turmoil does the correlation become positive, but this still does not mean there is any causation. Perhaps a more likely explanation for both markets recent struggles is that neither of them should have rallied to the levels they achieved mid last year. At the levels they achieved back then expectations for both markets were clearly elevated and so vulnerable to disappointment.

Regarding expectations going forward it is perhaps more telling to note the indignation that Americans now feel with their market apparently being at the whim of the Chinese, and this despite all the glowing talk of the benefits of globalisation over the last decade or more.

On 7th January Yahoo Finance ran the following headline;

The stock selloff is happening in a parallel universe

> Do we all live in China now? Investors could be excused for thinking that, given that arcane indicators such as a Chinese manufacturing index and the value of the Chinese yuan are inducing nauseating drops in the US stock market. And the surprise halt to trading in the latest Chinese session, a mere 30 minutes after markets opened, has thrown U.S. and European markets into a tailspin.
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> Last we checked, however, the Dow Jones and S&P 500 indexes were composed of U.S. companies that might do some business in China, but still earn the vast majority of their revenue elsewhere. And elsewhere, economic fundamentals are looking way better than the gloomy start to this year’s trading would suggest.
>
> The U.S. economy will probably grow around 2.5% this year, which isn’t great, but is a sustainable pace that seems nowhere near overheating. The economy can progress at that measured pace for a long time before the next downturn occurs.

The article then went on to list all the good news out there regarding the US economy. It also pointed out that things were improving in Europe and that while there may have been some reasons for a degree of caution there were no reasons for plunging markets. It quoted one major bank’s comments in a calming note to clients;

> “As far as the domestic economy is concerned, we see growth continuing, downside volatility caused by fear and uncertainty creates buying opportunities, in our opinion.”

It is indeed the case that ultimately downside volatility, fear and uncertainty, are all ingredients that are found at great buying opportunities, and at the end of bear markets. But the US market is still only down about 10% from its all time high mid last year and these recent moves may only be the opening salvos in what ultimately does turn into another bear market. It is also the case that at market bottoms the media are always involved in fanning the fear and uncertainty rather than in correctly cautioning in favour of a contrary view.

All of this highlights that what has already been seen to the downside, particularly in the US is generally being seen as unwarranted, unnecessary and therefore another one of those oxymoronic 'healthy corrections'.

On January 8th, after the worst start to a trading year in decades CNBC ran the story;

This isn't like 2008—but a correction IS coming

The prospect of a correction may have been alarming to some readers, but apparently there is no cause for concern, the article went on to point out;

> A 20 percent to 30 percent correction in equity prices would be **a healthy move** after the recent run-up over the last few years. (Emphasis added)

On the same day CNN pointed out that the Dow had suffered its worst start to the year EVER, tumbling into correction (down 10% or more) territory, and then listed the major indices of; France, the UK, Switzerland, Japan, India, Australia and Canada as all having joined the Dow in the correction zone and China and Germany as having already entered bear market territory (down 20%). But like CNBC none of this is cause for any alarm as the article went on to state;

> Corrections are not such a bad thing, especially if they aren't too long. They can be a lot like naps: **healthy breaks** that allow investors to reassess stock prices. (Emphasis added)

It is of great concern that so many still view what has been seen so far this year in such a benign fashion as this implies that expectations remain elevated and the chances of further disappointment far outweigh the possibility of a positive surprise.

Economic expectations

Even though I have long maintained that no causal link exists between the path of an economy and that economy's related stock market it is still useful to know what the majority expect from the economy. Not in the hope that those expectations will be right but rather that it provides good insight into the degree of optimism or pessimism that may already be priced in to markets, and so where disappointments or surprises may lie.

On January 6th the BBC reported;

What can we expect in 2016 from the world economy?

> If the mainstream forecasters are right slightly better than last year. The International Monetary Fund, for example, forecasts growth of 3.6% this year after 3.1% in 2015.

The Wall Street Journal each year surveys more than 60 economists and this year not a single economist is forecasting a recession in the US. The average forecast is for US growth to improve slightly, similar to the BBC findings, to an average growth rate of 2.6%. Remarkably, virtually the same number can be used for their forecasts in each of the next three years. A very neat extrapolation of what has been experienced since 2010. This would be an amazingly stable outcome if it were to eventuate, particularly given the growing volatility across asset classes and growing levels of tension geopolitically.

The same survey by the Wall Street Journal in December 2007 had the average of 54 economists looking for growth to accelerate through each quarter of 2008 from a meagre 1.5% in the first quarter of 2008 through to 2.7% in the fourth quarter and an average for the year of 2.2%. It actually came out twelve months later at -0.3%. With 54 economists being surveyed in 2007 there were 2016 separate quarterly estimates of growth, only 4 were negative! Given such universally optimistic forecasts immediately ahead of what would become the Global Financial Crisis it is not surprising that stock markets responded so poorly to the repeated economic disappointments that were delivered.

By December 2008, a year later, the same survey respondents had softened their optimism a great deal and forecast zero real growth for calendar 2009; it actually came out at -2.8%. In that survey those forecasting actual growth were about even with those calling for a decline, but the worst decline forecast was -1.9% so disappointments continued into 2009.

On the back of such severe disappointments expectations on the part of economic forecasters got ratcheted lower and lower and even through mid 2009, as evidence of a recovery was at hand and equity markets were soaring many economists erred on the side of caution and warned of the risk of the dreaded 'double dip'. In august 2009 the Financial Times ran the headline;

The risk of a double-dip recession is rising

Even late in the year that fear remained as the Reuters story from September;

Double-dip recession risk rising: El-Erian

And the Business Insider story from December highlighted;

Risk Of Double-Dip Recession Is Rising, Says Krugman

With such depressed expectations it was not difficult for markets to receive positive surprises and so the cyclical bull market that began in March of 2009 continued.

Unfortunately economic expectations now are more similar to those in late 2007 than those found at great buying opportunities like early 2009. The same is true of expectations for the stock market.

Stock market expectations

In the past I have frequently referred to the survey of Wall Street strategists that Barron's conducts in December of each year as forecasts from strategists can be just as informative regarding levels of expectations as those from economists. To the right is the cover from Barron's outlook edition last month and the subtitle reveals that for 2016 the average forecast from the Wall Street strategists surveyed is for the market to rise 10%, apparently propelled by modest profit growth. This seems a reasonable and measured forecast but unfortunately it is almost identical to that made by the same forecasters the year before. The average forecast from strategists in December 2014 was for the

S&P500 to end the year at 2210, a round 10% rise from the 2002 level that it was at when the survey results were published. Not one of those strategists surveyed saw the market falling in 2015, but to be fair the market did only fall a tiny fraction of a percent in calendar 2015.

Business Insider conducts a slightly broader survey of strategist forecasts and their results are very similar. The average forecast the fourteen strategists they surveyed gave was for the market to end 2015 at 2211 and like Barron's not one forecast a down year. Their survey for the year ahead reveals an expectation for the market to rise 10% to 2200 and incredibly almost half of those strategists surveyed look for the year to end at 2200 plus or minus just 25 points. It seems the very strong human instinct of herding is still alive and well and it does raise the question of where the surprise is most likely to fall.

It could be that the world, and particularly the US, continues its economic recovery at an even better rate than that forecast by the economists and that the stock market obliges with another positive year and rises possibly more than currently expected. Or, perhaps there is greater room for the economy to be a little less positive than expected and for the markets to reflect that disappointmnet. This is what happened in 2008.

Back then, at year end 2007, economic forecasters were modestly constructive and so too were strategists who forecast a 12% rise in the S&P. Both these expectations proved wildly optimistic as the economy imploded and the market fell by 38% in the calendar year.

It continues to be my concern that the possibility of the general news backdrop being more constructive and more positive than that currently expected is substantially lower than the risk of some modest disappointment. It is important to remember that for a bear market to begin and a peak to have occurred the news doesn't have to be outright bad, just not as positive as the majority previously anticipated.

This process of gradual and incremental disappointments and the subsequent rolling over of markets may already have begun.

Where has the return been?

Last month in 'Risk is not a knob' I highlighted that over the last year or more it really hasn't mattered what risk profile an investor had chosen, all risk profiles pretty much broke even and there certainly hadn't been any extra return generated through taking on more risk. Then I used the total return of US investment vehicles over the last year to illustrate this point, but this also raises a bigger question; has risk been rewarded anywhere and in what currency?

In New Zealand over the last year returns have been reasonable with the most aggressive risk profiles generating returns in the low double digit range, however, these returns have to be kept in perspective, particularly when compared to returns generated by the similar risk profiles in the US that I showed last month. When measured in US dollars the Kiwi fell by 13% in 2015 eliminating all the gains that risk taking had delivered. Risk did generate a little greater return in New Zealand, but not when looked upon on a global basis.

In researching the numbers from New Zealand Kiwisavers in order to be able to make this comparison I came across some interesting observations from a New Zealand Morningstar analyst that further highlighted the generally benign expectations that I have already described for 2016 from a US perspective.

On the 7th January the analyst was asked about the outlook for 2016. She felt that *"there was unlikely to be any major upset for KiwiSaver investors through 2016"* and that *"she was not expecting major equity market losses"*. She further went on to state that *"KiwiSaver funds were well diversified, with reasonable asset allocation that would make them able to weather market environments such as the current one well."* And that she was *"not worried about the structure of the KiwiSaver managers we cover."*

Her concluding remark was that *"She said she did not expect aggressive and growth funds to stop being the best performers because there is no equity market collapse predicted, and fixed interest is also expected to deliver muted returns."*

All this may be very comforting to the average investor, however, feeling safe because 'no equity market collapse is predicted' is probably not the firmest foundation upon which to build a strategy. No equity market was predicted at year end 2007!

The reward for dialling up the risk knob in New Zealand over the last year was not unique, total returns from equities were reasonable in a few other major markets, notably Germany, France and Japan. Unfortunately once converted into US dollars for comparison purposes the German and French experience, just as in the case of New Zealand, became far less rewarding as all the gains from risk assets were taken away by currency movements. Japan was virtually unique last year in rewarding risk as the yen was virtually flat versus the dollar.

Return from equities across major markets in local currency terms:

Country	Index	Gross Returns*	Components	
			Dividends	Capital
New Zealand	NZX50	**13.6%**	5.1%	8.5%
France	CAC 40	**11.9%**	3.4%	8.5%
Japan	Nikkei 225	**11.0%**	1.9%	9.1%
Germany	DAX 30	**9.6%**	-	-
US Nasdaq	Composite	**7.0%**	1.3%	5.7%
Australia	S&P/ASX 200	**2.6%**	4.7%	(2.1%)
US S&P	S&P500	**1.4%**	2.1%	(0.7%)
US Dow Jones	DJIA	**0.2%**	2.4%	(2.2%)
Developed markets (USD)	MSCI	**(0.3%)**	2.4%	(2.7%)
United Kingdom	FTSE 100	**(1.3%)**	3.6%	(4.9%)
Hong Kong	Hang Seng	**(3.9%)**	3.3%	(7.2%)
Emerging markets (USD)	MSCI	**(14.6%)**	2.4%	(17.0%)

*In local currencies

In Australia the returns from taking risk were very modest and became substantially negative when currency factors were included and the same was true in the UK, Hong Kong and the emerging markets.

The bottom line is that 2015 was a year when it was very hard to generate a real return on a global basis, despite the substantial rhetoric to the contrary amid the benign and optimistic forecasts for the year to come.

Thoughts on supply demand

Listening to the commentary that has accompanied this most recent leg of decline in the price of oil it would be easy to be taken in by the simple and appealing idea that the price of any asset (investment of otherwise) is simply a function of supply or demand. We seemingly hear daily that the price of oil continues to fall due to excess supply or that stock markets fall due to there being more sellers than buyers. Unfortunately things are far from this simple. When it comes to stock markets, there are always exactly the same number of buyers and sellers, otherwise a trade cannot take place, what matters is the level of enthusiasm or urgency on the part of buyers and sellers, and this is an emotional, expectationally, driven factor, not an economic one. And when it comes to commodities it is clear that even those organisations with the best information regarding levels of supply and demand consistently fail to forecast where prices will go.

In his marvellous 2010 book 'Economyths' David Orrell wrote of the futility in believing that somehow there was this direct relationship between the price of an asset and the prevailing supply and demand situation for that asset.

> In fact the idea that supply or demand can be expressed in terms of neat lines at all is a fiction. As econophysicist Joe McCarthy observed, there is no empirical evidence for the existence of such curves. Despite that, 'intersecting neo-classical supply-demand curves remain the foundation of every standard economics textbook'. Like unicorns, the plot of supply and demand is a mythological beast that is often drawn, but never actually seen.
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> This helps explain why large economic models, which are based on the same laws, fail to make accurate predictions (traditionally the test of reductionist theories).

He then goes on to review the forecasts, over the previous quarter of a century, of the Energy Information Administration, (part of the US Department of Energy). There forecasts are based upon computations using their World Oil Refining, Logistics and Demand model.

> In the 180s, the predictions called for prices to increase, probably because the models incorporated memory of the 1970s oil shock. Prices instead fell and remained low for the next couple of decades. The forecasts eventually learned that prices were not going to return to previous levels, and flattened out; but as soon as they did prices spiked up to $147 per barrel. Then plummeted to $33. Then doubled again.
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> This oil price spike played a large part in exacerbating the credit crunch, but went completely unpredicted by the experts. The reason is that it had absolutely nothing to do with supply or demand. According to the EIA, world oil supply actually *rose,* and demand *dropped,* in the six months preceding the spike.

Oil is obviously closer to the opposite price extreme now than it was when it hit $147 in 2008, and it is easy to believe that the price can only keep falling given the apparent oversupply that exists, however, it is important to remember that supply and demand does not set prices, what does is expectations on the part of market participants, and what causes prices to change are surprises and disappointments. It seems right now that given the extremely bleak expectations in the oil market that if there is to be a surprise or disappointment it is more likely to be a surprise. There still may be massive oversupply, but if that oversupply is less than the majority fear then it will qualify as a positive surprise and the price will rise.

Conclusions

2015 was not a good year for most investors, risk assets generally did poorly, and, as I have been documenting for much of the last couple of years, market after market and asset class after asset class is rolling over into what I fear will be another cyclical bear market comparable to the other two that have been endured so far in the 2000s.

The severe weakness that has been seen around the world over the first couple of weeks of 2016 will likely be looked back upon as having been merely a part of these cyclical bear markets and will almost certainly prove to be no more 'healthy' than any of the other so called 'heathy corrections' that have been seen over the years. I continue to feel this way, partly in spite of the generally benign expectations that seem to dominate currently and, possibly even more so, because of those expectations.

I have long maintained that economics should not be the foundation upon which investment views are constructed. Markets are a reflection of the expectations, the hopes and fears, of all those involved in a market and eventually those same emotions get reflected in economic data. However, there is a substantial lag. That is why markets are a better forecaster of the economy than the other way around. An understanding of crowd psychology and the biases that so beset all human behaviour is of enormous value in understanding why markets do what they do, certainly more so than looking for what may, after the event, appear to be a reasonable economic explanation for whatever has occurred.

I have shared many such thoughts and observations on what drives markets, why they do what they do and how to think about investing over the last eighteen years that I have been writing Strategy Thoughts. I have now been convinced by my publisher, Michael Wilkinson of Wilkinson Publishing, to attempt to pull all these ideas into one volume and have now begun work on;

Investing, how to win the expectations game and why most investors lose

I will keep readers posted on the book's progress and further developments to Strategy Thoughts in the months ahead of what may well prove to be a most challenging year.

Kevin Armstrong

12th January 2016