Strategy Thoughts

July 2014

Avoiding the irrelevant crutch

Introduction

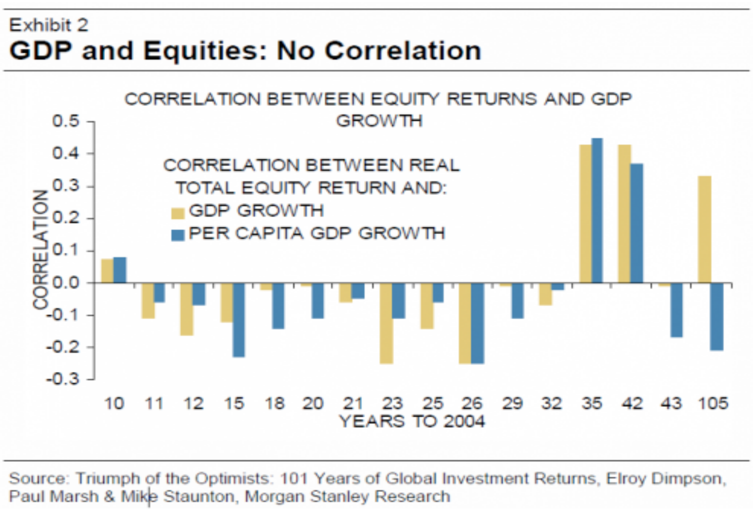
Investors must have an opinion or a view upon what markets are likely to do and why, particularly if they have any interest in having their investments perform and especially if they want to avoid 'permanent loss of capital'. It is therefore interesting to explore what the majority of investors base their views and forecasts upon, and why. Further, it is really interesting to examine whether there is any evidence that what the majority base their forecasts upon actually provide any insight whatsoever as to what may happen to markets.

In this month's Strategy Thoughts I pick up on one of the topics that I discussed last month and attempt to add further clarity as to just what it is that drives markets, how this can be identified and then how it can be employed over multiple time frames. Before this I examine the usefulness, or otherwise, of those things that the majority attempt to forecast and upon which they build their investment view, namely; economics, interest rates and earnings.

Economics

Over the last dozen or more years I have repeatedly attempted to wean investors away from believing that any stock market is driven by movements in that country or region's economy and that therefore all that is required for an accurate, and so useful, investment view was an accurate economic outlook. Unfortunately this just does not work, firstly because a consistently accurate, and so useful, economic view doesn't exist and secondly, and far more importantly, because over the time periods that most investors are interested in there is no correlation between economic movements and stock market movements. Both these facts have been illustrated many times as the following selection of pictures and quotes highlight;

- Morgan Stanley a couple of years ago produced the following chart that reveals a meaningful positive correlation between a country's economic performance and its stock market performance only exists after more than three decades! Far longer than most investors would ever contemplate investing for.



- Around the same time a Bank of New York Mellon research report arrived at a very similar conclusion when it announced “Over longer time periods, the statistical correlation between the quarterly change of real US GDP and the S&P500 is virtually zero.”

- That same BNY Mellon report went on to show a similar finding for European markets and European economic growth. Having undermined the readers’ faith in the usefulness of economics to help steer an investor through the stock market the report ended with “We believe investors should not invest in stocks purely based upon economic cycles, not least because **economic forecasts can be wrong.”** (Emphasis added)

- Further on the usefulness or otherwise of economics in investing Charles Plosser, the president of the Federal Reserve Bank of Philadelphia, is reported to have commented “If you study the Fed over the years, over its history, it’s always behind the curve.”

- The idea that the Fed are consistently ‘behind the curve’ was recently expanded upon in a Seeking Alpha posting;

> Unfortunately, in each cycle, the Fed eventually winds up 'behind the curve', still providing positive guidance even after economic conditions have turned sour.
>
> At that stage, when the reality no longer supports the Fed's optimism, it does not fool markets for long. They often have bear markets underway well before the Fed admits the changed conditions.
>
> There are far too many examples to cite. But for example, in May 2000, with the 2000-2002 bear market already underway, then Fed Chairman Alan Greenspan was still saying, *"Economic growth is enhanced by the kinds of financial innovation that technology and deregulation are now producing."*
>
> As the housing bubble burst in 2006, Fed Chairman Bernanke assured us that *"Our assessment is that this looks to be a very orderly and moderate kind of cooling."*
>
> In 2007, when it could no longer be denied that it had been a bubble which had burst, and as the economy headed toward the 2008 financial meltdown, he said, *"Our assessment is that there's not much indication that subprime mortgage issues will spread into the broader mortgage market, which still seems healthy."*
>
> In January 2008, with the 'Great Recession' already underway, Bernanke said, *"The Federal Reserve is not currently forecasting a recession."*
>
> In June 2008, as the economy and stock market rolled over into the second and worst downleg, Bernanke said, *"The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so."*

> This week, the Fed surprised markets and analysts, the majority of whom expected the Fed would have to acknowledge in its FOMC statement that both the economic slowdown and rising inflation have become problematic.
>
> Instead, the Fed said, *"Economic activity has rebounded since our last meeting* [in March]. And, "*Inflation has been running below the Committee's longer-run objective of 2.0%."*

Despite all the above, the failure of economics to forecast markets and the failure of even central bankers to forecast the economy, it is still the economy upon which the majority of stock market discussion is based and the outlook for the economy upon which investment strategies are built. This is highlighted by the following headlines from the financial media over the last few weeks;

Asia Pacific Market: Stocks gain on improving outlook for global economy

Emerging Stocks Climb to 13-Month High on Global Growth Outlook

Stocks extend losses after World Bank cuts outlook

Shares jump on improved global outlook

Perhaps adding to the confusion is that at times the economy and market not moving in synch provides frustration to central bankers as this recent Wall Street Journal headline reflects;

Global Markets' Strength Doesn't Reflect Economic Outlook, Central Banks Say

Perhaps the question that should be raised, given the historically weak and frequently negative correlation between the two, is 'why should it?'

It is understandable that investors want to know just what it is that drives markets, and it appears sensible that there should exist some relationship between economics and investing, sadly history has repeated shown that any comfort one takes from and economic outlook, whilst understandable, is terribly misplaced.

Interest rates

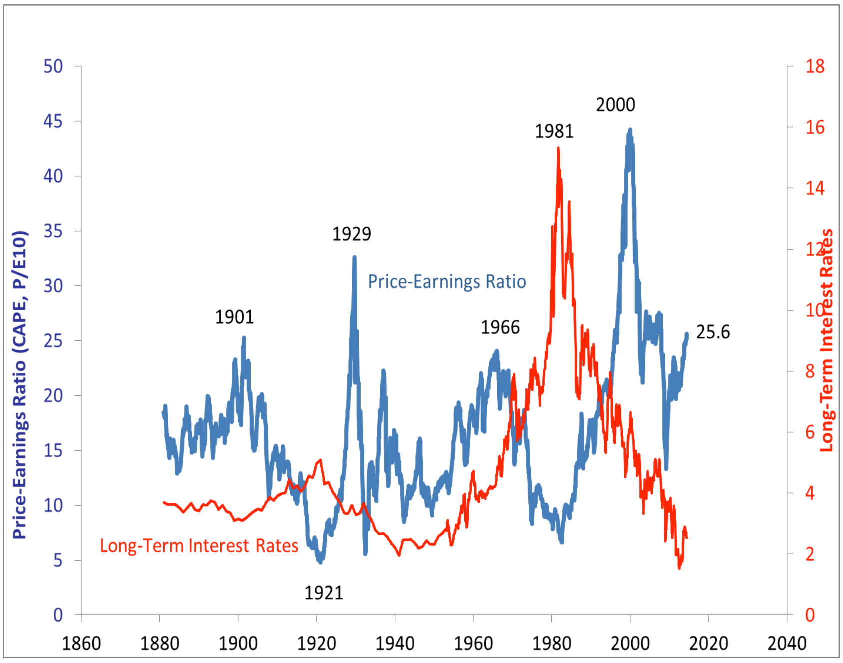
Through the nineties the so called Fed Model became a popular tool for forecasting future stock market returns. At its heart was the idea that if longer term interest rates fell then the attractiveness of equities would increase. Superficially this is a simple and appealing idea and it seems intuitively sensible that if returns from risk free treasuries were falling then the price one would be prepared to pay for a dollar of equity earnings should increase. Bolstering all this was the fact that the model seemed to work.

The accompanying chart shows what looks like a remarkably close relationship between the yield on the ten year treasury and the inverse of the S&P's P/E ratio. If one had had perfect foresight, and known that the ten year yield was going to continue to plunge for more than a dozen years, it would have seemed reasonable to assume that the great bull market of the nineties had many more years to run. Unfortunately, as so often happens in investing, just as any relationship becomes widely known and followed it totally breaks down and since 2000 the Fed Model has been no exception. Rather than continuing to move in lock step as the two lines had through the eighties and the nineties they have widely diverged and of course the two worst bear markets of the last seventy years have been endured. Nonetheless, many still hang on to the Fed Model and employ it to justify why markets continue to be 'cheap'.

Last week Professor Robert Shiller was interviewed on Yahoo's Daily Ticker and he had the following to say about current stock market valuations and the fact that very low interest rates do little to make him any more comfortable about those valuations;

> "I am definitely concerned. When was [the cyclically adjusted P/E ratio or CAPE] higher than it is now? I can tell you: 1929, 2000 and 2007. Very low interest rates help to explain the high CAPE. That doesn't mean that the high CAPE isn't a forecast of bad performance. When I look at interest rates in a forecasting regression with the CAPE, I don't get much additional benefit from looking at interest rates… We don't know what it's going to do. There could be a massive crash, like we saw in 2000 and 2007, the last two times it looked like this. But I don't know. I think, realistically, stocks should be in someone's portfolio. Maybe lighten up… One thing though, I don't know how many people look at plots of the market. If you just look at a plot of one of the major averages in the U.S., you'll see what look like three peaks – 2000, 2007 and now – it just looks to me like a peak. I'm not saying it is. I would think that there are people thinking – *way* – it's gone *way* up since 2009. It's likely to turn down again, just like it did the last two times."

Despite these comments from the architect of CAPE himself there still are a large number of investors who believe the very long term history of CAPE and interest data can be ignored.



This weekend I read an article that actually used Professor Shiller's own data to claim that the US market was cheap and heading to another almost doubling over the next five years. The author's analysis conveniently only looked at data in what he termed the 'modern era of investing', 1987 to present. He did concede that his analysis would have produced a quite different result had pre 1987 data been included.

Just as it is appealing to think that somehow economics holds the answer to where markets are going it is intuitively comfortable to rationalise that lower long term yields should justify higher stock markets through higher P/E ratios. It certainly seemed to in the eighties and nineties; however, it is far more likely that both were symptoms of some larger force than one being the cause and one the effect. It should also be remembered that in many ways the proponents of the Fed Model have been incredibly selective with the history they employ. The chart above is from Professor Shiller's website and shows the long term P/E ratio for the US market and long term interest rates. The neat inverse relationship that the Fed Model relies upon is clear from the 1966 secular peak in equities, through to the 1981 peak in yields (and trough in equities and P/E's) and on to the huge market peak in 2000. Since then, however, the relationship has totally broken down, and for the two decades leading up to the 1966 peak the relationship appears to have been the complete opposite of what the Fed Model would predict, bond yields and P/E's rose together.

Earnings

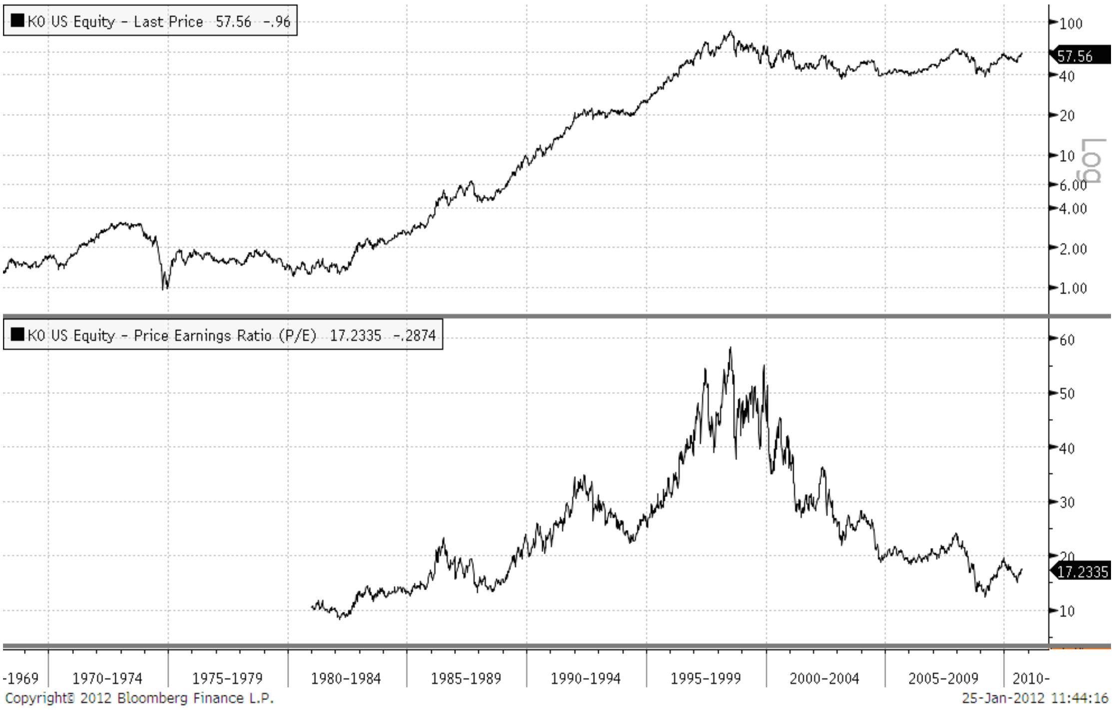
The third leg that most individual stock and broader market forecasts are based upon, after an economic outlook and a forecast for interest rates is earnings, be it for an individual stock or the market as a whole. Forecasting earnings has become an enormous and widely followed industry and just as with the other two 'legs' it does feel as though having perfect foresight on earnings would provide some valuable insights as to the direction of individual stocks and markets as a whole. Again, despite the seeming sensibleness of basing an investment on an earnings outlook, history has been less than kind to this apparently sensible and prudent approach.

Looking at the market as a whole I went back and reviewed the earnings and price performance of the S&P500 since 1960. Over these fifty three years there have been ten years during which earnings fell; interestingly the market only fell in three of those years. Overall having perfect foresight on whether corporate earnings were going to rise or fall only proved helpful to an investor less than two thirds of the time. In eighteen of the fifty three years the market either rose when earnings fell or fell while earnings rose. In fact simply betting that the market would rise (it only recorded 14 declining years) proved more accurate than the possession of perfect foresight on earnings direction. Given the huge swings that have been seen in price earnings ratios over that time period, as illustrated above, this should not be too surprising.

Despite this clear disconnect between earnings direction and market movement the vast industry of analysts and economists continue to attempt to forecast what the S&P will earn next year. Sadly any comfort an investor may feel from a positive forecast for corporate earnings is again misplaced.

The same is true in the world of individual companies and the earnings that are forecast for them. A couple of years ago I reproduced some long term charts for the Coca-Cola Company, at the time it was to illustrate the existence of long term secular moves in valuation for individual companies, but they also illustrate the relative futility of perfect foresight in forecasting corporate earnings.

The chart below shows Coca-Cola's price history back to the late 1960's. Unfortunately P/E data is difficult to source prior to 1980, however we do know that at the share market peak in late 1972, early 1973, there were a group of companies in the US, known as the 'nifty fifty' that were supposedly one decision stocks. Price didn't matter, these companies had such strong brands and businesses that all one needed to do was hold on to them. As a result the 'nifty fifty' became incredibly expensive. McDonalds traded on 71 times earnings, Avon Products on 61 times, Johnson and Johnson on 57 times and Coke on 45 times earnings. This marked a long term, secular, price peak for most of these companies, what followed was a devastating bear market that hammered the ‘nifty fifty’. Coke’s share price fell from a high of $3.13 to a low of just 93 cents, a fall of more than 70%, but more importantly from an investment perspective the share price languished, as can be seen on the chart below until 1982, by which time its previously astronomical valuation had fallen to a mere 8.4 time earnings.



This marked the end of a secular bear market for Coke, and most of the ‘nifty fifty’, and so the start of a phenomenally rewarding secular bull market that would last for Coke until 1998, by which time its valuation had once again risen to an historically high level, 57 times earnings. This was the end of its secular bull market. Since that peak Coke’s share price has meandered around in a broad trading range from $40 to $80 and as a result of this sideways action and continued earnings growth the P/E fell to 12.4 in 2009. Probably a P/E somewhere in the high single digits will need to be seen some time over the next few years to mark the end of the current secular bear market, whether that will require the stock to fall below its mid 2000’s low only time will tell. Nonetheless it is clear that secular extremes are seen in individual stocks and sectors, just as they are in markets as a whole.

Of equal importance to the existence of secular bull and bear markets in Coke is that throughout the period described accurately forecasting earnings was of little use in forecasting what the stock would do. It is obvious that the huge contraction and then expansion and then contraction in P/E ratio has been far and away the primary driver of Coke’s stock price, not its underlying earnings. Analysts forecast earnings because they can, and they get a lot of guidance as to what they might be. Investors would be far better placed considering what P/E ratios might do over lengthy periods of time, for both individual stocks and the market as a whole, but this is far more challenging. As I illustrated earlier P/E ratios, despite some widespread belief to the contrary, are not the reciprocal of interest rates or the result of movements in interest rates, but what does drive those expansions and contractions gets closer to the heart of what it is that actually drives markets.

The true driver of markets

I have written many times that the ultimate driver of any market is the collective, wisdom, mood or view of all participants in that market. If you think about this statement for a while you quickly realise that this has to be the case. The only thing that moves markets is the buying and selling decisions, be they impetuous or considered, of underlying investors and, as the discussion above clearly illustrates, there is no neat causal relationship between changes in earnings, interest rates or the economy that cause those decisions to be made. Rather those decisions are driven by the very powerful, deeply ingrained behavioural biases that drive so much of human activity. Much as we may wish to be we are far from being the totally rational and entirely self-interested 'homo economicus' of economic theory. It is those biases of herding, loss aversion and hindisight, amongst others, which result in our collective, frequently irrational, investment behaviour, and then there is the very strong bias we all have to anchor. James Montier in 'Behavioural Investing' described anchoring as the tendency we have to grab on to the irrelevant as a crutch when we are faced with uncertainty. Investing is obviously inherently uncertain, it always involves the future, and so it is understandable that we look for something to 'grab on to' and earnings, interest rates and economic forecasts, despite their poor record of providing any actual help, do offer seemingly sensible and rational things to anchor on to.

Observing that it is sentiment or mood that drives markets is one thing, and it does at least start to provide a different perspective on what is actually happening in markets and can provide a level of discipline that can assist in avoiding the many biases we all face, but it is obviously very difficult to pin down or quantify. There are no hard and fast measures or indications of sentiment.

In many ways one of the major investment approaches, value investing, is nothing more than sentiment investing. If you think about why any market, or an individual stock, becomes historically cheap, and so appears on a value investor's screening, it has to be because sentiment towards that market or individual stock is miserably depressed. Things become cheap not because of any direct influence from so called fundamentals, things become cheap because nobody wants to own them and expectations for the future of that stock or market are bleak at best. From such a position the news, or fundamentals, for that stock or market do not have to reverse and become good for the price to rise. All that has to happen is that the news or fundamentals need only to be a little less bleak than by then the majority expect.

Reflecting back to the most important reversal in global equity markets of the last decade, the lows of early March 2009, reveals this market behaviour clearly. As what would become known as the GFC unfolded and markets fell lower and lower so too did investor expectations. Sentiment grew blacker and blacker and economic forecasts became grimmer and grimmer. With hindsight it is tempting to think that the so called fundamentals reversed around the same time as the market, this would seem to make some causal sense, but this is far from what actually happened. When the markets started to rebound and accelerate higher there was almost universal condemnation of the rally, it was just another of the many false dawns and 'dead cat bounces' that had been seen many times over the prior year, and forecasts for the economy and earnings, quite rightly, continued to be cut. Only after markets had rallied for many months and in some cases doubled did the so called fundamentals of earnings and the economy begin to say that the worst of the GFC had indeed passed.

The reason markets bottomed when they did was because the by then feared 'Great Depression II' did not eventuate. The background news and fundamentals continued to be bad and to worsen, but it wasn't as bad as by then the vast majority feared. Markets bottom not because things start to recover, waiting for that will result in nothing but frustration, markets bottom because things are still bad but not as absolutely miserable as the majority expect. Markets bottom amid deeply depressed expectations, sentiment and mood.

The same, in reverse, is true of peaks, although important peaks do tend to be more diffused than important troughs. Why this is I don't know but it may have something to do with another of those fundamental biases that we are all prey to, loss aversion. Research has shown that we feel the pain of a loss as being about twice as painful as the pleasure we get from an equivalent gain and so at a market peak, when everyone is playing with the houses money, emotions or sentiment may not be as acute as a at a trough when everyone is feeling pain. Nonetheless, even though peaks may be more spread out similar, only reverse, behaviours and expectations are observed.

Thinking about the Coca-Cola example earlier, that stocks two important peaks, in 1972/3 and 1998 did not occur because the company's business suddenly imploded. Those peaks occurred because when valuations had been pushed to such historic extremes expectations, and so sentiment, were through the roof, there was no room for disappointment. When expectations become so extrapolated whatever actually happens is almost certainly going to be a disappointment and a previously virtuous spiral goes into reverse.

Over the last month I have studied a lot of the published research on the relationship between economics and the movement of investment markets. Earlier I mentioned a couple that clearly showed that the correlation that so many expect and hope for just doesn't exist, however, another published by Schroders went a little further and touched on the point I have been trying to make regarding the role of expectations;

> If expectations are key, a poor economic outlook will already be priced in, and investors' returns will depend instead upon whether market expectations are overly optimistic or pessimistic with regards to future GDP growth.

The paper's final conclusion was;

> Because changes to growth expectations do seem to have a significant impact on equity returns, investors should pay close attention to surprises (on the upside or downside) which are likely to drive market returns.

At least from a GDP standpoint it is clear that over the long term there are many surprises as the chart below shows.

The chart not only illustrates the futility of hoping an economic forecast will be right, (let alone help build a useful investment view) it also demonstrates the magnitude of economic surprises and disappointments that have been seen over the last few decades and the major negative surprises have all offered great investment opportunities.

The challenge for investors is not coming up with better forecasts for earnings or interest rates or even GDP, the challenge for investors is to establish in what direction the next large surprise is likely to be. After more than five years of a bull market and the accompanying ramping up in expectations I continue to believe that the biggest risk investors currently face is disappointment, not that the news, be it on the economy, earnings or interest rates, will be even better than the majority by now hope.

As I wrote earlier there is no single means of determining the level or magnitude of investor sentiment, this is why investing is an art not a science and it is also why comfort and success rarely go hand in hand in investing. However, over the last almost fifteen years that I have been writing Strategy Thoughts, a period that has witnessed at least two important market peaks and two important troughs, I have frequently used the analogy of bull markets climbing a 'wall of worry' and bear markets sliding down a 'slope of hope' to help illustrate the importance and usefulness of investor sentiment.

A recent 'Seeking Alpha' post noted the list of worries that the market currently had to face. The list included.

- Russia taking back the original USSR and eastern Europe
- China going after Japan/Taiwan
- Israel and its ongoing escalation with Iran, Hamas, and every other mid-east country
- North Korea vs. anyone and everyone
- The Iraq fiasco and our stupidity to seek a potential alliance with Iran?
- Opening the gates to illegals, including cartel members.
- Many of the minor potential military conflicts and, of course our own staggering economy.

The author did not go on to mention that this was a healthy sign for the market but was fairly cavalier regarding the potential negatives of these worries. This set me thinking about the old adage of a bull market climbing a 'wall of worry'. Unfortunately this aphorism gets widely misused late in a bull market. There are always things to worry about, the essence of the phrase is whether or not the majority **choose** to worry or not. In the early stages of a bull market they do, in the latter stages, when the 'wall' has been largely surmounted, they choose not to. Currently there seems to be far more choosing not to worry than expressing real deep seated concern over what these worries could actually mean for markets.

Conclusion

A view and a discipline are essential to any investor, as is an understanding and appreciation of the time frames over which that view applies and how that discipline will be brought to bear. It is a cop out for an investor to imply that they don't care what the market does, particularly if they then support that contention of ambivalence by maintaining that they are investing for the long term. Sadly very few investors have the internal fortitude, self-confidence and most importantly the discipline of legendary investors like Warren Buffett. The troughs of deep bear markets are all littered with the discarded portfolios of previously steadfast long term investors who just couldn't take the pain of seeing their net worth fall lower and lower every day. Investors whose time frames contracted and contracted as the bear market ran its course until finally to get rid of the pain, and with the 'long term' well and truly forgotten, they sold out at any price.

Hopefully this month's edition of Strategy Thoughts has further clarified what I believe drives markets, what an investor should consider when they are building their own view and also what they should not rely upon. Understanding the driving force of investor sentiment, and studying it over multiple time frames, allows an investor to build a disciplined approach that can help side step many of the powerful behavioural biases we all so easily succumb to.

I continue to believe that preservation of capital will be the most important investment goal, not chasing further gains or higher yields, for most investors over the coming months. My views remain largely unchanged and readers will not be surprised to hear that the following excerpt from Streetsmartreport.com's blog that was published in Barron's recently struck a chord with me;

> In spite of investors being right so far this time with their complacency and confidence, as measured by the VIX (the "Fear Index"), put/call ratios, Investors Intelligence Sentiment Index, record margin debt, and so on, we believe otherwise. We are looking at the high stock valuation levels, the negative seasonality (in terms of annual "Sell in May," and the intermediate-term four-year presidential cycle), and numerous other ominous situations seen at previous market tops. And we are paying attention to warnings from smart money, even though most have been wrong since turning negative on the market a year ago. Nobel prize economist Robert Shiller: "The Shiller CAPE P/E ratio is unusually high right now. Historically it hasn't been this high many times in history, just 1929, 2000, 2007." Mohamed El-Erian, former co-chair Pimco, current chief economic advisor, Allianz Group: "I am watching patiently from the sidelines. Does it mean I may be forgoing more profits? Yes, it does, but that's a risk I'm willing to take." Jeremy Grantham, CEO of GMO, in his first-quarter letter to clients: "There is simply no alternative to standing your ground and taking it on the chin when crazy markets get even crazier. Our consolation will be knowing that we will win in the end." We could fill the page with others to whom we are paying attention, not because they are in agreement with our position, but because their warnings have been so accurate in the past, even though early.

Kevin Armstrong

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