Strategy Thoughts

May / June 2016

How things have changed

The dollar, equity markets, Apple and the danger of Tina Fomo

Introduction

Over the last few months expectations towards a number of markets have changed dramatically. Given that it is expectations which are reflected in markets and that it is surprises and disappointments driving markets these recent swings in expectation have laid the foundations for what may be some important reversals in markets. In this month's Strategy Thoughts I re-examine the US dollar and the recent extreme negativity it has attracted and raise the possibility that the currency's next bull leg has just begun. I also question whether the remarkable bounce back equity markets have enjoyed over the least four months is sustainable given the accompanying, and very rapid, bounce back in expectations towards global equities, and I revisit Apple. Over the last fourteen months I have been tracking the relative performance of Apple and the stock it replaced in the Dow, AT&T. Since that switch was made the underperformance of Apple has been enormous, however, now it seems that expectations may have begun to catch up with and match the deterioration that Apple has suffered.

Finally this month's Strategy Thoughts looks at the danger of relying upon whatever may be obvious to everyone to support a market view. In the past this may have been liquidity or interest rates, now it is two acronyms; TINA and FOMO. There is no alternative and fear of missing out.

The US dollar

From the beginning of December last year through to the start of May the US dollar index had fallen 8% and was at the same value it had first reached in late January last year. Over the intervening fifteen months the currency rose for a couple of months and then entered a broad trading range. Last month I described how attitudes towards the dollar deteriorated as that trading range progressed and raised the possibility that a meaningful rally may not be that far away. I wrote;

> Long time readers will know that I have favoured the US dollar as a store of value in the pursuit of capital preservation for some time. I did sell half my position in the long US dollar ETF more than a year ago after the dramatic run up the dollar enjoyed in 2014; however, I continued to feel that further upside was still possible. After that dramatic run up I included Investup.com's sentiment indicator for the US dollar which had just reached the highest possible level of 100. At the time in late January 2015 I wrote;
>
> > I am far from convinced that the dollar bull market is over and I don't think that what we have seen recently is the extreme extrapolation and overestimation that is seen at long term turning points, however, the move over the last few months has been extreme as has the shorter term shift in sentiment that has accompanied it. On the back of this, and in the interests of full disclosure, I have now sold half of my long US Dollar position and brought the dollars back into Kiwi dollars. I fully expect that on a meaningful US dollar correction I will reestablish my full position and hold it until something similar, only in reverse, to that which was seen in late 2007 occurs.

I did not ever get the opportunity reinstate the position largely due to the fact, as can be seen in the updated Investup.com chart (left), the dollar has been meandering in a relatively narrow trading range since it reached that extreme sentiment peak fifteen months ago.

What is interesting now from a sentiment standpoint is that this sideways consolidation has been sufficient to work off all that record breaking enthusiasm for the dollar and sentiment measures are now, for the first time in two years once again entering the fear range. None of this means that the dollar is set to suddenly rally higher, however, with expectations diming for the US currency it seems that the most likely surprise would be a dollar rally over the coming months. This is particularly the case given that now it seems everyone knows why the US dollar has been so weak and why this should continue, as reported by Reuters on 30th March;

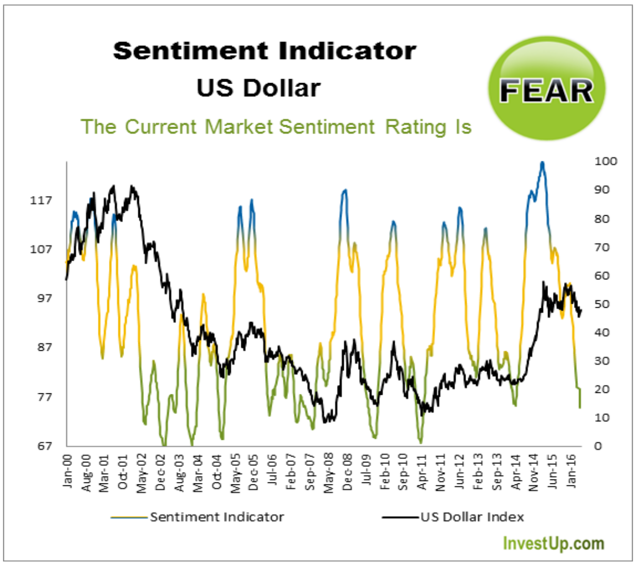
> **Why the US Dollar Is Suddenly Worth Less This Week**
>
> **It's on track to post its biggest quarterly percentage decline in 5 years.**
>
> The U.S. dollar hit its lowest level against the euro in nearly seven weeks on Wednesday following dovish comments from Federal Reserve Chair Janet Yellen that pushed out expectations for the central bank's next interest rate hike.

It is expectations that drive markets and the diminishing expectations for the US dollar described in this article highlight that the possibility of a surprise, rather than the disappointment that currently seems more likely for equity investors. The Investup.com chart shows that hope is now as absent toward the US dollar as it has been since mid 2014, however, it can clearly become even more absent. A rally of significance may not be just around the corner but if the dollar continues in the trading range it has been in for the last year, expectations will likely continue to diminish as they have throughout the trading range to date and this in turn will lay the foundations for another leg up in the dollar.

Since writing those comments in early April sentiment toward the dollar continued to deteriorate and on 23rd April Bloomberg ran the headline:

Hedge Funds are bearish on Dollar for first time since July 2014

This story was accompanied by a chart showing that hedge funds were net short the US dollar for the first time since July 2014. However, what the article didn't point out was that being short the dollar in July 2014 was not actually a great strategy as over the next eight months the dollar rose in an almost uninterrupted fashion by more than 20%. As pointed out last month, mid 2014 was the last time that Investup's US dollar sentiment indicator was fearful and it has continued to fall.



This updated Investup sentiment chart for the US dollar (right) was produced on the 13th May, not long after the US dollar index had suffered its worst slide in more than five years and fallen to its lowest point within the broad consolidation of the prior fourteen months. Ten days earlier, on 3rd of May, in a similar vein to the Bloomberg headline of late April, Business Insider was reporting;

> For the first time in nearly two years FX traders, collectively, are short the US dollar.

And picking up on the same deterioration in attitudes towards the dollar the UK's Daily Telegraph wrote;

> This is a massive shift in sentiment since the end of last year when investors were betting heavily that the US Federal Reserve was on track for a series of rate rises, which would draw a flood of capital into dollar assets.

One day earlier Bloomberg was flagging the challenging outlook for the currency;

> **The Real Story Behind the U.S. Dollar's Decline**
> "Perilously close" to a bear market for the greenback

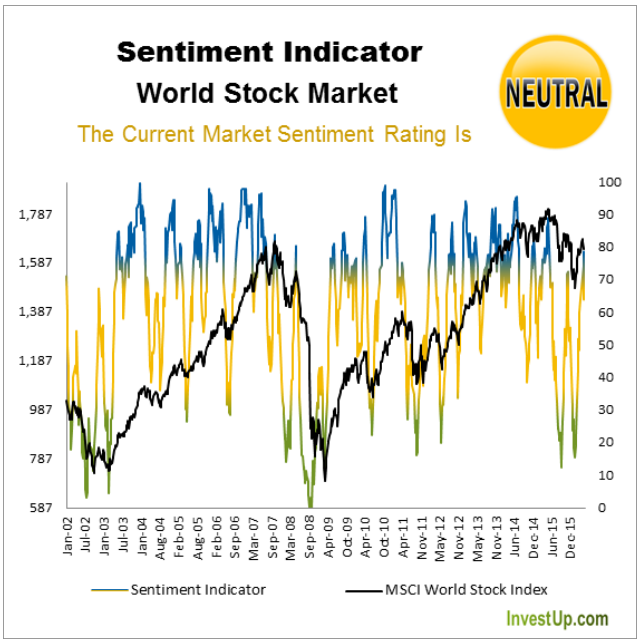
It is interesting to note how the US dollar has traded since these comments and headlines were being published two and a half weeks ago. The chart (below) shows the ETF UUP, which mirrors the US dollar index, over the last couple of years. The end of the previous bull market in early 2015 is clear, as is the frustrating sideways consolidation that has accompanied the protracted deterioration in attitudes and expectations towards the dollar so apparent in the more than 85% collapse in Investup's sentiment reading.

The intraday low in this index was the 3rd of May, the same day as headlines were reporting on the extent of the decline that had already occurred. Given that expectations towards the dollar were recently as bleak as they have been since 2011 it is quite possible that the last few weeks of rally in the dollar index may only represent the beginnings of the next important move in the US dollar, a move that will see the dollar index break out to new bull markets highs. Certainly there is far greater room for a positive surprise than further disappointment.

The recent and dramatic decline in expectations towards the US dollar has not been the only spectacular reversal in expectations recently.

What a difference four months can make

How expectations have changed over the last four months.



Late last year, and again earlier this year expectations regarding the outlook for global equities was as grim as it had been since the depths of the GFC. A similar picture is seen in the US market. What is remarkable is how much attitudes have changed on the back of the somewhat faltering rally that has been seen over the last few months. Analysts are now raising forecast for how high markets will go over the next eighteen months and presenting a case of stability and recovery.

In late January and early February the American Association of Individual Investors survey showed an overwhelming bias in favour of bearishness with close to 50% of respondents indicating they were bearish and only 20% bullish. This was as the US market was suffering one of its worst starts to a year ever. Now, with markets have clawed their way back to approximately breakeven for the year those numbers have almost reversed. As recently as early April the same survey revealed 50% more bulls than bears.

The sharp selloffs in global equity markets in late January and early February were triggered by major concerns about the Chinese economy and stock market and plunging commodity prices. This contributed to a growing fear that the bull market was over and the prospect of recession loomed in many countries.

Off the back of these depressed sentiment levels markets have generally rallied, although as can be seen in the chart above the world index has only recouped some of its early year decline and still lies comfortably below the highs of 2014 (Over the same period sentiment has fully recovered from the slide). A similar picture is seen in the majority of the major equity indices of the world.

- The US. The S&P500 remains 4% below its highs of last year and has made no net progress over the last eighteen months.
- Japan. The Nikkei index is down 20% from its most recent high and, like the US is flat over the last year and a half.
- Europe. The EuroStoxx 50 index is down 23% from its high recorded 13 months ago and is at the same level as it was two and a half years ago.
- Australia. The ASX is down 10% from its most recent high and, like Europe , is flat over the last two and a half years.

- Hong Kong. The Hang Seng index is 30% below its high and flat over more than the last four years.
- Emerging Markets. The emerging market index is down about 25% from its 2015 high, 30% from its 2014 high and 35% from its post GFC recovery high in 2011. It is currently trading at the same level as it was at in late 2009.

It is of some concern that sentiment has generally recovered so quickly and dramatically even though the rally from the depths of the early year selloff has failed to generate new recovery highs. Such recoveries in sentiment are more commonly found in the early stages of bear markets, when hope is high and quick to bounce back, and the slide down the 'slope of hope' still young, rather than in the early stages of what may turn into a meaningful and rewarding up leg.

The alacrity with which so many have so easily shrugged off the dramatic sell off at the start of the year should be seen as a cautionary sign rather than a green light for further bullishness.

Apple

Expectations are beginning to change here too. A little over a year ago I highlighted the potential folly of getting too excited after Apple's stock was added to the Dow Jones Industrial Average at the expense of AT&T and have been monitoring the two stocks relative performance ever since. At the time of the switch I highlighted the markedly different performance of the two stock leading up to the switch and the understandably (but not necessarily useful) different expectations that industry analyst had for the two stocks.

> Given this history it is not surprising that analysts hold quite different opinions on the former and new Dow stocks. AT&T is followed by thirty two analysts and twenty four of them (75%) have either a hold, underperform or sell opinion. Apple, on the other hand, is followed by forty nine analysts and only ten of these (20.4%) have a hold or underperform opinion. None have a sell opinion.

This was all written in the April 2015 edition of Strategy Thoughts in the wake of the Apple / AT&T switch taking place on the 18th March. Since then AT&T has risen about 10%, Apple has plunged more than 25% and the market as a whole has slipped about 3%. As an aside had the switch never been made the Dow would almost certainly be comfortably trading at meaningful new high.

Despite Apple's poor performance the love affair with industry analyst continues, their average rating continues to be between a buy and a strong buy, this may highlight that the risk of disappointment continues. With AT&T however, the picture has changed with a marked improvement in the average analysts opinion to between neutral and a buy, and over the last few months there have been a number of analysts instituting new buy ratings on the stock.

Even though analyst may not be giving up on Apple the media has certainly been having a field day as the following Bloomberg headlines in the wake of the companies poor earnings report in late April highlight;

There's Something Rotten in the State of Apple

Apple Forecasts Second Sales Drop as iPhone Woes Deepen

Apple Becomes the Dow's Worst Performer

These headlines are a world apart from those being seen little more than a year ago when, with the stock trading at $130, Forbes wrote;

Apple Target Price Raised To $260

At the same time CNN reported glowingly that;

Apple stock is making regular

Americans rich

And analysts from seemingly every Wall Street firm were playing leap frog with their own targets for the stock.

Given this reversal in expectations, at least on the part of the media, towards the prospects for Apple now may be a sensible time for any trader that instituted the historically justifiable trade of buying the stock leaving the Dowand shorting the incoming stock to take at least some of their gains off the table.

Tina Fomo

Last week Barron's magazine's 'Striking price' column ran the following headline:

Tina Fomo: The Market's Femme Fatale

The title was a clever amalgamation of two acronyms; There Is No Alternative and Fear Of Missing Out, that have become the primary justifications for investors remaining fully invested in, or even plunging now for the first time into, a bull market that is undoubtedly ageing and showing real signs of deterioration. The mere fact that these two acronyms are being used so extensively is in and of itself another sign of the deteriorating fundamentals supporting the US market. Whenever a rationalization for why any market should continue doing what it is doing becomes widely accepted it is highly likely that something will happen to shatter the broadly held comfort that was provided by the seemingly sensible and obvious rationalization. The broad and extensive use of TINA and FOMO, particularly now they are combined, certainly qualifies as such a widely accepted rationalization.

Something similar was seen in 2007, only then it wasn't TINA or FOMO, it was 'Liquidity'.

Nine years ago, in the April 2007 edition of Strategy Thoughts, I wrote:

Liquidity?

Much has been made about “liquidity” throughout the recent bull market, that along with the private “equity put” have become the primary reason to be bullish and why any sell off is just a “healthy correction” or letting off of steam. Some months ago I commented that liquidity was now becoming as strong a reason for this market extending as the “new era” was back in the nineties, and this still remains the case, however, a couple of highly respected commentators have put liquidity in its place. Noriel Roubini, admittedly an outright economic bear, and, perhaps more balanced, Paul McCully of Pimco have both highlighted the fragility of the liquidity argument and its dependence upon sentiment. The view is best summed up in one of McCully’s quotes;

> “At the end of the day liquidity isn’t about money stock growth, but a risk seeking frame of mind. In other words liquidity isn’t about money sitting on the sidelines per se, but rather about the risk appetite of those on the sidelines. And when risk appetite turns, no amount of liquidity on the sidelines matters, particularly when a crowd gathers there. This is the essence of modern day finance. The human condition is, in the end, momentum driven, not value driven.”

Less than six months later the fragility of the seemingly sensible and increasingly obvious ‘Liquidity’ argument became apparent. As the McCully quote above makes clear, it is not liquidity that drives markets, it is the aggregate risk appetite, or the enthusiasm or fear, of market participants that drives markets. This was also abundantly clear in Japan in the 1990s, throughout that decade the previously high flying Nikkei plunged, and continued to plunge despite ever falling interest rates and more than ample liquidity. What was missing was any desire on the part of the Japanese investor to take any risk.

TINA and FOMO have resulted in something of a liquidity argument in the US market currently. The billions of dollars flowing into various mandatory retirement accounts does have to go somewhere, and the fact that the US market has risen as it has over the last seven years it would seem logical that a substantial part of that liquidity has been flowing into the market. However, those flows, even if they continue at an ever growing level, do not have to go into the equity market and in no way insulates the market from a substantial collapse, as was clearly seen in both the early and late 2000s. When investors switch from seeking increased risk to focusing upon preservation of capital no amount of liquidity will push a market ever higher.

Conclusion

This month’s Strategy Thoughts has focussed upon how much attitudes and expectations have changed over the last four months, however, these changes have only reinforced my own outlook and expectation for markets. In April I concluded with**:**

> I continue to prize capital preservation, I am not chasing yield and I do believe that the US dollar will eventually break out of the long trading range it has been in to the upside. Eight years ago this happened once the May 2008 bounce proved to be nothing more than another dead cat bounce and rolled over, from there the dollar index rallied more than 20%.

I continue to believe that a highly cautious outlook is still warranted, possibly even more so given the enthusiasm that so many have shown toward the recent rally in equity markets. Preservation of capital should still be all readers’ primary concern.

This month's Strategy Thoughts has been delayed due to a recent visit I made to the US. The visit was entirely for pleasure, in fact it was for golf which will not surprise many readers. I was fortunate enough to be invited to play in the Olympic Golf Club's 79th annual invitational golf tournament (very many thanks Dick). We spent nine days in the US (only five of which were on the golf course), and my time there did nothing to change either my enthusiasm for the dollar or my caution towards most other investment assets.

In two weeks we leave for an extended trip to Europe, my intention is not to write another Strategy Thoughts until early August, however, if events require some comment I will endeavour to get something out. In the meantime I am pleased to report that **'INVESTING, the expectations game, why most investors lose and what really drives markets'** is in the final stages of publication. I will naturally let all readers know when advance copies are available.

Kevin Armstrong

22nd May 2016