Strategy Thoughts

November 2014

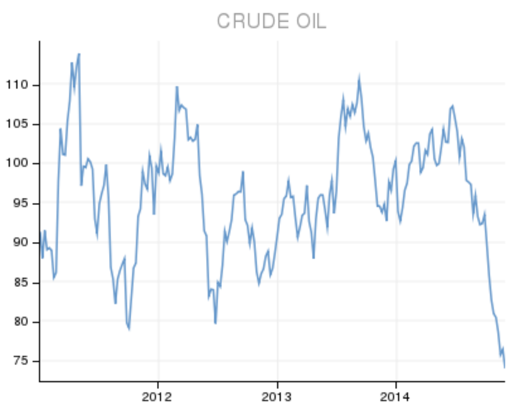
Economics versus Sentiment, and

Looming Opportunities in Oil?

Introduction

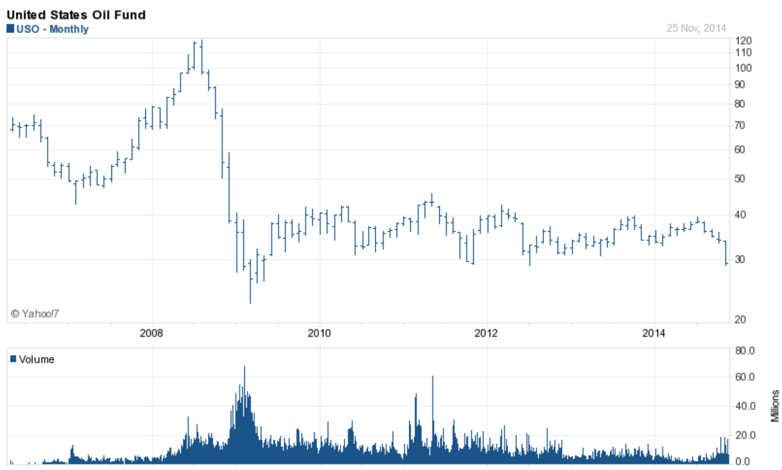
This month's Strategy Thoughts is about three weeks late, this is partly due to my three weeks spent travelling around Europe, partly due to there being little change to my overall view and largely due to the time I have been investing in the Strategy Thoughts Allocation Model. The October edition of Strategy Thoughts prompted easily the most feedback of any edition to date and I have been delighted with the level of interest so many readers have in investing in such a disciplined, rules based, investment product. I will keep you all updated on progress in the STA product and if any other readers would like to learn more about the ideas discussed at length last month then please let me know.

Despite little having changed in my overall view towards equity markets over the last six or seven weeks there have been a couple of sharp sell offs in two commodity markets that potentially present constructive opportunities; oil and gold. I discuss the set up for both, from a 'sentiment' rather than 'economic' standpoint, this month. Also in this month's edition I review the 'value' that perma bull professor Jeremy Siegel, of Wharton and 'Stocks for the Long Run' fame, has provided investors over the last decade given the heightened media coverage that his comments are once again garnering. Finally I update some of my observations from last month regarding 'turns' that have been seen and finish with some comments on developments with the STA product.



Oil

The price of oil, whether Brent or West Texas Intermediate, has been attracting attention for all the wrong reasons over the last few months, at least that is the case if you have been an oil investor, it has generally been good for oil consumers.



One instrument that has been available to individual investors in the oil market has been the USO ETF that attempts to track the price of West Texas Intermediate Light, Sweet Crude. Since the USO ETF, came into existence in mid 2006, an investor has been soundly whipsawed. The launch of this ETF was yet another example of an ETF or fund being launched when there is maximum demand, rather than when it may be an opportune time to invest. The launch came amid great fanfare and expectation as the oil price had risen six fold over the prior seven and a half years. Almost immediately after the launch of the ETF the price of oil fell by forty percent over the next seven months, it then soared in what can now be seen was an enormous, and totally irrational, parabolic curve up to the sensational price of $140. An almost tripling in just eighteen months. At the time 'experts' were tripping over themselves to come up with even more outlandish forecasts to justify the levels that had already been achieved.

> **Goldman's Murti Says Oil `Likely' to Reach $150-$200** *May 6, 2008*
>
> May 6 (Bloomberg) -- Crude oil may rise to between $150 and $200 a barrel within two years as growth in supply fails to keep pace with increased demand from developing nations, Goldman Sachs Group Inc analysts led by Arjun N. Murti said in a report.

The Bloomberg headline and story above was typical of the remarkable, but totally understandable, extrapolation that is seen at historic peaks.

From that peak level the price of oil fell by about 75% and the USO ETF has languished ever since, recently hitting a multi year low price. This vehicle has undoubtedly been a hugely disappointing investment for those who jumped on board at any time in the ETF's first two years of existence, the question that investors should be asking now is does the poor performance of oil tell us anything?

As an aside, while I was considering this question, I wondered whether an STA analysis would have helped such an investor. This analysis can be conducted from early 2007, while the price was still rising, and the encouraging result is that an STA investor in the USO ETF would have 'reaped' a positive return of almost 3% over the last seven and a half years. Not that impressive I know, but it is a far cry from the more than forty percent loss that the straight ETF investor has endured. This only goes to show that it is indeed impossible to turn a sows ear into a silk purse!

Not surprisingly the rampant enthusiasm on the part of investors for oil has evaporated over the last seven years. Earlier this year Goldman's Arjun Murti retired into academia but naturally the investment bank still feels it is 'valuable' to have a view on the price of oil. Ironically it is now approaching an almost mirror image of that presented by the firm at the record high as the following CNBC story from late October illustrates:

> **Goldman slashes 2015 oil price forecast, as output tops demand**
>
> Goldman analysts said in a report released late on Sunday that it expects U.S. benchmark West Texas Intermediate crude to fall to $75 a barrel and Brent to $85 a barrel in the first quarter of 2015, both down $15 a barrel from its previous forecast. WTI could fall as low as $70 in the second quarter and Brent as low as $80, when oversupply would be the most pronounced, before returning to first-quarter levels, Goldman said.

Since then WTI has already fallen to the firm's first quarter low target, it will be interesting to watch where not only Goldman Sach's forecasts but most forecasts for oil go from here.

With an OPEC meeting approaching fears of what may happen if no agreement for production cuts are reached grew as the International Business Times UK edition highlighted with the following headline:

Opec Must Cut Production or Oil Will Fall to $60 a Barrel

The 'hope' that sensible behaviour from OPEC may relieve the plunge that has already been seen in oil prices is certainly understandable, unfortunately, as so often happens in markets, it confuses cause and effect. OPEC has a long history of beginning to cut production after a peak in the oil price, and continuing to cut until well after the trough in the oil price has been seen. I originally illustrated this point in Strategy Thoughts almost eight years ago:

> **OPEC**
>
> With the price of oil having already fallen dramatically some hope that the slide will be reversed on the back of OPEC production cuts is being voiced regularly in the financial and mainstream media. Unfortunately history does not provide much support for this idea, even though it does seem to make such sense.
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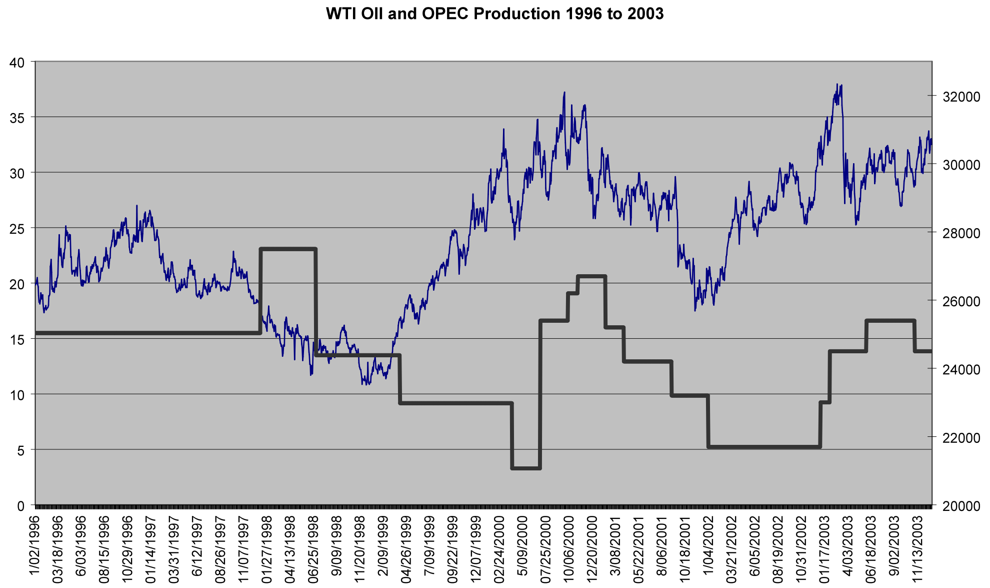
> The chart below shows the price of WTI from 1996 to 2003, a period of great turmoil in oil markets, and overlaid on top of the oil price is the level of OPEC's agreed production.



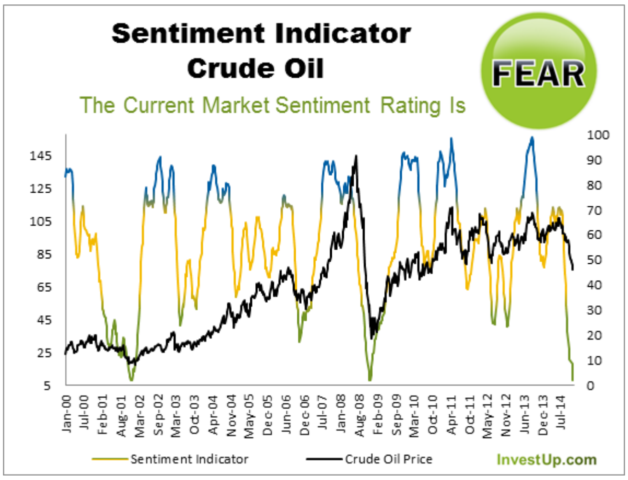
> Just as cause and effect get confused in investment markets it seems that the role of OPEC as the driver of oil prices may not be the one generally believed. It is clear from the chart that oil production consistently peaks after the price has peaked and bottoms well after the price has already started to rise. Generally OPEC takes along time to respond to price slippage before cutting production and then continues to cut throughout a decline in the price of oil.
>
> It therefore seems a vain hope that one further cut will reverse the current decline, but hope often springs eternal in markets that have further to fall. This was evident in December last year. OPEC cut production in the hope of stemming the falling oil price and the media got predictably excited as the price of oil rallied back up through $60 to $63. As regularly happened in the past this recent bounce was just that, a brief bounce, as the price decline soon resumed.
>
> It is unlikely that one OPEC cut will produce the reversal so many hope and that OPEC will continue to cut until well after the oil price finally bottoms and rallies again.

Even traders have now given up on oil and the ability of OPEC to reverse its decline:

OPEC won't save oil prices: Trader CNBC 25th November

The price of oil will not bottom because OPEC, or anyone else, cuts production. The price will bottom because sentiment has reached an irrationally fearful extreme where expectations have plunged through the floor. At such a time, as has been seen regularly throughout history and across markets and asset classes, prices bottom because the 'news' whatever it is, whilst probably terrible, is not as bad as the majority fear.

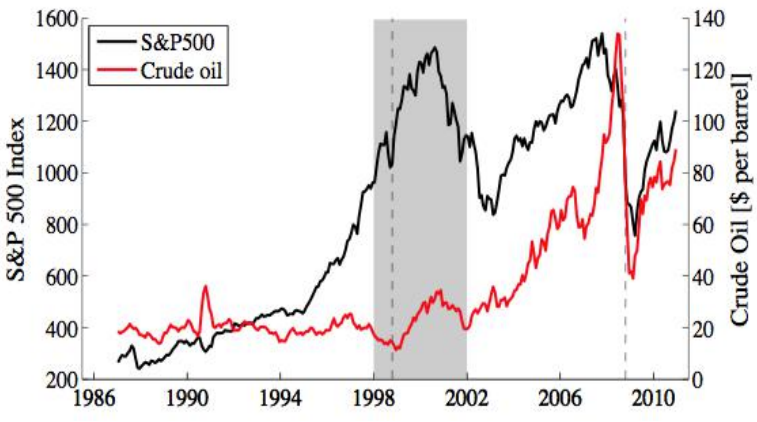
With the fears expressed in the earlier headline appearing all over the world it is no surprise that sentiment towards the price of crude oil, as measured by InvestUp.com, has plummeted.



As can be seen in the chart (left) the negative sentiment towards oil is about as bearish as it has ever been, comparable only with the spike lows seen in the price in 2008 and the early 2000's.

One of legendary investor Sir John Templeton's 'time tested maxims' was "The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." He has been far from alone in expressing this view, but sadly, no matter how many times the majority hear it expressed, and it doesn't seem to matter by whom, they ignore its uncomfortable wisdom just when it would be most valuable.

Whatever the news is that comes out regarding supply and demand and the other so called fundamentals it is far more likely that oil is currently at, or very close to, a point of opportunity, not risk. It is also worth noting from the chart above that whilst optimistic extremes can persist for extended periods the same cannot be said for extremes of pessimism.



My original question was whether or not the recent weakness in the oil price tells investors anything about where the markets may go? The short and simple answer to this is no as the slightly out of date chart (left) illustrates. At times the two markets move together and at times they don't, sometimes one leads the other and sometimes it is the other way around.

Up until the most recent crack in oil the two lines had displayed some similarities, this even led some bearish stock market forecasters to call for a crack in oil on the back of their anticipated crack in the markets. Through the mid October low in equity markets this looked like a reasonable call, even though oil had rolled over first. Since then however, oil has continued to slide and the markets, particularly in the US, have roared back. No useful relationship exists. Notwithstanding this, if oil prices were to reverse dramatically and rally commentators would no doubt be able to rationalise either that this should be good, or bad, for the markets, which ever they favoured for whatever reason. The bad reason would be the obvious interpretation that higher oil prices are a tax on consumers and so a dampener on economic activity that will eventually flow through to earnings and so hurt stocks. This seems to make sense except that history, and the chart above, clearly shows that the market can indeed rise with rising oil prices. But it can fall with rising oil prices too, despite this though those that may want to push a bullish picture for stocks will point out that rising oil prices are a clear indication of strength in the underlying economy and so a reason for longer term optimism.

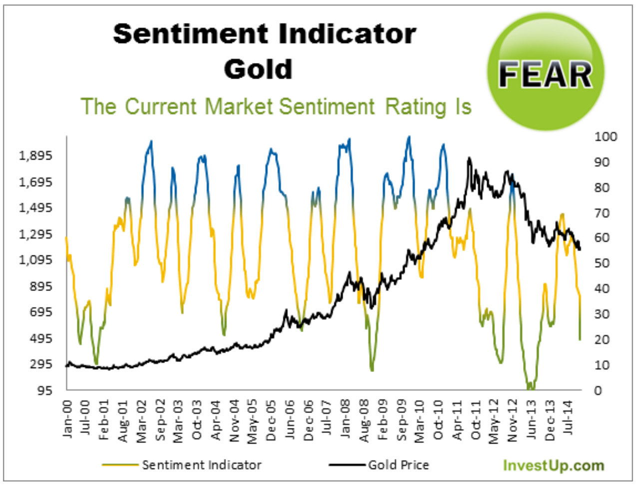
The bottom line is that there is no causal link between the direction of oil prices and the direction of the stock market, even though at times there may be an apparent close correlation and at other times an apparent inverse relationship.

Both markets are driven by, and a reflection of, the aggregate anticipations and emotions of the underlying market participants in each market. Sometimes they may be in synch and at other times quite out of synch. Currently they are obviously out of synch and given the opposite extremes of emotion present in the standout US equity market, and the very depressed oil market, they will likely remain out of synch for some time. If now is a time of opportunity, rather than risk, in the oil market it is quite easy to argue that the reverse is the situation in US equity markets.

Gold

Oil is far from the only asset that has reached something of an emotion price low, gold may also be approaching a similar extreme.

While I was travelling through Europe last month gold was making the headlines, but for all the wrong reasons, at least for those already long gold. The price broke down as can be seen in the chart (below) of the ETF GLD. Its price fell from over \$120 on the 21st October to below \$110 two weeks later on the 5th November. This fall included a one day mini crash of almost 5% on the 31st October and another 2% fall on the 5th November. After the plunge on the last day of October Yahoo finance ran the following headline:



This chart will scare gold bugs

The story quoted a technical analyst looking for a fall to \$700 and a fundamental analyst stating that 'there is no reason to hold gold'.

Five days later, as the fall continued sentiment soured even further resulting in CNBC running the following story:

'Devil's metal' burns investors as gold melts down

The Devil's metal, or silver, had indeed fallen even further than gold, but it is not a term that is used very often (in fact I couldn't recall an investment news site ever using the description before), and it certainly wasn't intended to inspire enthusiasm for either metal on the part of investors. Nonetheless, to date the lows in gold and silver in early November have held, at that point silver was down a massive 70% from its high three and a half years earlier and gold was down more than 40% from its all time high.

Like oil it is likely that the path of least resistance for both precious metals from the lows earlier this month is higher rather than lower.

Sentiment or Economics (Jeremy Siegel)

My intention here is not to poke fun at the steadfast bullishness of professor Siegel, far from it. His book 'Stocks for the Long Run' first published in 1994 has been an incredible success. Earlier this year the book's fifth edition was released and it has been named by Business Insider as one of the 'most important finance books ever'. Siegel's 'buy and hold' philosophy presented in the book is sound and the long term data that he presents in the book is compelling. However, we have all been through two gut wrenching bear markets over the last decade and a half and that experience revealed that very few investors have the long term confidence or discipline to stick with 'buying and holding' through bouts of severe devastation when it appears that things can only get worse.

He has frequently pointed out that even if you were so unlucky as to invest at the market peak in 1929, just prior to the Crash, it only took fifteen years to breakeven. This may have been true if one had bought the whole index (sadly many companies just fell and were never seen again after the Crash) and also if one had held their nerve through the almost ninety percent plunge in the index. I doubt if any of those investors who bought at the peak in 1929 were still holding the same securities fifteen years later.

Where I do think professor Siegel can be helpful now, albeit indirectly, is by monitoring the media attention he attracts. Now, once again, he is sought after for his long term optimism as he is once again telling the story that so many want to hear, and he is being listened to. This has not always been the case as the following selection of headlines and quotes highlights.

> At the end of 2007, with what would become known as the GFC already underway, the professor released his upbeat outlook for the following year:
>
> *I think the stock market will have another winning year in 2008. For every percentage point that stock returns fall below 8% (my prediction) this year, they should exceed 8% next year (meaning, for example, if stocks gain 6% this year, they should finish 2008 up 10%).*
> *And I believe that financial stocks, which have plummeted 18% so far this year, will outperform the S&P 500 Index next year as the credit crisis fades.*

We all now know that this is not quite what eventuated, 2008 was an absolutely miserable year and as a result of that huge, and very public, miss the professor's reputation as a stock market guru faded along with the public's faith in his 'Stocks for the Long Run' argument

By early 2009 Siegel was being publicly ridiculed for his total underestimation of the economic contraction that occurred and the worst bear market in seven decades.

Jeremy Siegel's 2008 economic forecast- hilarious!!!

By the end of March 2009 even other academics were questioning the validity of Siegel's long term assumptions as the following NY Times article illustrates:

> In an interview, Professor Stambaugh said that while Professor Siegel's research shows that mean reversion is powerful, it is hardly the only force affecting the stock market's long-term returns. Because estimates of those other forces are imprecise, Professor Stambaugh said, uncertainty about market fluctuations increases with the holding period — the opposite of what happens because of mean reversion.

Understandably questions as to the credibility of both Siegel, and his book 'Stocks for the Long Run', were asked more frequently after such a devastating bear market as this simple headline from CBS Marketwatch succinctly pointed out:

> **Where 'Stocks for the Long Run' Went Wrong**

To his credit Siegel stuck to his guns throughout. Now he once again appears to be being feted as a seer and is once again garnering enormous amounts of air time with his pleasant sounding, and very benign, long term outlook:

> Jeremy Siegel – Fair Value for the S&P 500 is 2,300 Advisor perspectives November 25, 2014, 1:06 pm

My intention, as I stated at the outset, is not to criticise professor Siegel, rather it is firstly to illustrate that no matter how highly qualified an economist may be he is unlikely to forecast the economy consistently and certainly not the market. Secondly my intention is to point out the shortcomings of the herd, particularly as reflected in the popular media. At peaks they will always latch on to the most bullish prognosticators and the reverse is true at troughs. As a market is rising no one wants to hear from someone saying, actually things may not keep on getting better and better for ever, conversely at troughs any optimistic commentary is quickly derided as foolish and naïve and not fully abreast of just how bad 'things' are.

Personally I admire professor Siegel's consistency, he seemingly never wavered in his convictions at the GFC low, despite the derision and criticism he was facing, and now looks to have been of far greater value to investors than those who questioned his buy and hold philosophy. Nonetheless, if stocks do roll over again and suffer another cyclical bear market comparable to the last two I fear he may ultimately be remembered as the twenty first centuries Irving Fisher (the eminent professor who in late 1929 described the market as having reached a 'permanently high plateau' just weeks ahead of the Crash). What I am more concerned about is that the majority have once again found it so easy, and comfortable, to quickly overlook, or more likely forget, his, and the majority of economists, shortcomings just seven years ago ahead of the most severe decline in more than seventy years.

Over the very long term stocks do rise and they do, over the very long term, reflect underlying economic conditions and corporate earnings. As I have frequently pointed out, value does work as an investment tool, but only over uncomfortably (for most people) long periods. In the meantime, and the meantime can be a decade or more, both the huge secular swings from historically cheap to historically expensive and back, and shorter term cyclical moves in markets are driven by swings over multiple time scales in the emotions, mood and expectations of investors.

Turns (a follow up)

Last month I included charts of; yield spreads indicating that the may have potentially bottomed, (Barclays high yield etf), weakness in emerging markets and Europe, weakness in the Russell 2000 and the resumption of the bear market in gold and the bull market in the US dollar. While I was writing last month's Strategy Thoughts real weakness was appearing across most asset classes with the exception of the US dollar. However, since then the majority of commentators, who were calling the weakness nothing more than the long awaited, and oxymoronic, 'healthy correction' have been at least partially vindicated as the major US equity indices have rallied to yet further new highs. At the same time the idea that an important reversal had begun can certainly not be ruled out for most other assets. The Barclays High Yield ETF I mentioned last month, despite having rallied through mid October, has now resumed its downtrend that began in late June and the same is true of the broad emerging markets indices (although their peak was in early September). In Europe the picture is similar with most markets, even after their October rallies, still sitting at lower levels than at their September and June peaks.

The US dollar has continued to rally and gold did continue its bear market, finally bottoming out below $1150 after a severe plunge through the second half of October.

Among major markets it is only the major US indices and the Japanese market that have continued on to new recovery highs. The result of all this is that the jury is still out as to whether what was seen during October was a 'healthy correction or the onset of something more severe. I continue to fear the latter.

STA update

Last month in my conclusions I wrote the following regarding the STA models;

> In the meantime a summary of the STA positions currently would be; totally out of most European markets, out of the Australian market, out of the small cap US market, out of gold and out of Hong Kong. The STA remains long the New Zealand market, the major US indices, Japan and US bonds over bills.
>
> The STA has been gradually becoming more cautiously positioned over the last year; my expectation is that this trend will continue.

It is pleasing to see that the STA model performed well during the extreme volatility seen in October. It was long, and remained long, those markets that have continued on to new recovery highs and was broadly out of those markets that have not.

As an aside, the STA model would still be long Berkshire Hathaway, which incidentally has risen another 5% since the October Strategy Thoughts included an STA analysis of the stock.

Over the last month and a half I have continued to refine the STA models shown in the last edition of Strategy Thoughts. My aim has not been to enhance the possible returns that could have gained by cherry picking or data mining, rather it has been to identify what the actual performance of the various models would have been utilising exactly the same list of discipline 'rules', although with slightly modified parameters, and employing actual ETF products that are efficient, low cost and freely available. For New Zealand tax payers these also have the potential of delivering particularly advantageous after tax results.

The results so far have been pleasing and I am continuing to explore how this highly disciplined, rules based, approach to investing can be made more freely available. As I said in the introduction I continue to welcome any feedback or further interest in these potential products.

The Economy

This is a sub title that has rarely been seen in Strategy Thoughts and you can rest assured that I have not suddenly converted and become part of the majority that believe an economic forecast will help forecast where and investment market will go. I continue to firmly believe that economic forecasters will continue to 'miss' more often than they 'hit', particularly at important inflection points when extrapolation tends to dominate, and that even when they do 'hit' their interpretation of what that may mean for markets is highly likely to 'miss'.

Nonetheless, it is always useful to watch how markets and commentators react to supposedly important economic news.

Over the last week we have seen the Chinese central Bank cut interest rates due to the weakness of economic activity, Mario Draghi in Europe repeat his now famous pledge to do whatever it takes and a third quarter US GDP number that beat economist expectations. Over the last few years all of these events would have resulted in dramatic surges to the upside in equity markets and yet recently the reaction has been more subdued

On the other hand the recent minutes from the US FOMC, it was reported in the Wall Street Journal, "pointed to a somewhat weaker economic outlook and increased downside risks in Europe, China, and Japan, as well as to the strengthening of the dollar over the period," This could have been interpreted as bad news yet it is fascinating, and potentially illuminating, to see how those 'increased downside risks' are being dismissed among US commentators.

Conclusions

The continual encouraging interpretation, or ignoring, of bad news by the media, and the rejuvenated belief in buying and holding, particularly in the US equity markets, are an indication that we are now in a very different position than when fear was the dominant emotion five years ago. I continue to believe that a cautious approach to equity markets generally is warranted, especially the elevated US markets, and I continue to favour the highest quality fixed income instruments along with the US dollar. This represents no change. Where I do see some emerging opportunity is in the now very depressed commodities of gold and oil and I will be following their no doubt volatile paths from here very closely.

For those of you who continue to be invested in equity markets I encourage you to either determine that you have a comparable self-confidence and internal fortitude to that of professor Siegel or to establish a very disciplined set of rules that will ensure that you alter your portfolio appropriately at times when doing so will undoubtedly be the most uncomfortable thing you could think of doing. For the time being I will keep readers updated periodically on my own rules based STA conclusions.

Recommendation

The tragedy of the European Union, The great degeneration

While travelling over the last month I picked up and read the collection of George Soros' essays that have been put together in a book 'The Tragedy of the European Union, the great degeneration'. I would strongly recommend it to all readers. Having read most of what Soros has written over the years this was particularly easy to read, especially when compared to his 'Alchemy of Finance', and I certainly share many of his concerns. One in particular was brought home while in the UK and I witnessed the wave of support that was emerging for the UK Independence Party. I fear that if Prime Minister Cameron's promised referendum on membership of the EU (dependent upon the conservatives winning in May and currently not planned until 2017) were held now the overwhelming result would be to leave.

I have included below an extract of the review that appeared in the Financial Times.

> For the Hungarian-born billionaire, the "tragedy" of the EU has a clear culprit: Germany's political class – in particular, chancellor Angela Merkel. For much of the postwar era, Soros argues, "Germany was always willing to give a little more, and take a little less. That is what made the process of integration so successful for a time." This approach changed when Germany finally reunified in 1990. Reunification turned out to be expensive and this changed its attitude *vis-à-vis* the rest of Europe.Soros's book initially reiterates the call he made in an essay for the New York Review of Books in 2012. Germany should lead its partners towards a more integrated eurozone that would involve, for example, the issuance of mutually guaranteed debt – so-called "eurobonds". Alternatively, Berlin should leave the euro and let the rest of the union form closer ties.He concedes, however, that Merkel has managed to shape EU institutions according to her vision. "The window of opportunity to bring about radical change in the rules governing the euro has closed," he admits. In the absence of a grand step towards more integration, the relationship between creditor and debtor countries brought about by the crisis has crystallised. Failure to act decisively will push Europe into deflation and allow the "process of disintegration" to gather momentum.It is tempting to share this pessimism. After all, in May's elections to the European Parliament, anti-EU forces are set to make large inroads. Yet the hope pro-Europeans must cherish is that any success from the eurosceptics will force a discussion over the pros and cons of the process of European integration.This is a debate that federalists, including Soros, can still win. But they must go beyond simply arguing that the politicians (such as Merkel) should have been more ambitious in the management of the crisis. Rather, they must acknowledge that the German chancellor, like any other EU leader, was constrained by her electorate in terms of the steps she could take.For the past two decades, the federalists have sold their dream of an ever-closer union to the politicians. But, as the recent anti-euro backlash has shown, this is not enough. The case must be made directly to the electorate. Only the Europeans can decide where Europe's future lies.

Kevin Armstrong

27th November 2014