Strategy Thoughts

October 2015

Was that it, or was it just the beginning?

Introduction

Last month's Strategy Thoughts finally got written, after a number of false starts as markets plunged, on the 25th August. This was almost exactly at the low point of the recent decline. At that time the MSCI world index was down a little over 20% from its late May peak, officially in bear market territory. Since then markets have recovered somewhat with the MSCI index rising about 10%. The question this raises is; was that it, or was it just the beginning?

In September of 2009 I paraphrased the great Winston Churchill by titling Strategy Conclusions "The Beginning of the End, or the End of the Beginning?" Then I was describing the new cyclical bull market that at the time was just six months old but had seen global markets rally substantially. I concluded that what had been enjoyed up until then was far from all I expected and that we were a long way from the beginning of the end. The situation now is almost the mirror image of what I described six years ago. A cyclical bear market began across various asset classes and regions of the world five or six months ago, and what has been seen to date, even including last month's volatility, is likely just a beginning.

Was it a healthy correction?

On the 1st October Bloomberg summarised just how bad things had been for investors so far in 2015;

2015 Is Turning Out to Be a Terrible Year for Investors

> For investors around the world, 2015 is turning into a year to forget. Stocks, commodities and currency funds are all in the red, and even the measly gains in bonds are being wiped out by what little inflation there is in the global economy.
>
> Rounding out its steepest quarterly descent in four years, the MSCI All Country World Index of shares is down 6.9 percent in 2015 including dividends. The Bloomberg Commodity Index has slumped 16 percent, while a Parker Global Strategies LLC index of currency funds dropped 1.8 percent. Fixed income has failed to offer much of a haven: Bank of America Corp.'s global debt index gained just 1 percent, less than the 2.5 percent increase in world consumer prices shown in an International Monetary Fund index.

Despite this supposed misery the majority of commentators seem convinced that what has been suffered is indeed just a healthy correction, or the pause that will refresh, both expressions that when applied to markets are oxymoronic and should always be seen as major warning signs.

Back in mid June CNBC proclaimed that the Chinese market had suffered a 'healthy correction' but that all was still fine as the authorities could still 'do more' and valuations were not stretched!

At the time the Shanghai Composite index had fallen by about 12% and been falling for little more than one week. Over the next three and half months that 'healthy correction' was transformed into a major bear market as the index continued to fall and is now down 40% from its high and more than 30% since the 'correction' was declared 'healthy'!

Over the last month CNBC and Bloomberg have been describing the falls seen in both the major markets and the emerging markets as 'healthy'.

At a major market bottom no media organisation is out proclaiming the fall that has just been endured as healthy. Far from it in fact, generally the fall is by then being seen as a precursor of worse to come and an indication that the economy will likely deteriorate further.

So what would be 'healthy' for investors?

I included the following in Strategy Thoughts back on the 28th April 2009; just seven weeks into what would become a very rewarding bull market.

> In the early weeks of the current rally doubt appeared to be the dominant attitude as the following collection of headlines put together by Investec research illustrates;
>
> **Rally, Yes; Bottom, No**
> ***Forbes.com** – 3/10/09*
> **No Way You're Getting Me Back in This Market**
> ***Yahoo! Finance** – 4/8/09*
> **Is this a sustainable bull market?**
> **The March run likely will lead to weakness**
> ***MarketWatch** – 4/1/09*
> **Warning: The bear isn't hibernating yet**
> ***CNNMoney.com** – 4/1/09*
> **Goldilocks rally meets the bears**
> **March was good, but a downturn is inevitable**
> ***MarketWatch** – 4/1/09*
> **Don't Buy the Chirpy Forecasts**
> **The history of banking crises indicates this one may be far from over.**
> ***Newsweek** – 3/30/09*
> **Bear Rallies Turn Market Into a Circus**
> ***Wall Street Journal** – 3/23/09*
> **Enjoy the Sucker's Rally, Says Merrill's Rosenburg**
> ***Yahoo! Finance** – 3/19/09*
> **Roubini Says Rally is a "Dead Cat Bounce"**
> ***The Business Insider** – 3/16/09*
> **Is This A Real Rally Or Dead Cat Bounce?**
> ***Investors Business Daily** – 3/16/09*
>
> Perhaps the most remarkable display of doubt, or suspicion, of the current rally was displayed by, of all people, the CEO of the New York Stock Exchange, Duncan Niederauer, in an interview with the Financial Times in mid April;
>
> ***Chief of NYSE cautious over rally in March***
>
> *"The March stock market rally that fuelled hopes of a broader economic recovery was deceptive because "real money" investors remained on the sidelines, according to the chief executive of NYSE Euronext, the world's largest stock exchange. In rare comments about market movements, Duncan Niederauer said in an interview with the Financial Times that the rally was driven by short-term traders trying to take advantage of high volatility and not by large institutional or other long-term investors. Mr Niederauer suggested the high trading volumes and gains in leading indices did not necessarily reflect any real conviction that the worst of the economic crisis was over. He said the volumes had been concentrated in a handful of stocks reflecting what he termed a "traders' market"."*
>
> The existence, and persistence, of doubters is healthy, it's what forms the 'wall of worry' and fuels a bull market.

It would be very difficult to describe what has been seen in the media in the wake of last month's tumult as anything like the attitudes found at any previously important buying opportunity.

What drives markets?

Over the last month global investment markets were sweating over whether the US Federal Reserve was going to raise interest rates for the first time in almost a decade, and the sharp selloff that markets suffered in August only served to exacerbate that 'sweating'. My attitude throughout has been that whatever the Fed did or did not do was a side show in the overall scheme of things and it was unlikely to prevent the rolling bear market that began in some asset classes several years ago. The futility of hoping the Fed would make everything right in markets, a delusion that I have often ridiculed, was summed up by John Hussmann mid month.

> When you examine historical data and estimate actual correlations and effect sizes, the dogmatic belief that the Fed can "fine tune" anything in the economy is utter hogwash. At the same time, the demonstrated ability of the Fed to provoke yield-seeking speculation and malinvestment is as clear as day. An activist Federal Reserve is an engine of disaster and little more. Even with the best intentions, a dogmatic Fed, unrestrained by reasonable rules and constraints, is a reckless and deceptive beast, constantly offering to heal the nation with precisely the same actions that inflicted the wounds in the first place. John Hussman 14th September 2015

One week later, after the Fed did not raise interest rates, Hussman commented;

> **The main defense of the Fed's inaction seems to be that years of zero interest rate policy have been hopelessly ineffective, so continued zero interest rate policy is necessary.**

It has always concerned me that investors truly believe that central banks drive markets in some way and that therefore anticipating their moves will somehow give an investor a heads up. Firstly, most commentators have a poor long term record of forecasting central bankers' moves, and secondly, and perhaps more importantly, even if they do there is still a very large chance that the conclusion they arrive at will be wrong.

In early August a strong consensus built that the Fed would raise rates in September, as reported by Marketwatch on the 7th August;

> The futures market is now pricing in up to a 75% probability that the Fed will raise interest rates at the September meeting, according to Steven Englander, global head of G-10 FX strategy at Citigroup.

One week later Fortune reported an even higher conviction regarding a rate hike amongst economists;

> **Poll: 82% of economists expect a September rate hike**

Prior to mid August the US market had been locked in a very narrow trading range for the majority of the year, it is possible that this lack of volatility hinted at complacency on the part of investors, but that all changed over the next eight days as world markets plunged and the S&P500 fell more than 10%. Remarkably, in the wake of that plunge 'expert' expectations for what the Fed would do also changed. Expectations for the rate hike diminished and the US dollar, which supposedly had been strong on the back of the prospect for higher rates in the US, fell.

When the time came in mid September for the Fed to announce their intention not to raise rates markets were initially in turmoil. US equities rose, and then more than reversed that rise, and the US dollar slipped. However, it has been interesting to watch the US dollar rally since then and equities struggle.

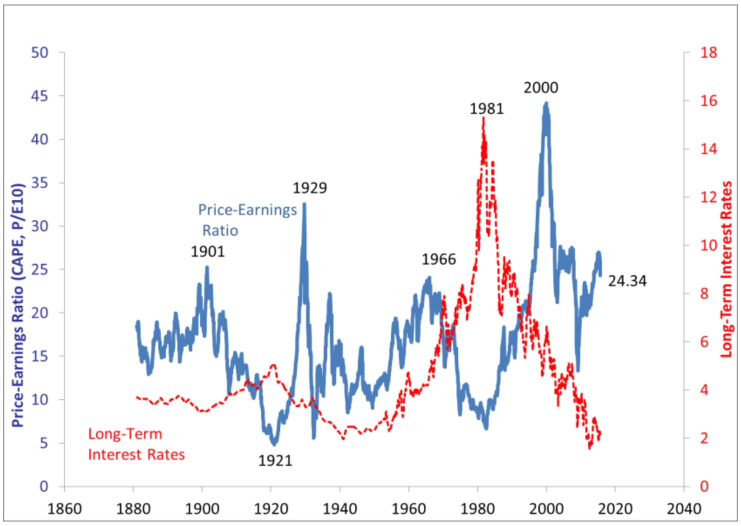
This whole protracted soap opera of the on again off again rate hike has provided a wonderful illustration of just what is driving what, and it certainly looks more like the markets are driving the Fed rather than the other way around. As so often happens in investment markets cause and effect get confused, as do causation and correlation.

So what is it that ultimately does drive markets? To start with it is easier to describe what it is not.

- It is not the economy (at least over time frames that are meaningful to most)
- It is not earnings.
- It is not the Federal Reserve
- It is not valuation.

All of these factors do at times have an influence over markets, but, importantly, it is not a direct influence, and the fourth point above is particularly interesting and serves to highlight why the influence of these factors is far from direct.

Over the years I have frequently stated that over the very long term valuation is important. Secular bull markets always end at extremes of valuation on the high side and the depths of a secular bear market are always associated with extreme low valuations as can be seen in the chart of Robert Shiller's CAPE ratio over more than the last century.



However, the mistake that so many investors and commentators make is to state that somehow over the long term valuations drive markets. Again this is confusing cause and effect.

Markets at any point in time are a reflection of the collective expectations of all those investors participating in that market. The reason anyone pays the price they do for any investment, is that, rightly or wrongly, they have elevated expectations. When any investment falls to an extremely low valuation, particularly when compared to its very long term history, it is telling any disinterested observer that the very strong view of the vast majority of market participants is bleak and that expectations are modest at best. That is why it has become long term very cheap. That was certainly the case in the US in 1921, at the depths of the Great Depression, in 1942 and again in 1974 and 1982.

From those long term low points in valuation markets did not get 'driven' higher by valuations, they rose because from those bleak depths of collective expectation it was not hard for the news flow to deliver positive surprises. Even though in absolute terms the news was far from good it still surpassed those desperately low expectations.

Valuations don't drive markets, they are merely a reflection, or symptom, of the collective mood of market participants. At extremes of valuation (or expectation and mood) the chances of a surprise or disappointment are greatly increased and it is surprises or disappointments that move markets. The expected can't move a market, by definition it has already been factored in.

The other factors I mentioned above, the Fed, the economy and earnings, and many more that I have not listed, are all capable of delivering surprises or disappointments but in and of themselves they do not drive markets. It is how all of those factors as they come out compare to the collective expectations that are already factored in that move markets

Are high yield bonds telling us anything?

Over the years I have frequently cautioned against the danger of 'chasing yield'. As the old adage 'more money has been lost chasing yield than at the point of a gun' makes clear, this can be a very dangerous behaviour. Chasing yield is generally either evidence of a cavalier attitude amongst investors towards risk, or, as is more likely now, evidence of desperation for a return on the part of investors as apparently 'there is no alternative' or TINA, as it has become known. Neither of these moods provides a healthy backdrop for investors.

A little over two years ago, in early July 2013, I wrote the following about TINA in Strategy Thoughts;

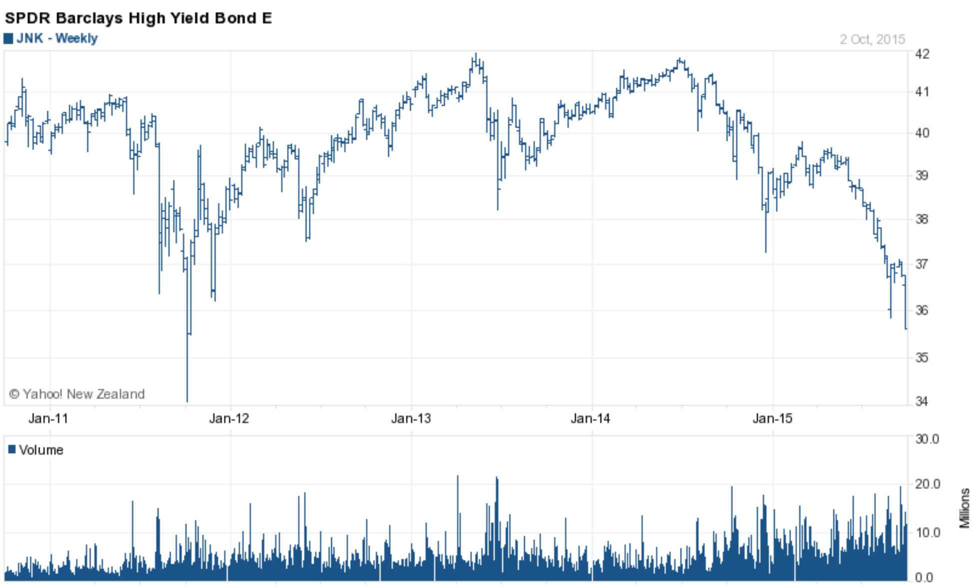
> **Don't trust TINA**
>
> One of the primary planks that so many bullish commentators are basing their optimism upon, particularly over the US stock market, is that there is no alternative (TINA). With bonds falling and yields still historically low they offer little attraction, with commodities seemingly locked in a bear market they too have lost their appeal and even the so called 'safe haven' of the last decade, gold and to some extent silver, have been collapsing. With that backdrop for the assets that had been working and the prospect of earning nothing, or next to nothing, for cash on deposit then the yield on stocks and the, until recently, rising stock market appear to offer the only chance of generating the return that investors require.
>
> Superficially this seems to make sense and can, for a while, become self-fulfilling. However, what all those investors that have jumped out of poor performing bond funds and into previously rising equity markets have missed is the very important fact that, just because a particular return is required it does not have to be available and if it is then it certainly does not have to be sustainable.
>
> As I have listened to and read about the driving force for equities being TINA I was struck with a powerful sense of déjà vu. The last time I could remember hearing the argument that equities had to rise because there simply was no other alternative was in the very late nineties. Undoubtedly the poster child of the nineties bull market was the internet and the NASDAQ but the broader market rose too. In fact the S&P 500 was rising throughout that entire decade at an annualised rate of about 17%. At that same time the 'Baby Boomer' generation was

realising that they had to think about taking care of their retirement. Most had saved very little and when the y sat down with a financial adviser and laid out what they had saved, what they could save and when and what income they wanted to retire on they quickly realised that they needed a spectacular return from their current and future savings. When they looked at bonds and cash they saw that they would never get where they needed to be but the stock market appeared to give just what they needed, a return that would double an investment every four years or so. It seemed obvious to so many that there simply was no alternative. As a result the boomers poured massive amounts into equity investments. This undoubtedly sustained the market's rise for a little longer than it otherwise would have lasted, but ultimately the price was paid when the markets suffered their most severe bear market in decades. Just because a particular return was required it was certainly not sustainable a little over a decade ago, similarly now, just because it seems so hard to find anything that will give a positive return it does not mean that one should put everything into the only asset that is still rising.

At times merely preserving capital, not generating a return, is the best one can hope for and it actually increases ones relative wealth. An investor who merely marked time in low or zero yielding cash through the GFC was far better off in an absolute sense, and even more so in a relative sense, than those that had chased returns. The same was true through the 2000 to 2003 bear market.

Through such periods, or cyclical bear markets, there does not have to be an alternative and the mere fact that TINA is being so readily utilised to rationalise piling into an equity bull market that is now more than four years old should be a warning sign in itself.

The chart below shows the performance of the High Yield ETF JNK over the last five years;



The high for this investment was in May of 2013, one month before I wrote that Strategy Thoughts, since then the ETF has fallen about 15% in value and perhaps more worryingly it seems to be accelerating to the downside. The performance (or lack of) of junk bonds over the last couple of years is disconcerting as is the performance (or lack of) of global stock markets, this despite there apparently being no alternative. The chart below shows the performance of global equities with the US excluded. Like the high yield ETF this ETF is also down about 15% from mid 2013 and also seems to be accelerating.

Over the years I have frequently discussed the importance of breadth to a market, the fact that a rising market is far healthier when the majority of stocks are rising rather than just a handful of leading stocks. Four years ago, in a Thoughts and Observations piece, I quoted from John Rothchild's 1998 "The Bear Book";

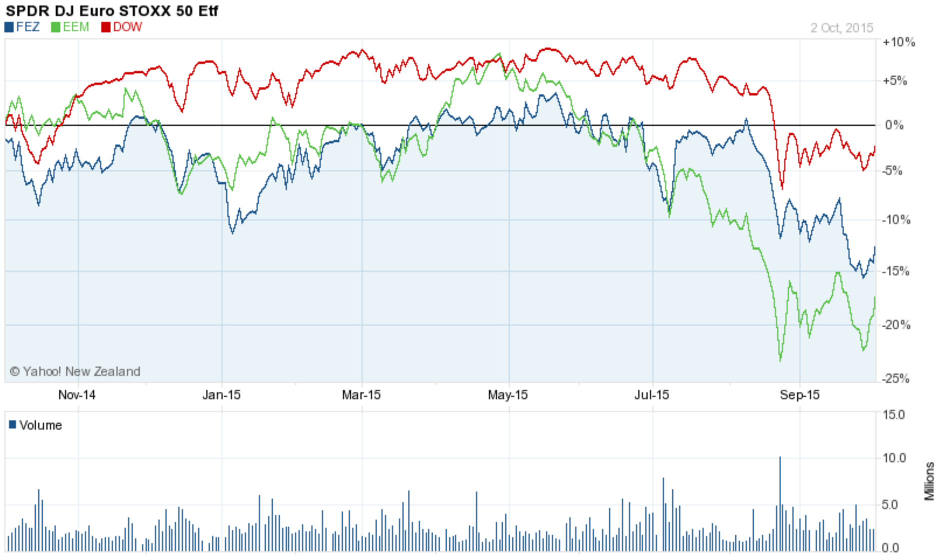
> *"Hong Kong pundit Marc Faber says stocks reach the top when the generals (large stocks) are charging up the hill while the troops (small stocks) lag behind. It is not uncommon, says Faber, for the generals to plant the flag nine months after the troops have retreated."*

The performance of the world ex the US ETF illustrates that the US may be the final 'general' having 'planted the flag' as recently as mid July this year.

Since I wrote the Strategy Thoughts discussion on TINA back in mid 2013 the US markets have risen another 40% or so. Over the same period European markets and the Australian market have been flat and emerging markets are actually down about 15%. However, more recently the 'retreat of the troops' is more obvious. Over the last five months emerging markets have fallen about 30% and European markets are down nearly 20% while the US has fallen barely 10% from a much more recent high.

Is Europe leading the world?

Whilst the US market may be the general it seems that despite its relative size the European markets are competing with the emerging markets to be the most active 'troops' in retreat.



The chart above shows the performance of the broad European index, the broad emerging markets index and the Dow over the last year. Whilst the emerging markets may have been the weakest over the last five months more recently the European markets have led the way down, particularly compared to the Dow. Given this poor performance in Europe over the last five months it is interesting to review where expectations were for the US and Europe five months ago.

In April of this year Yahoo finance ran the story;

Why European Stocks Could Outperform

The primary reason seems to have been that European markets were cheap compared to US markets. On the same day Time ran the following;

Why You Should Invest in Europe—Now

This article highlighted that after two miserable years of relative performance Europe had begun to outperform the US.

Those elevated expectations for Europe back in April / May have clearly been disappointed and the relative weakness of Europe, and the rest of the 'Troops' may be indicating that the 'generals' of the US may soon be joining the widespread retreat of equity markets.

Despite this, as discussed earlier, it is a source of some concern that the weakness already suffered has generated so little concern amongst the majority of investors.

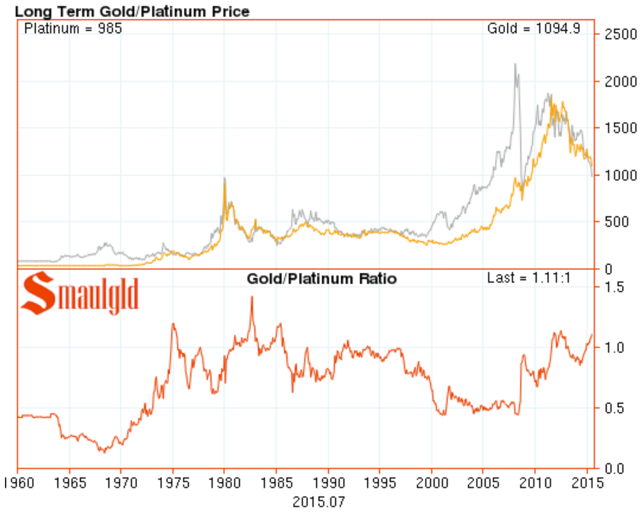
Is Platinum telling us anything?

A couple of weeks ago I was struck by the very sharp fall in Platinum

Platinum prices fall to 6-1/2 year low Reuters Tue Sep 22

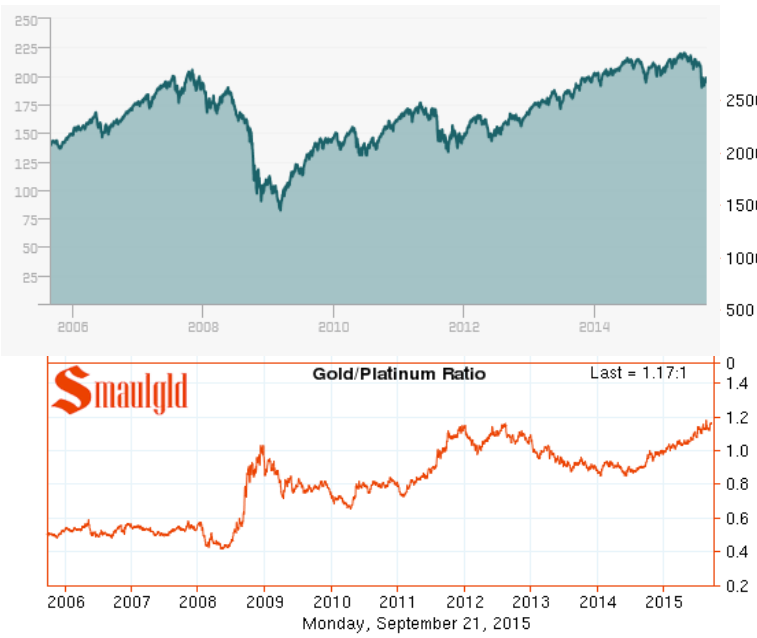
The price of Platinum fell by $36, or nearly 4%, overnight.

It is fascinating to look at the long term relationship between gold and platinum. The chart below shows the two metals prices and the gold/platinum ratio. Over the very long term it appears that gold outperforms during secular bear markets and platinum through secular bull markets.



From the early 1970s through to the early 1980s gold dramatically beat platinum as equities were locked in a prolonged and broad trading range. Once the new secular bull market began in 1982 platinum began to outstrip gold through until 2000. Since then gold has once again become the better performer.

Over the shorter term it seems this relationship between gold, platinum and the world stock market continues.



The chart to the left shows the gold/platinum ratio over the last decade and over the top I have placed a ten year chart of the S&P Global Broad Market Index, an inverse relationship between the two is easily seen.

If platinum continues to underperform gold, as it has since mid 2014 then world equities are likely to continue to fall and the secular bear market will still have further to run.

Conclusion

I began this month's Strategy thoughts questioning whether the volatility and downdraughts that markets endured through late August and September was 'it' or whether it was just the beginning. My conclusion is that what we have recently witnessed is merely the beginning of the next cyclical bear market, and that while we may be at the 'end of the beginning' there is probably a long way to go before we are close to the 'beginning of the end'.

On a more positive note this cyclical bear market will likely bring the last fifteen years of secular bear market to a close, but from far lower levels (both in price and valuation) than have been seen this year. As I have illustrated this month, many of the worlds markets have in fact been in a cyclical bear market for many months and in some cases years, what has happened over the last couple of months is that it seems the last ‘general’ holding out at the summit of the hill and planting ‘the flag’, the US market, has finally joined in the retreat.

Now is a time for extreme caution, the majority of investors and commentators are incredibly sanguine regarding what has already occurred and that is not a healthy sign for investors. Optimistic expectations on the part of European investors may have been dashed over the last five months but the real risk exists that more disappointments, rather than positive surprises, lie ahead for many.

Now is the time to really focus upon capital preservation and avoid being tempted by the siren calls of TINA (there is no alternative). This will undoubtedly feel uncomfortable, but as the founder of investing giant Fidelity, Ed Johnson II, wrote years ago;

> “When trading with the crowd exercise caution, when trading against the crowd be BOLD”

Now is the time for BOLDLY focussing upon capital preservation.

Kevin Armstrong

6th October 2015