Strategy Thoughts

March 2017

Frustration!

But now is not the time to fold

Introduction

Over the last month US equities have rallied, European markets are up a similar few percent, Japanese equities are up less than one percent, as are China, Australia and New Zealand. This continued advance in equity markets since the US election should be a surprise to the vast majority given the rampant fear expressed widely by so many about the then unlikely prospect of a Trump victory. However, the reverse now seems to be true. As I write this edition of Strategy Thoughts the US Federal Reserve has just raised interest rates again and the broad consensus continues to grow, that the US economy is in good and improving shape and that further rate hikes lie in the near future. Whilst equity markets may have edged slightly higher the same cannot be said of commodities, particularly oil and gold. In this month's Strategy Thoughts I examine how frustrating this recent market action has been, liken it to previous periods of frustration, and highlight the danger of the majority apparently understanding why a particular outcome is likely.

How easy it is to forget!

It is only four months since the historic 2016 US election but it seems that has been plenty of time for so many commentators and 'experts' to move on and apparently forget the often extreme positions they were taking ahead of the election. Immediately after the US election I wrote the following in Strategy Thoughts;

> Ahead of the election commentators and pundits seemed not only to have agreed on the inevitability of a Clinton victory, but also that if by some incredible miracle Trump were to win then all hell would break lose. CNBC reported that J P Morgan forecast that the markets would continue to decline if Trump were to win; Barclays forecast a (remarkably precise) 11-13% fall and Citi a five percent fall. On the 1st November, a week ahead of the election Market Watch published an opinion piece from an MIT professor predicting a Trump victory would likely cause the stock market to crash and to plunge the world into a recession and a week earlier Politico ran the headline:
>
> **Economists: A Trump win would tank the markets**
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> At the same time CNN reported the opinions of two forecasting firms, Macroeconomic Advisors and the Brookings Institute, who were calling for an 8% and a 10-15% 'nosedive' in the stock market if Trump were to win.
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> Finally, the day before the election I received a lengthy email detailing why all the polling was wrong and that in fact Trump would defy the odds and win the election. This forecast was obviously remarkably prescient; however, the author went on to detail how I should position myself ahead of this 'surprise'. The US dollar would fall, the stock market would collapse and gold would rocket higher.

There was certainly a heightened level of fear and anxiety about the prospect of a Trump presidency but the vast majority were comforted by the fact that such an outcome was extremely unlikely.

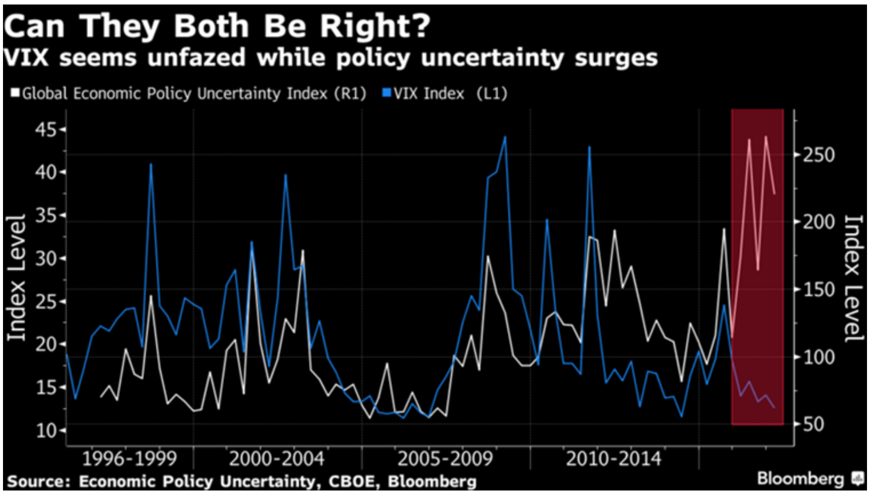
In the thirty five years I have been following global investment markets one of the overwhelming behavioural biases that has continually staggered me is our tendency to anchor. How amidst uncertainty we all tend to look for something to hold on to, something that will give us some comfort and, at least temporarily, make the uncertainty go away. And it doesn't appear to matter how illogical or unfounded that anchor may be, or what the track record of those providing it is. This is what we saw glaringly through the GFC. Ahead of the peak in 2007 the vast majority of economists, particularly those at the IMF, were extremely optimistic and they retained that optimism well into the horrendous downturn. Then as the bottom approached their outlook was overwhelmingly gloomy and getting gloomier by the day. Despite their totally missing the start of the downturn investors still clung on to economists' considered opinions and this once again left them on the wrong side of the market as the great bull market, that is now eight years, old began as the economic consensus at the time was that bad as things were they were destined to get much worse.

Undoubtedly throughout that period there were extreme levels of anxiety and uncertainty so it should not be surprising that investors anchored, but we should all endeavour to learn from these periods. Only by recognising and overcoming the myriad of illogical behavioural biases that plague us all can we hope to become successful investors. Unfortunately it is clear that the majority either learnt nothing through that vivid experience eight and nine years ago, or have by now forgotten the lessons they did so painfully learn.

The last four months

Perhaps it is understandable that over a period of eight or nine years lessons that have been learnt, no matter how painfully, fade, but that they can be totally forgotten in the space of four months is staggering. We now know that in the wake of the Trump victory markets did not 'Tank', they didn't fall 5% or 11%, the world has not been plunged into a recession, gold has not soared and the dollar has not collapsed. In fact almost all of the forecasts ahead of a Trump victory have turned out to be totally incorrect. Not slightly out or off by a few percent but 180 degrees wrong. Yet those same forecasters who explained why things would be so dire are now forecasting a continuation of the rally that they never saw as even possible. Of even greater concern is that the vast majority are happy to listen and go along with the comforting outlook. This can be seen in near record high optimism readings in various investor sentiment surveys and continuing high levels of consumer confidence in the US. Unfortunately confidence readings are lagging indicators and generally reflect what has happened and so are a poor indicator of what may lie ahead, and sentiment surveys, at least at extremes, tend to be contrary indicators. Currently the risk of a disappointment, and for the neat extrapolations of the last four months being once again wrong, is high.

Last month I highlighted a similar level of comfortable complacency amongst investors by showing a chart of the S&P volatility index, the VIX. Bloomberg recently included the chart (next page) which compared the VIX with the Global Economic Uncertainty Index. Up until the last year the correlation between the two indices has been fairly high. However, over the last year the two lines have diverged dramatically. That economic policy uncertainty is at near record high levels is understandable, particularly in the wake of BREXIT, Trump's victory and the potential for further electoral turmoil in continental Europe. What is remarkable is the near record low level of the VIX. This tends to imply that investors are comfortable with the smooth extrapolations of continued economic improvement and stock market advance that are being forecast daily, irrespective of the forecasters' long term or even recent track record.



Currently, investors the world over seem to be avoiding the frustration they may have been feeling for sometime over the relatively sluggish economic growth that has plagued the world since the GFC and are now accepting what seems to be the 'obvious' answer.

At the beginning of March the New York Times ran the story;

What Booming Markets Are Telling Us About the Global Economy

The article went on to describe how many investors were shedding their previous pessimism about the world being destined to remain in what had become known as the 'new normal' of lower growth rates. Now investors have shed their pessimism their levels of frustration will undoubtedly have been reduced, but unfortunately succumbing to the 'obvious' explanation may increase comfort but will most likely result in even greater disappointment.

Economic forecasts may have improved since Trump's victory, however, no one should be looking to economic forecasters to alert them to a possible economic disappointment. I was reminded of this by a Bank Credit Analyst paper recently that highlighted just how poor economic forecasts have been, particularly ahead of a down turn. They produced a neat table showing what the Federal Reserve was forecasting for the US economy ahead of recessions going back to the 1950s.

In August of 1957 the Fed commented that "activity remains at high levels, showing a modest upward tilt". This would no doubt have provided a great deal of comfort, unfortunately the outcome was that the economy contracted by 3.2% over the next twelve months and endured a peak to trough decline of 3.7%. Less than three years later, in April 1960, the Fed's comments included "information indicates the probability of a moderate expansion in activity", what followed was a peak to trough decline in the economy of 2.3%. In December 1969 the forecast was for growth of 1.4% but what followed was a peak to trough decline of 1.5%. In November 1973 the forecast was growth of 2.4%, the outcome was a fall over the next twelve months of 4.9% and a peak to trough rout of 7.8%. More recently, ahead of the 1981, 1990, 2001 and 2007 recessions the Fed has had an average growth forecast of over 1.7% and these have preceded average declines of almost 2%

Currently investors seem happy to accept the comforting rationalisations as to why the recent rallies, and now aging bull markets, will continue. Unfortunately, important inflection points in markets are generally preceded by periods when the majority do believe they understand why markets are doing what they are, and what they are likely to do next. What is even more surprising is that after the surprise, or disappointment, occurs the majority believe that somehow that alternative outcome was also somehow obvious. The always dangerous 'hindsight bias'.

Frustration

In May of 2007 in attempting to describe just how frustrating investing can be I reprised an analogy that I first put into writing two and a half years earlier. Whether or not the current positioning of markets is in anyway analogous to those in mid 2007 only time will tell, nonetheless, it is still worthwhile reviewing that analogy of the frustration of investing and the pervasiveness of hindsight bias:

> *"Investing is complex and highly multi faceted, and a myriad of different influences affect any market in different ways at different times.*
>
> *Attempting to solve the many riddles that investing poses is somewhat analogous to solving a good "whodunit" as you turn the pages or watch it unfold on the screen.*
>
> *A good author or screen writer will quickly deliver a suitable bad guy, someone everyone takes a speedy dislike too, someone that clearly had all the motive and opportunity to commit the crime. You hope that they are the perpetrator of the crime and you hope that they are caught, but deep down you know it won't be them, that would be far too obvious. No, with a good whodunit it's only at the very end that the true villain is revealed and their guilt was far from obvious to anyone with the possible exception of the most diligent and lateral thinking readers. However, after the ace detective has revealed the complex web of interconnecting clues the result is obvious to everyone and some even kid themselves that they sort of knew it all along.*
>
> *So how can this possibly be like investing?*
>
> *At times in any market there is often a popular and widely accepted expectation for the market's future direction, more and more investors get drawn to what seems such an obvious outcome. Eventually there is no one left to buy the obvious idea and a far more complex and poorly understood story starts to unfold. Its eventual outcome will only be generally understood by most participants when it is far too late to profit from it, although many will kid themselves that, even though they never quite got on board, the eventual outcome was sort of obvious from the start."*

The last few months have been frustrating as more and more investors have climbed on board the market, and the apparently inevitable continued economic expansion, however, long term success in investing is only possible if one is prepared to put up with the discomfort and frustration of 'daring to be different' to the vast majority. Following the herd may provide some short term comfort but it is certainly destined to end in the disappointment of owning too much at peaks and throwing in the towel and getting out close to market bottoms.

Valuation

That expectations, at least in the US market, are high is not only apparent in the media commentary and sentiment measures. It is also obvious from valuation measures. I have long maintained that valuation is not the driver of markets the way many believe, but rather that valuation is a reflection of aggregate expectations. The reason any valuation gets extremely high is because investors are clambering over each other to get into that stock or market and are prepared to pay any price. And the reverse is true at long term troughs in valuation, things become historically cheap because no one is interested in them. Valuation is not a short term timing tool in anyway but it is a valuable indicator of exactly where long term expectations are and what long term subsequent returns may be. It goes without saying that long term returns are substantially better when anything is bought at an historically cheap price than at an historically expensive price. The challenge all investors face is that our herding bias makes it much more comfortable to buy what is hot and expensive than what is overlooked and cheap.

Currently the US equity market is historically expensive as the chart (below) of Robert Shiller's cyclically adjusted P/E ratio shows.

It is currently more expensive than it was ahead of the GFC, more expensive than it was at the end of the great bull market from 1942 to 1966, almost as expensive as it was ahead of the 1929 Crash and Great Depression, but not as expensive as it was at the peak of the largest speculative bubble the world has ever seen, the Dot Com Bubble. That the only two periods where valuations were higher preceded a collapse of almost 90% in the Dow Jones Industrial Average in the 1930s and an 80% collapse in the NASDAQ in the early 2000s should not be seen as a source of comfort.

In a recent Bloomberg article professor Shiller was quoted as saying that the US market was 'way over priced' and expressed concern that the current excitement about Trump reminded him of the hype around the 'new era' of the Dot Com boom.

> The last time Robert Shiller heard stock-market investors talk like this in 2000, it didn't end well for the bulls.
>
> Back then, the Nobel Prize-winning economist says, traders were captivated by a "new era story" of technological transformation: The Internet had re-defined American business and made traditional gauges of equity-market value obsolete. Today, the game changer everyone's buzzing about is political: Donald Trump and his bold plans to slash regulations, cut taxes and turbocharge economic growth with a trillion-dollar infrastructure boom.
>
> "They're both revolutionary eras," says Shiller, who's famous for his warnings about the dot-com mania and housing-market excesses that led to the global financial crisis. "This time a 'Great Leader' has appeared. The idea is, everything is different."

'Everything' is never different when it comes to markets. They are driven by everyone involved in them, they are an immediate barometer of aggregate investor expectations but these are shaped and moulded by a whole host of irrational biases. Markets may not roll over immediately, but now is not the time for a disciplined investor to lose their discipline, no matter how frustrating the current environment may be.

Oil

The value of looking at investment assets from an expectational point of view is clear in other markets too.

Last month I focussed upon the expectational extremes that were being seen in the oil market. I wrote;

> Attitudes towards the price of crude oil are now as optimistic as they have been for many years as the Investup.com chart (left) shows. It is also clear from this chart that attitudes have been whipsawed wildly over the last few years; however, what is remarkable about the current extreme bullishness towards oil is that it has come after what has been a rather modest bull market in oil. Admittedly the price has doubled but this has only retraced a fraction of the damaging bear market that preceded it.

Later in that same article I commented;

> In late January and early February this year, amid positive expectations regarding OPEC compliance and production cuts, the following headlines appeared;
>
> > **Analysts See Oil Prices Rising as OPEC Production Cut Bears Fruit**
> >
> > **IEA hails 'solid start' to OPEC cut pact, raises oil demand outlook**
> >
> > **Crude Oil Price Forecast: Possibly The Most Encouraging Move of 2017**
>
> These are a world apart, and almost 180 degrees shifted, from those seen a little over a year ago as sentiment towards, and so expectations for, the price of oil have moved from a record low to nearly a record high, as a result the risk of disappointment has increased markedly.

After writing those comments expectations, at least as presented by Investup.com continued to rise as oil continued to plateau, but then came the disappointment and a marked decline in the price of oil.

The Financial Times on 9th March ran the story;

> **Oil slide continues as benchmark falls below $49 per barrel**
>
> Renewed concerns about supply glut send ripples through currency market

This was after the largest one day drop in WTI in over a year and the gloomy headlines continued to abound as the price fell further. By the 13th March the price of WTI had fallen more than 13% in just three weeks.

It is not surprising that rationalisations as to why this fall should have occurred now abound and perhaps not surprisingly they seem to focus upon the same issue that had previously led to the optimistic forecasts, supply and demand. If only markets were that simple and supply and demand were the answer.

In any market every sale must be matched by an equally sized purchase so what actually sets the price is the enthusiasm or otherwise of all those buyers and sellers and this is a reflection of the aggregate expectations of all participants in that market. If supply and demand were all that set the price of oil then, as I wrote at length in "Investing: The Expectations Game", organisations such as the US Department of Energy's Energy Information Administration should be able to fairly accurately forecast the price of oil. In reality this organisations forecasts have been no better than anyone else's and all regularly fail to pick the very important inflection points, which as an investor is all that really matters.

Conclusions

Over the last month the consensus for continual improvement in economic conditions and optimism towards equity markets has grown, probably to the point of complacency. At the same time, as shown in the chart of the VIX and economic policy uncertainty, investors are clearly choosing to ignore many things that they could choose to worry about, this should be a cause for concern.

Some may describe what is happening as the market successfully climbing the 'wall of worry'. Unfortunately many misconstrue exactly what the old adage 'the wall of worry' means. It doesn't mean that so long as there are things to worry about the market can rise, what it does mean is that as long as a large number of investors choose to be worried then the market can continue to rise. There are always things that investors could worry about, however, when the point is reached where investors choose not worry then the 'wall' is very close to have been 'climbed'. That seems to be where many equity markets are now.

Last month I concluded with;

> None of my views have materially changed over the last month and preservation of capital, rather than chasing what is looking increasingly like a runaway train, should continue to be the majority of investors' primary objective. A number of extremes have been seen across asset classes over the last few months and the risk of reversals and accompanying increases in volatility remains high.

All of this continues to be the case and some of that volatility and reversal has been seen in the oil market. Now is not the time to lose discipline and seek comfort in the increasingly large herd.

Recommendations

I have recently finished two books that I believe everyone interested in markets, what drives them, and how an investor might succeed, should read. The first is Eward O Thorp's **"A Man for all Markets, From Las Vegas to Wall Street, how I beat the dealer and the Market"**. I first came across Ed Thorp when I read William Poundstone's book "Fortune's Formula" more than a decade ago and I didn't know that Thorp was still alive. He is now in his eighties but the book is brilliant and readable story of how this academic took his card counting and analytical skills to not only succeed at black Jack and roulette but also to become one of the most successful hedge fund managers ever. More details can be found at;

http://www.edwardothorp.com/books/a-man-for-all-markets/

The other book that everyone should read is Michael Lewis' **"The Undoing Project".** I have frequently referred to Nobel Laureate Daniel Kahneman's "Thinking Fast and Slow" that reveals the power of the many behavioural biases that beset us all. Lewis' latest books touches on many of these, but reveals far more about the evolution of the experiments that led to their identification and the remarkable friendship that developed between two very different but brilliant men, Danny Kahneman and Amos Tversky.

Kevin Armstrong

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