Strategy Thoughts

May 2017

Buy the Rumour, Sell the News

It's an Expectations Game!

Introduction

Over the last few days there has been much discussion about the outcome of the French election and the 'surprising' weakness seen in the Euro in its immediate aftermath. The dominant conclusion has been that this is just another example of 'buying the rumour and selling the news'. There is an element of truth in this, however, investors should take a slightly deeper look at this old adage and understand that the real driver of market movements is expectations. In this month's Strategy Thoughts I review the importance of looking at news from an expectational standpoint, reflect upon Goldman Sachs and whether they are doing 'God's work' or whether they are merely 'human', question what financial stocks and volatility may be hinting at for markets generally and present some expectations that may now be at an extreme.

Expectations and the French election

I have long maintained that markets are not actually driven by what so many consider to be the 'fundamentals' such as earnings, or interest rates or other economic variables. Obviously all of these elements have some effect upon market movements, however, it is important that investors realise that there is no direct cause and effect between changes in these variables and what markets do. Markets can rise or fall on both increases and decreases in any number of supposed fundamentals, it all depends what the majority of market participants expect. It is changing expectations that shape markets and then surprises and disappointments that create inflection points in markets. I have expanded upon this idea at great length in 'Investing: The Expectations Game' however, it is still worthwhile reiterating the role that expectations play. In the introduction of the book I wrote;

> At the heart of this book is the belief that all market movements, whether over many years or just a few days, are attributable to the changing expectations of all those involved in that particular market. At any moment in time the price level of a market must be a fairly accurate representation of the average, and aggregate, expectations of all those involved in the market. This has to be the case as, if it were not, and a large number of market participants considered the market either very cheap or expensive, then they would either jump in and buy at what they considered bargain prices or sell what they thought was extremely overpriced. As a result the market would move to reflect those aggregate expectations.
>
> The next step is understanding why a market moves and again it comes back to expectations. Given that at any time a market's price level is a reflection of aggregate expectations, if the expected happens then the price should not move. For the price to move something other than the expected needs to occur. There needs to be a surprise or a disappointment, something that results in a change in expectations.
>
> Unfortunately levels of aggregate expectations cannot be easily measured, except by reference to a market, and more importantly, it is hard to project what would constitute either a surprise or a disappointment. Nonetheless, it is essential that an investor build their investment discipline and strategy around an approach that understands a market is driven by

the actions of all those involved in a market and that at any time the market reflects those investors' aggregate expectations. The result of this is that news events, be they earnings, economic or driven by the various 'authorities', must be looked upon in quite a different way and the key question, as a market move progresses, needs to be; what is more likely, a surprise or a disappointment.

Given that it is expectations that shape a market it should be no surprise that markets frequently rise in anticipation of a particular event, often for extended periods, only, to the surprise of many, to stop rising when that long anticipated event actually occurs. When it finally happens it has become a central part of the vast majority's expectations and therefore cannot be a surprise that could fuel further rise. The same obviously happens in reverse, markets do not bottom because the background news shifts from dire to good. What actually happens is that the bad news stops getting even worse than the growing majority fear and this actually qualifies as a positive surprise. A very large and notable example of this was the important stock market bottom that occurred almost simultaneously around the world on the 9th March 2009. It was many months before the so called 'fundamentals' showed any sign of improvement, in fact the most economists, including those at the IMF, continued to downgrade their forecasts for fear of a double dip recession. The news remained bad, but it wasn't as dire as so many had come to fear. This represented a positive surprise and markets reversed.

On a far smaller scale a similar response has been seen in the currency and stock markets in the build up to and aftermath of the recent French election. The chart below shows the Euro / US dollar exchange rate over the last couple of months. The Euro began rising in the second week of April, a couple of weeks ahead of the first round of voting, it then jumped higher after Emmanuel Macron won a comfortable victory and continued to rise ahead of the final vote on May 7th. Polls showed that Macron was expected to win with Marine Le Pen given only a one in six chance of a shock victory. With such one sided expectations ahead of the election it was obviously no surprise when Macron did in fact win a comfortable victory. What should have been a surprise was that so many commentators saw that victory as justifying further Euro strength, and were disappointed when none was seen and the currencyt rolled over, as can be seen in the chart, in the immediate aftermath.

What had been widely anticipated, and factored into aggregate expectations, happened, it was certainly not a surprise but the rising expectation of a Macron victory had certainly been the driver of the Euro's strength ahead of the election. For the result to actually have qualified as being a positive surprise something far more than just a comfortable victory would have been needed.

The media responded to the Euro slide by describing it as having been another example of the old market adage;

'Buy on the rumour, sell on the news.'

There is an element of truth to this; it is true that by the time everyone knows something, even if it is correct, it is of no value from an investment standpoint. However, the adage is an oversimplification, it assumes that by the time everyone knows something, whatever it is, it is already factored into the market. In a sense this is true, it just needs to go a little further. Being factored into the market really means that it has already been incorporated into the aggregate expectations of market participants.

To really appreciate why markets do what they do it is essential that investors strive to look at all those fundamentals that are discussed and analysed endlessly each day not in an absolute sense but from an expectational viewpoint. Investment markets really are an 'Expectations Game'.

Goldman Sachs

Earlier this week in an interview on CNBC Lloyd Blankfein, the long-time CEO of Goldman Sachs, evidenced an unusual degree of humility as his company's stock price slipped after a disappointing earnings miss on the back of poor trading results. The man who nearly eight years earlier defended the bonuses his company paid, even though the GFC was barely over, as justified on the basis that they were doing 'God's work', was pleased to announce that 'This quarter we underperformed, and guess what, I'm happy to report we are human.'

In a generally flat market Goldman Sach's share price fell a little over a half of one percent on the back of this report that supposedly displayed 'human frailty', by contrast, the 'God's work' assessment came at the culmination of a remarkable more than tripling in price over the first nine months of 2009. Whether the financial giant really is, or was, doing 'God's work' is clearly immaterial, at least as far as the market is concerned as, at its recent peak, in early March the price of Goldman Sachs was almost exactly the same as it previous price peak, pre the GFC, back in October 2007. Nonetheless, the action of Goldman Sachs, and the broader financials index, may be providing at least one useful insight.

Goldman's price is now down 12% from its high recorded on 8th March this year, the US financials ETF IYF, of which Goldman Sachs is a constituent, has fallen about 5% since early March, all while the broader market, as measured by the S&P500, has risen about 1.5% to a new record high.

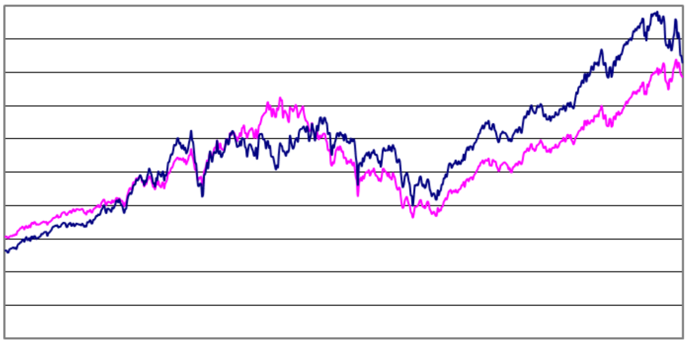
Naturally this weakness, and earnings disappointment, on the part of the financials may just be a blip that will be corrected over coming quarters, however, such a divergence on the part of financials has provided very valuable insights in the past, most notably in late 2007.

In the December 2007 edition of Strategy Thoughts I wrote;

> **Are Financials telling us anything?**
>
> It is a little hard to see on the chart below but globally financial companies have been markedly underperforming the broader averages for most of this year. This is perhaps not that surprising given the multibillion dollar write offs being, almost continually, announced in the wake of the subprime and related unwind. However, what is clear from the chart is that financial underperformance is not necessarily a healthy sign for the market. The last time such financial weakness was seen while broader averages continued higher was in the late nineties.

Admittedly the financials did then out perform in the subsequent bear market but financials weakened for more than a year before the final speculative peak in the market.

World index compared to world financial stocks since 1995



Back in 2007 the early weakness in financials, that had previously been such strong performers throughout the bull market rising close to 50% more than the broader market, was an indication of far worse to come. Again, through this most recent bull market the financials have delivered substantially greater returns than the market rising more than fourfold up until their early March peak versus a less than threefold increase over the same period on the part of the S&P500,.

The VIX, volatility

In the February 2017 edition of Strategy Thoughts I wrote;

> A worrying sign of complacency amongst traders in the US can also be seen in their expectations regarding volatility. The S&P500 volatility index (VIX) has fallen in the early weeks of this year to its lowest levels in many years as can be seen on the chart below.

> The last time the VIX fell to such a low level was ten years ago in February 2007. An extrapolation of this current low volatility would be for it to continue and even fall to new record lows and, worryingly, this seems to be what a majority of large speculators are anticipating as they currently hold a record short position in VIX futures contracts. This complacency regarding volatility remaining low and the market continuing to rise is also apparent amongst institutional fund managers in the US who currently hold only 3% in cash, also a new record. Rather inauspiciously the previous record low cash level was set in 2007 at 3.5% and the record prior to that was seen in 2000 at 4%.

Undoubtedly such extremes can become more extreme and markets could well rise further but the risk of the extreme being unwound only continues to increase, just as it did in 2007 and early 2000.

After that the VIX index did rise by close to 50% through the second half of February, March and into April, while at the same time the market, as measured by the S&P500 faltered slightly.

However, since mid April, the S&P500 has risen another 3% to record a new all time high and the VIX index has plunged to yet another new low for the past decade

These record low readings on the VIX have spawned an immense amount of discussion about what it may mean and whether it still is an indication of complacency. Obviously no one knows the answer to this but my own fear is that it is indicative of complacency that has grown out of what is now a very aged bull market. Whilst I might not know the answer to that question I am prepared to make a bold forecast about the volatility index, and that is that it will rise. This may not appear particularly incisive, but, as the first VIX chart above shows, periods of very low volatility have always been followed by periods of high volatility, eventually. Reuters reported recently that noted fixed income investor Jeff Gundlach shares this view. In an interview he commented;

"I think the VIX is insanely low. Anytime the VIX is below 10, if you could actually buy it, you should."

Unfortunately buying the VIX is not necessarily that easy and importantly a higher volatility reading does not automatically tell us anything about what direction the market is moving, just that it is doing it in a volatile fashion. The current low VIX readings are the lowest since 1993, a period that was followed by an increasingly volatile bull market. Those low volatility readings came in the early years of what would become a long bull market, which is a quite different situation to where markets are now, so my fears about complacency remain. Those fears were also bolstered recently by some observations on CNBC.

O the 10th May the network highlighted a report from Merrill Lynch strategists on the relationship between the VIX index and demand for corporate loans. In the past falling loan demand has been associated with rising volatility.

Loan demand has been contracting for some time, as can be seen in the chart (right), yet so far the VIX has remained steadfastly low. If this trend in loan demand continues to weaken it would not be surprising to see economic forecasts pegged back and so some disappointment to the largely complacent holders of elevated equity markets. An increasingly volatile bear market may follow.

Expectations and Dow 150,000!

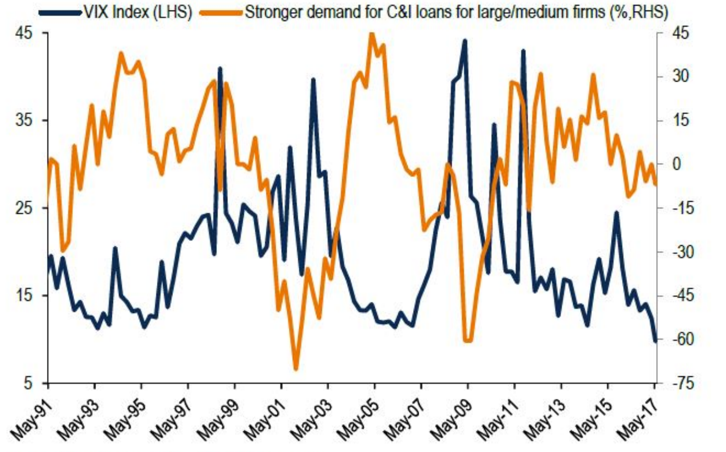
Noted financial adviser and prolific author Ric Edelman has been promoting his latest book ‘The Truth about your Future’ and his comments have been widely discussed, notably he has been promoting the idea that the internet and other technological advances mean that by 2030 the Dow, currently at 21,000, will have rocketed to 100,000, and that if he’s wrong then it will be 150,000! That would be an annual compound growth rate of between 13 and 17%, and investors would have received dividends on top of this. Who wouldn’t like that?

Unfortunately such forecasts, while very appealing, rarely come at an opportune time.

History is replete with ever more optimistic and extravagant forecasts dominating the media at just the wrong time:

- In August of 1929 John J Raskob, a noted investor and chairman of the Democratic National Committee gave an interview in the Ladies Home Journal titled ‘Everyone Ought to be Rich’. His investment advice was based upon the technological advances that had been seen, the proliferation in the availability of consumer debt that had fuelled automobile buying and an extrapolation of the advance that the stock market had made over the prior decade. This article appeared just weeks before the prominent economist, Irving Fisher declared that stocks had reached a ‘permanently high plateau’. This was just nine days before the Crash and the onset of the Great Depression.
- In late 1989, with the Nikkei index approaching 40,000 and having delivered a 500% rise over the prior decade, Nomura securities confidently forecast another more than doubling to 80,000 over the next five years. Ten years later the index had actually **fallen** by 70%.
- In the second half of 1999 there seemed to be a cottage industry emerging with the aim of producing an ever higher and more extravagant forecast of where the US market would go. With the Dow trading around 10,000 first a book appeared with a target of ‘Dow 36,000’, this was followed by ‘Dow 40,000’ and then ‘Dow 100,000. All of this just ahead of the worst bear market since the thirties and an 80% decline in the NASDAQ.
- In May of 2007, with most stock markets having made further new highs, despite an obvious problem in the US

Figure 1: C&I loan demand for large/medium firms vs VIX



Source: Federal Reserve Senior Loan Officer Survey, Bloomberg housing market, the Wall Street Journal ran the following, supposedly comforting quote, '*"Stocks are cheap, there's plenty of money and the economy's ok!"*. This was just a couple of months ahead of the onset of what would become the Global Financial Crisis.

Whilst there are many examples of extravagance and confidence immediately ahead of important peaks, the same cannot be said at times which, with the benefit of hindsight, were fantastic opportunities:

- Ahead of the great bull market of the forties, fifties and sixties no one wanted to own equities and many US insurance companies were barred from owning them due to their by then 'obvious' risk.
- In the late seventies, ahead of the great bull market of the eighties and nineties Businessweek ran its now famous cover story 'the Death of Equities'.
- In 2009, after the GFC and ahead of the bull market that may now finally be ending the conventional wisdom that equities always outperformed all other assets was dismissed as it was by then obvious that equities had not outperformed government bonds for decades.

The greatest opportunities in equity markets do not appear when the general media and increasingly optimistic book titles are proclaiming that such an opportunity exists. Unfortunately such periods in the past have always been associated with extended expectations that have fairly rapidly been followed by desperate disappointment.

Conclusion

Last month's Strategy Thoughts was largely devoted to the danger of getting too wrapped up in the active versus passive debate and in so doing missing out on what actually drives the disappointing long term returns that most investors actually receive; chasing what's hot just before it rolls over and bailing out on long term positions when the pain gets too great and so missing the recovery. In order to be able to avoid these traps it is essential that any investor establishes a discipline that they are able to live with, and also that they understand what really drives markets. Despite what the financial media would have investors believe being a better forecaster of the economy or interest rates or earnings is not the key to being a better investor. What is really required is the ability to understand where expectations may be and where the greatest surprises or disappointments may occur, these are the things that really drive markets.

Currently expectations in many markets are as constructive as they have been for many years. Many of Europe's problems have apparently passed with the French election having been a bullet that was dodged, the US is set to continue to grow, apparently even if president Trump doesn't get any of his proposals through, and the Chinese 'bubble' that has been talked about for so long is not going to burst. Naturally there are many things, particularly geopolitically, that investors could worry about if they chose to, but right now it seems they don't, and therein lies the risk. The 'wall of worry' is not summited when there is nothing to worry about, it is summited when the vast majority choose not to worry, and markets don't roll over because something bad suddenly happens, rather they peak because the news whilst good in an absolute sense it is not good enough to qualify as a positive surprise. From there the slide down the 'slope of hope' begins. Extended expectations, low levels of worry, record low volatility and weakening financial stocks are all hinting an important inflection point may be imminent.

Kevin Armstrong

11th May 2017

Disclaimer

The information presented in Kevin Armstrong's Strategy Thoughts is provided for informational purposes only and is not to be considered as an offer or a solicitation to buy or sell particular securities. Information should not be interpreted as investment or personal investment advice or as an endorsement of individual securities. Always consult a financial adviser before making any investment decisions. The research herein does not have regard to specific investment objectives, financial situation and the particular needs of any specific individual who may read Kevin Armstrong's Strategy Thoughts. The information is believed to be-but not guaranteed-to be accurate. Past performance is never a guarantee of future performance. Kevin Armstrong's Strategy Thoughts nor its author accepts no responsibility for any losses or damages resulting from decisions made from or because of information within this publication. Investing and trading securities is always risky so you should do your own research before buying or selling securities.