Strategy Thoughts

August 2017

It remains an Expectations Game!

And expectations are getting even further stretched

Introduction

Having not published a Strategy Thoughts since May it is both frustrating and gratifying to see that my concluding remarks from three months ago still apply. On the 11th May I concluded with.

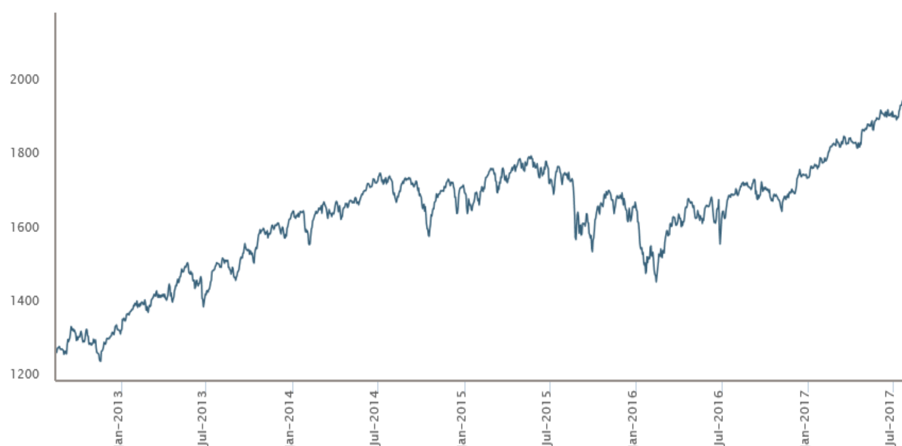
> Naturally there are many things, particularly geopolitically, that investors could worry about if they chose to, but right now it seems they don't, and therein lies the risk. The 'wall of worry' is not summited when there is nothing to worry about, it is summited when the vast majority choose not to 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.

Whilst it is apparent that all these comments still apply, particularly on the geopolitical front, it is frustrating that the hinted at inflection point has so far only been seen in selected indices, such as transports, small cap and selected European markets. Unfortunately, just because something that may have been feared hasn't happened it doesn't become less likely, yet in markets this is exactly the way in which the majority behave. As human beings we are expert at extrapolating the recent past way into the future and so the longer a bull market lasts the more confidence the majority has that it will last even longer. This is not a behaviour that any investor should take comfort in and yet that is exactly what is being seen currently, this makes the risk of a very important reversal in many markets even higher now than it was three months ago.

In this edition of Strategy Thoughts I'll review; the North Korean 'Wall of Worry', the record low volatility, the super extended expectations for the future and the blind belief in the power of 'economics', and the performance of financial stocks.

North Korea and the Wall of Worry!

The chart below shows the MSCI all country world index for the last five years. What is clear is that there was a challenging period for investors through 2014 and 2015, however, most of 2016 and all of 2017 so far, have exhibited a remarkably orderly and steady appreciation.



Trump Vows North Korea Threat Will Be Met With 'Fire and Fury'

Despite president Trump's extravagant and colourful comments last week about what potentially lay in store for North Korea the potential nuclear conflict has so far shown up as barely a blip on this global index. Ironically this is being viewed by many commentators as being yet another example of the markets climbing the proverbial wall of worry. As I stressed back in May this is not how investors should look for either a wall of worry or a slope of hope. It is not the simple existence of things that can be worried about, or things that one can be hopeful over, that drives markets, it is whether investors do choose to worry or to be hopeful.

When worries and concerns dominate the news media, particularly after a protracted decline, it is likely that there exists far greater potential for a positive surprise as opposed to continued greater disappointment. This was obviously the case back at the bear market lows in early 2009 when economists were calling for a still deeper setback, the background news seemed to get darker each day and the idea that equities always outperformed bonds over the long term was being seriously questioned.

It was also the case back in the early 2000s at the depth of the tech wreck bear market, and going back even further, as I outlined at length in 'Investing: The expectations Game' at the depths of the 1942 bear market low during the World War II.

At peaks there are certainly things to worry about, it's just that most investors choose not to. They would rather continue to make more and more seemingly riskless profit and listen to the comforting platitudes of anyone who says that what has been will continue to be. This was certainly the case at the 2007 bull market peak when there was absolutely a lot to worry about. A number of hedge funds had folded and the US housing market had already clearly rolled over but despite these and many other reasons one could choose to worry investors were being encouraged not to panic through comforting and measured comments from the likes of Ben Bernanke, who, in an interview in July 2007, when asked about the housing market, conceded that there was some weakness but concluded with;

> Overall, the U.S. economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend.

Even when markets had clearly rolled over investors were being urged not to worry as the following headline from the Wall Street Journal in January 2008 illustrated;

The Economy Is Fine (Really)

This was no doubt intended to comfort investors who had already suffered what so many were then calling a healthy correction having fallen about 15% from its all time high.

Unfortunately the article, which typifies so many that are seen soon after peaks, was wrong on both counts. We now know that the economy wasn't fine, it was about to begin its worst collapse since the 1930s, and investors should not have remained calm.

The summits of walls of worry are not when miraculously there is nothing to worry about, this never happens. It is when the vast majority chose to be oblivious to whatever there may be to worry about, preferring to listen to the comforting forecasts of economists and others!

This attitude was clearly present in a recent USA Today article in the wake of president Trump's comments;

Investment anxiety? What to do if North Korea has you worried

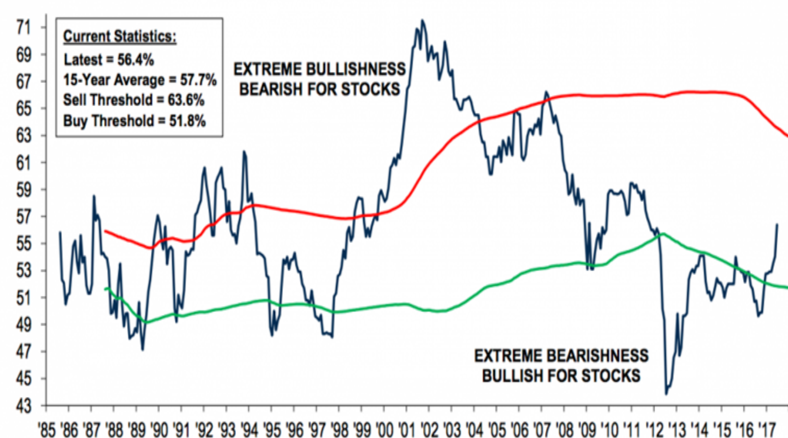
> While that type of emotional thinking might not seem irrational given recent threats from Pyongyang and President Trump saying the U.S. would respond with "fire and fury," rejiggering your portfolio in a major way due to the recent saber-rattling isn't a strategy recommended by most investment pros. While unsettling, the latest geopolitical scare has done little to dent the improving economic outlook.

Such commentary may seem sensible and measured, but unfortunatley it is of little value. When markets are rising in a nice steady and orderly fashion no one needs to be advised not to alter their portfolio, unfortunately when some advice to 'rejigger' your portfolio would be of value, ahead of any important turn, such advice will not be found in main stream media or heard from the majority of commentators. Extrapolating the recent past into the future is the simplest and easiest forecast to give and our hard wired herding nature ensures that most investors are over invested at peaks and have finally given up at long term troughs. This has to be the case given that it is the long term swings from enthusiasm and back to pessimism that ultimately drive markets. As H 'Woody' Brock of Strategic Economic decisions Inc wrote a number of years ago;

> *Cycles of optimism and pessimism about returns on any kind of investment are arguably the most important of all variables driving asset returns. They are certainly more important than interest rates – variables whose importance has been overestimated partly because they are measurable and constantly talked about, and partly because the all important concept of "Belief Structures" as a variable in its own right has only recently entered financial theory in a rigorous manner, and is not yet widely appreciated.*

Cycles of Expectation

A number of these long cycles of optimism and pessimism can be seen in the chart right produced by Bank of America Merrill Lynch. I was a relatively young broker in Merrill Lynch's London US institutional equity sales office when this indicator was first released. It attempts to highlight extremes in expectations on the part of the brokerage community by averaging the allocation each firm is recommending clients should have in equities in a balanced portfolio. It is perhaps not surprising that at the secular bull market peak in 2000, and for a while thereafter, the most extreme expectations ever were on display. These got ratcheted back through the tech wreck only to reinflate again, only not to quite such an extreme level, into the 2007



Source: BofA Merrill Lynch Global Research US Equity & Quant Strategy
Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviation from the rolling 15-year mean. A reading above the red line indicates a Sell signal and a reading below the green line indicates a Buy signal.

peak. The subsequent bear market unwound much of this until as equities rallied so too did the recommendations of brokerage firms.

This is not intended to ridicule the recommendations of brokerage firm strategists, rather it is to highlight that they, just like most of us, succumb to the same behavioral biases, and herding and anchoring are very powerful. As a result investors will generally be encouraged to be more aggressive in their allocations at just the wrong time, when risks are highest, and more defensive just as opportunities are most abundant.

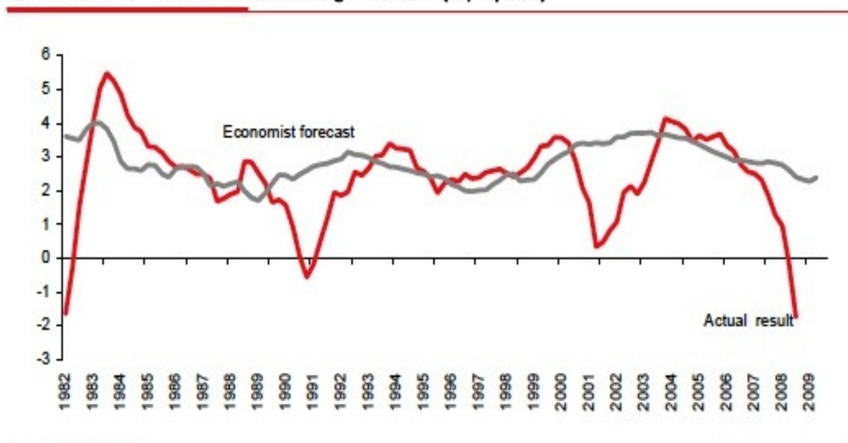
There is no absolute level that should be employed as a trigger with this indicator, but I feel certain that when more data is eventually available secular bull and bear market peaks and troughs will be apparent, along with the cyclical swings in between. In the meantime it is instructive in showing how expectations have moved over the last few years as equity markets have risen.

Not surprisingly brokerage firm recommendations have grown more and more aggressive the more the market has risen over the last five years. None of this means that a reversal has to occur now, but it does highlight that the risk of disappointment now is far greater than it was five years ago.

Expectations are undoubtedly stretched towards optimism, as is the ever misplaced reliance upon an 'economic' justification. The closing remark in the comments on North Korea *'While unsettling, the latest geopolitical scare has done little to dent the improving economic outlook'* highlights the neat causal relationship that so many continue to believe exists between the economy and stock market returns and the reliance that so many still put in an economic forecast. This despite the obvious shortcomings displayed by Ben Bernanke in his 2007 interview and the Wall Street Journal's comforting economic outlook in early 2008.

Economic Expectations

Over the years investors have been repeatedly let down by economic extrapolations that totally missed important inflection points, as can be seen in the chart on the right. This was the case with the new era thinking in 2000, the stagnation forecast in 2003, the optimism evident in 2007 and the downright fear in forecasts in 2009 and even into 2010. The remarkable thing about investors and markets is that lessons painfully learned are always eventually forgotten just when that lesson would be most useful. As Jeremy Grantham, of GMO, commented when asked just what investors would learn from the financial crisis;



> **"In the short term a lot, in the medium term a little, in the long term, nothing at all. That would be historical precedent"**

When these sage comments first appeared I referred to them frequently but wondered just what 'the long term' might be. I thought it may be one or even several decades, but remarkably it has been only eight years. At the depths of the Great Recession we had all learned the danger of believing that; central bankers could avert financial market disasters, that excessive debt, particularly covenant lite debt, was a time bomb, as were highly complex financial engineered products. We had also learned that economic forecasters were really just extrapolators, consistently missing important turning points that may or may not influence markets. Yet all of this knowledge, that had been so painfully learned, has now been discarded. Debt levels are generally even higher than they were eight years ago, covenants are lite again, and expectations are once again buoyed on the back of comforting words from benign economic forecasters!

Current Economic Expectations

When I returned from Europe at the beginning of August I began reviewing end of second quarter investment reviews and outlooks for the third quarter, almost all of them began immediately with a comforting benign economic outlook. A number even utilised this constructive outlook as the rationale for their position in the title of their quarterly reviews. The following is just a selection of theses summaries or titles from major investment firms;

> **Worldwide expansion continues with recession risks low**
>
> **The Global expansion is chugging along, deflation fears and near term political risks appear to have faded**
>
> **We think the fundamental supports of economic and earnings growth remain positive, helping stocks continue to rise over time.**
>
> **Our 12-month view for equities remains positive as the economy stays on track.**

The consensus of expectation as to what is going to drive markets, and in what direction, over the coming quarters is worrying and rather than providing any comfort to investors it should be waving a very large warning flag. Now is not the time to throw previously held caution to the wind. It may be uncomfortable, given the prevalence of benign economic commentary providing the (misplaced) foundation for a constructive market outlook, but now is the time to remember that comfort and success rarely go hand in hand in investing, whatever is comfortable, (as a result of herding and all our behavioral biases) is almost certainly wrong.

One final illustration of this, and the fact that we never seem to learn, was provided by the man once known as 'The Oracle', Alan Greenspan. In an interview with Bloomberg the 91 year old former chairman of the Federal Reserve said;

Greenspan Sees No Stock Excess, Warns of Bond Market Bubble

> "We are experiencing a bubble, not in stock prices but in bond prices. This is not discounted in the marketplace,"

Perhaps his intention was to provide comfort to equity market investors, or to alert bond investors to the risks, however, his sanguine outlook for equities was based upon the largely discredited 'Fed Model' for valuing markets. This 'model' did seem to 'work' throughout much of Greenspan's tenure, however, over much longer periods the relationship between earnings yields and bond yields totally breaks down. It should also be remembered that far from being the 'Oracle' it was Greenspan that warned of irrational exuberance, only four years too early, and despite an eventual 80% collapse in the NASDAQ it never fell below its level when Greenspan made his famous comment. Later Greenspan realised that the tech revolution was real, only that was just prior to the tech wreck, he also saw the remarkable value in derivatives spreading risk, just ahead of the GFC. He may have been very smart at some things but Alan Greenspan never really helped investors with market guidance, but then that wasn't his intention. He did famously say;

> *I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said.*

That is one lesson that should have been learned by investors!

The more important lessons that all investors should take on board and continually refer back to are;

1. Any economic outlook, no matter how constructive or benign, is quite likely to be wrong. This is particularly true when an important reversal may be at hand.
2. Even if an economic forecast turns out to be correct the interpretation as to what that means for investment returns is still highly likely to be wrong.

In 'Investing: The Expectations Game' I couldn't have stressed this point more strongly and referred to an article that appeared in the Financial Times in April 2013 under the headline;

> **Rising GDP not always a boon for equities**

I wrote that the article stated that 'contrary to standard economic theory' if a relationship exists between economic growth and stock market returns it is a negative, not a positive one. Quoting research from Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School that looked at nineteen countries over the period from 1900 to 2011 they wrote that the correlation between compound growth rate in real GDP growth per capita and the compound growth rate of return on equities was **negative** 0.39. In the world of emerging markets such research has only been done over the period from1988 to 2011 but the result is similar, **negative** 0.41. Totally counter intuitively investors would have been better off investing in those economies with the most sluggish economic growth, not the best. Despite this it is easy to understand why investors feel there has to be a relationship between growth rates and the market.

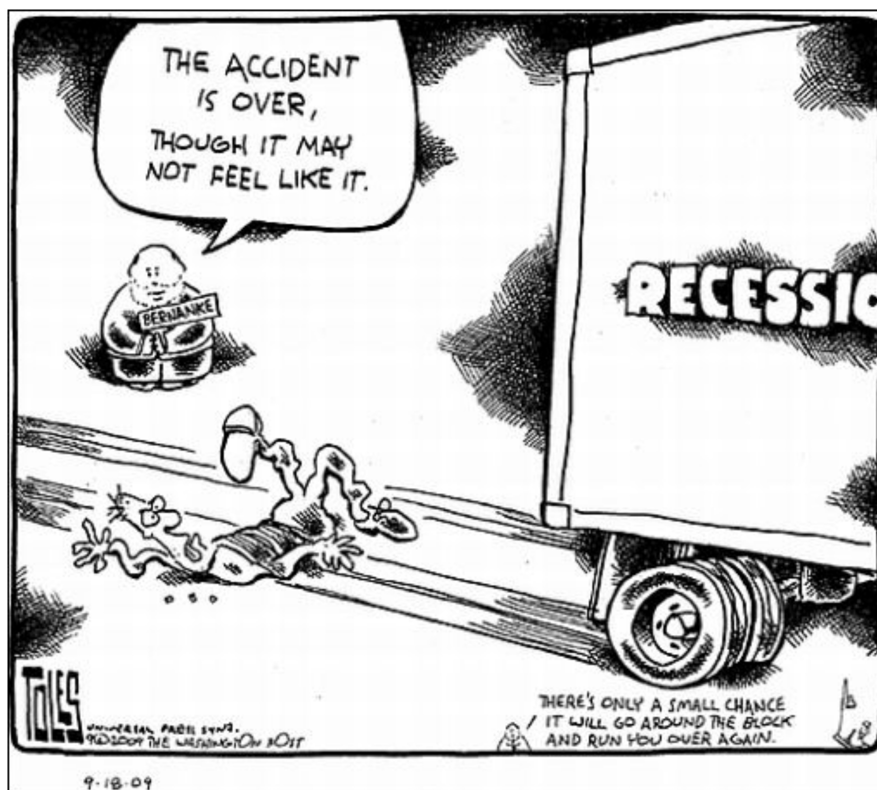
A relationship does exist, but it is far from causal and results from, and reflects, the many behavioural biases that beset us all.

It is not the absolute level of economic growth, or earnings growth, or even interest rates that determine the direction of investment markets. Whilst it would be nice and neat if there were a simple causal relationship between these factors and market movements, there is not, and really there can't be. If everyone knew exactly what a market would do when particular parameters were met then the market would not be able to trade as everyone would be on the same side attempting to benefit from the same 'assured' outcome.

What has always driven markets, and will continue to drive markets, are levels of expectations on the part of investors and the degree to which those expectations are exceeded or disappointed. As a result behavioural factors play, and always will play, an enormous role in the movements of markets.

None of this means that investors can ignore economics, earnings or interest rates, however, they have to be looked at through an 'expectational' lens rather than in an absolute sense. Currently the generally benign interpretation of the economic outlook, and the assumed constructive interpretation this implies for investment markets, should be seen as a red warning light, and not a green all clear sign, for investors.

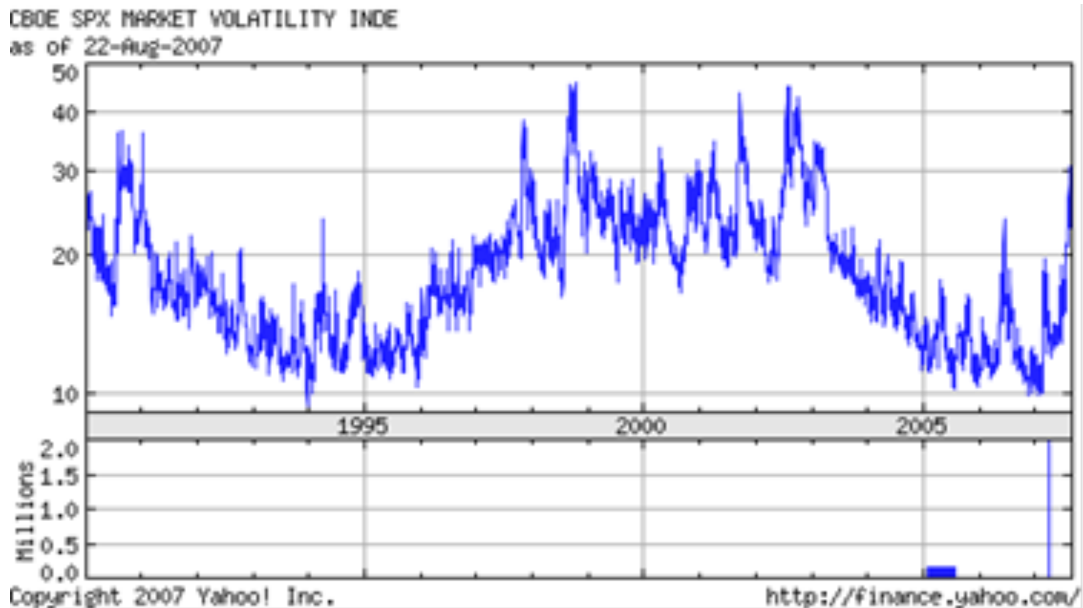
Conversely, history has shown that at times when investors should be looking for opportunities they should not be expecting a rosy outlook being broadly forecast on the back of a positive economic forecast. Back in early 2009 and 2003, the last two great buying opportunities, the overwhelming chorus of economic forecasters were for stagnation at best in 2003 and a double dip recession in 2009/10. In fact, as late as the second half of 2010 I continued to use the cartoon below in presentations.



Cartoons are often highly effective indicators of where majority expectations are. The one above was original drawn in September of 2009. It reflected the widely held fear that the recovery wasn't robust and that a second, or double dip, recession was still a possibility and, as I commented above, it continued to reflect the popular view well into 2010.

Volatility

Nearly ten years ago, in the September 2007 edition of Strategy Thoughts I included the chart below of the VIX index to highlight just how much volatility had increased and from what a low level (10) it had risen.



Currently the same index has been trading between 11 and 17 having recorded an all time low of below 9 in late July. Over the last twenty years the most profitable periods to be investing have accompanied falling volatility while periods of rising volatility have tended to coincide with more challenging markets.

Financial stock performance

The chart below shows the performance of the S&P500 year to date compared to the performance of the iShares US financials ETF. The marked underperformance that I commented upon in May is clear, however, it is also the case that this sector continues to lag behind the broader market and is well below where it was at the March peak, whereas the broader market remains close to its all time high.

It is also the case that smaller capitalisation stocks have been lagging behind larger capitalisation stocks, and, perhaps even more importantly, transportation stocks have been markedly underperforming the Dow Jones Industrials. The chart below shows that over the last six month the transportation index has moved sideways, in a volatile fashion, while the industrial index has risen in a fairly steadily.

This is a reversal of what had been seen throughout most of the bull market since early 2009, a period when the transportation stocks have tended to lead the industrials up.

None of these divergences, or the uptick in volatility, mean that markets are about to immediately reverse. However, when accompanied by the 'history lesson forgetting consensus outlook' for continued positive markets on the back of steady economic growth, investors should be getting increasingly concerned.

I was also struck by the increasingly cautionary tone outlined by the great investor Ray Dalio of Bridgewater Associates last month.

> For the last nine years, central banks drove interest rates to nil and pumped money into the system creating favorable carries and abundant cash. These actions pushed up asset prices, drove nominal interest rates below nominal growth rates, pushed real interest rates on cash negative, and drove real bond yields down to near zero percent, which created beautiful deleveragings, brought about balance sheet repairs, and led to more conventional economic conditions in which credit growth and economic growth are growing in relatively good balance with debt growth. That era is ending.
>
> Central bankers have clearly and understandably told us that henceforth those flows from their punch bowls will be tapered rather than increased—i.e., that the directions of policy are reversing so we are at a) the end of that nine-year era of continuous pressings down on interest rates and pushing out of money that created the liquidity-fueled moves in the economies and markets, and b) the beginning of the late-cycle phase of the business/short-term debt cycle, in which central bankers try to tighten at paces that are exactly right in order to keep growth and inflation neither too hot nor too cold, until they don't get it right and we have our next downturn. Recognizing that, our responsibility now is to keep dancing but closer to the exit and with a sharp eye on the tea leaves.

Dalio is in an enviable position to keep that 'sharp eye on the tea leaves', however, most investors are not and therefore risk falling in to the same trap that Charles Prince did when he used the dance floor analogy and the need to keep dancing.

In July 2007 the then CEO of Citigroup, Charles Prince, was asked by the Financial Times about his companies role in providing increasing amounts of liquidity to the leveraged buyout boom then still underway. He was quoted;

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Over the next year and a half Citigroup's stock price fell by more than 95% in value. Still dancing, but a little closer to the exit, may be an appropriate strategy for the boldest, smartest and most nimble of investors, but history has repeatedly shown that far more investors find themselves caught holding something they never really wanted when the music stops than get out just in time.

Conclusions

In the three months since the last edition of Strategy Thoughts many of the aspects of investment markets that were already extended have simple grown more extended with the result that expectations have grown more optimistic and sanguine. This can be seen in amongst other things the reaction to the Korean situation and the benign commentary accompanying almost all quarterly outlooks. This, along with the internal divergences that are being seen within and across markets and the recent record lows in volatility should all be cautionary signs for investors.

The appropriate, albeit uncomfortable, strategy continues to be to focus upon capital preservation. There will be many opportunities for investors over the coming months and years, however, it is vital to recognise that such opportunities will not be being presented amid a broadly constructive and benign backdrop.

There were a number of topics that have been in the media over the last few weeks that I did plan to address in this month's Strategy Thoughts that will now have to wait until September. These included the 'Fiduciary rule', that requires the financial industry to act in the best interests of clients and, most importantly, to put the clients' interests ahead of their own. I also wanted to provide some perspectives on the STA approach, given this increased focus on the fiduciary rule, and also to update readers on the STA portfolio.

Finally I would like to thank all those readers who noticed that Strategy Thoughts had not appeared in June and July and contacted me directly and also everyone who has expressed interest in the developments of the STA portfolio. I hope that the September issue will provide a detailed update on the STA's performance and how it could be utilised going forward

Kevin Armstrong

17th August 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.