Strategy Thoughts

February 2018

Where's the Melt Up gone?

Introduction

The last couple of weeks have witnessed a remarkable turnaround in equity markets the world over. Through the early weeks of 2018, as I discussed at length last month, there was a growing expectation that markets were set to accelerate even higher in what became known as a 'melt up'. Clearly, at least for now, that melt up has gone into reverse. Now investors should be taking note of how the majority are reacting to the recent rout. The fact that there has been an almost universal recognition that what has been suffered was to be expected, is healthy and lays the groundwork for even greater advance, and that the down draft is largely irrelevant given the healthy economy and corporate earnings, not only misses what it actually is that drives markets but should also be a stark warning sign. Expectations were clearly through the roof prior to this sell off and it seems they still are.

Melt up turns into melt down! What drives markets?

Last month in Strategy Thoughts I commented at some length on the growing conviction that stock markets were on the verge of a melt up, an expression that was written about by Jeremy Grantham of GMO and then picked up by many more as the market shot higher from the first trading day of the year. The following was a small sample of the 'melt up' headlines that dominated both the financial and mainstream media through January;

> A Financial Times headline read;
>
> **New Year's Global Stock Market 'Melt Up' Silences Bears**
>
> CNBC ran;
>
> **Legendary investor Bill Miller: Market could be headed for a 'melt-up' of 30%**
>
> Bloomberg reported;
>
> **Blackrock's Rupert Harrison Sees a Market 'Melt Up'**

I concluded last month's comments on a melt up with the following;

> The chances of an investor benefiting by investing in the last stages of a blow off are very remote as anyone jumping into the latest dot.com offerings in late 1999 can testify. The problem is that everyone involved wants the party to continue and so are only too happy to believe that any sell off is just a 'healthy correction' and another buying opportunity. Unfortunately, the last 'healthy correction' always deteriorates into a miserable bear market. Playing this game can be very dangerous and I continue to consider the downside risks in equities far outweigh any last stage blow off potential.

What has happened since can clearly be seen in the following chart of the US equity market;

All the supposed 'melt up' of January, and more, has now been lost.

This raises the critical question as to whether the January peak was the peak to the great bull market since early 2009, or is what has been suffered over the last couple of weeks just a so called 'healthy correction'.

Whilst the majority clearly prefer to believe in the latter history may not offer quite such a sanguine perspective, however, perhaps the most disconcerting aspect of the coverage of what has happened is that it continues to overlook just what it is that really drives markets (our collective expectations and the surprises and disappointments they lead to) and takes comfort, erroneously, in the supposed fundamentals and the cause and effect relationship between them and market action. One high profile example of this came in one of president Trump's many tweets.

Up until now I have avoided giving any airtime to the tweets of Donald Trump, however, this morning I had to make an exception when I heard CNBC report the following tweet;

> In the "old days," when good news was reported, the Stock Market would go up. Today, when good news is reported, the Stock Market goes down. Big mistake, and we have so much good (great) news about the economy!

The reason for reproducing this tweet is not that I have any sympathy for the president's sentiment or for his desire to take credit for the remarkable surge markets displayed in 2017. I wanted to reproduce the tweet because it gets the heart of what many prefer to believe drives markets, highlights the overly simplistic attitude that so many investors and commentators have been taking to the market, and illustrates the widespread misunderstanding of what really drives markets.

As the market was falling from its record highs the overwhelming message being pumped out was some version of;

- This is great, it is the buying opportunity we have been waiting for.
- This is a healthy correction and allows the markets to reset.
- There is nothing for the average investor to be concerned about, earnings are growing and the economy is set to continue to expand.

All of this was captured in a Bloomberg article immediately after the Dow Jones Industrial Average first plunged more than 1000 points. They ran a story;

Buy the dips takes hold

The story included the following quotes from market commentators;

- our view is that the medium term fundamental backdrop remains supportive and that one should indeed use the recent dip as buying opportunity
- We view short term moves such as this as attractive opportunities to exploit any over reactions in the market
- So far this pullback looks like a fat-tailed reminder for those short vol, but nothing else too sinister so far.

A week later, after further turmoil and another 1,000 point collapse Bloomberg ran the story;

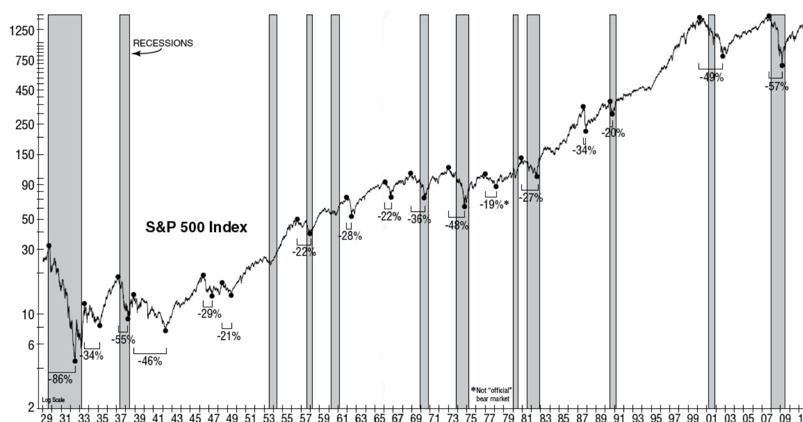
Buy the dip goes mainstream

The accompanying story pointed out that;

> Following the worst day for US equities since 2011, on Wednesday the dip buying phrase was mentioned more than any day since at least 2007.

What the president and all these commentators miss is that markets always, always, peak amid good news and the market will always have been rising into that peak amid a backdrop of ever improving news. What that ever improving news does is build higher and higher expectations on the part of investors, expectations that get harder and harder to surpass, and for the market to continue to rise that is what is required. Not just good news, or even great news, as the president sees it, but phenomenal knock your socks off news. Given the already extremely highly elevated level of expectations on the part of investors the world over, the merely good, or even great news that the president refers to, isn't enough. For a bull market to continue market participants need to be delivered positive surprises, the expected good news is never enough, all bull markets have always peaked amid good news.

Importantly, they have always peaked ahead of an economic down turn and a reversal in earnings. Markets are an immediate barometer of aggregate social mood, on the other hand economic numbers and earnings are always lagging indicators. A review of the official recession dates from the US back to the late seventies shows that on average a recession begins seven months after a bear market begins and the announcement that a recession had begun lags the stock markets peak by 15 months. An investor waiting for a recession to be officially declared and recognised will on average have already suffered a 14% loss.



No recession has ever begun, let alone become obvious and been officially declared, before a market peak. Yet still the media is full of commentators and experts proclaiming that all is fine with the market as there is no recession. There never is until one starts and by then the market is always lower.

In New Zealand the ubiquity of this notion that all is fine as the economy is in good shape was highlighted by an article in a major newspaper authored by a former news reader;

> **Kate Hawkesby: We need to stop calling the market blip a 'bloodbath'**

The article included the following 'sage' observations;

> In the grand scheme of things, this is not a bear market, and there's no recession looming.
>
> The experts will tell you our economy and market is in good health, full of low risk, stable, predictable, solid companies so we more than anyone, should be robust enough to trade our way through it. More reason to turn off the alarm bells. Prudent to note that this was a Wall Street issue, not a main street issue.
>
> So while the market movement may well experience a few more trembles before it settles again, what's the very best thing we can do right now? Keep calm and carry on.

Ms Hawkesby's comments captured the essence of what was being heard throughout the world in response to the last couple of weeks of turmoil; the economy is fine and there is no recession, this turmoil is a 'Wall Street' thing not a 'Main Street' issue, and there is no reason to panic, things will be back to 'normal' soon!

The important point that all these seemingly sensible observations miss are; just what it is that drives markets, and just what is cause and what is effect!

What is cause and what is effect in markets has always, and continues, to get confused! The reason for this confusion is understandable, we would like to believe that some neat cause and effect relationship existed to explain market action, it would naturally make investors more comfortable and comfort is what we all instinctively seek. Unfortunately, comfort and success in investment rarely go hand in hand, and if they do it tends not to last long and always ends badly. What most investors and commentators fail to appreciate is that the reason the market has been as strong as it has been is because the economy and all the other supposed fundamentals look as good as they do.

Not only do corporate earnings and economic numbers lag the stock market, unfortunately, the forecasts of those who attempt to forecast earnings and the economy end up lagging the things they are trying to forecast. So don't expect to see too may headlines about a recession or a profits collapse until after such an event has already begun. More importantly, investors should take no comfort from the measured outpourings of economists and analyst in the wake of the recent rout.

Lessons from the past. "Oh Yeah?"

The early stages of bear markets have always, and will continue to be, dominated by similar comments to those detailed above. All bear markets begin as 'healthy corrections' and the economy and earnings always look fine. Anyone waiting for a recession or earnings collapse to be obvious will likely have suffered almost all of whatever the bear market has to offer. This was seen through the early, and even mid, stages of the bear market associated with the Great Recession and global financial crisis, the early stages of the collapse following the Dotcom bust, and historically in the early stages of what would become the Great Depression. This was beautifully summarised in a little book by Eward Angly titled 'Oh Yeah'. This book was originally published in 1931, well before the final low in the US market was seen, and it captures in quotes from famous commentators of the time

the evolving attitudes as the market collapse progressed. In the early stages they were universally positive. Some examples include;

- On October the 26th 1929, with the market down but only a couple of days ahead of the Crash, The Wall Street Journal reported, "Conditions do not foreshadow anything more formidable than an arrest in stock activity….Suggestions that the wiping out of paper profits will reduce the country's real purchasing power seem far fetched."
- In the immediate aftermath of the two day Crash in 1929 John D Rockefeller Sr was quoted stating, "Believing that fundamental conditions of the country are sound and that there is nothing in the business situation to warrant the destruction of values that has taken place on the exchanges during the past week, my son and I have for some days been purchasing sound common stocks." He went on to say that they intended to continue to do so.
- In his New Year's message of 1930 Andrew Mellon, the secretary of the treasury, wrote, "I see nothing, however, in the present situation that is either menacing or warrants pessimism."
- Less than two weeks later the secretary of commerce, Robert Lamont, was quoted "Reports to the Department of Commerce indicate that business is in a satisfactory condition."
- On January 26th 1930 the president of the New York Stock Exchange said "The psychological effect of stock market activities on business is, I think, usually overemphasized…I do not think that the fall in security prices will itself cause any great curtailment in consumption, and the trade figures thus far available seem to bear this view of the matter."
- Finally, the noted economist of the time, Irving Fisher, was quoted in the New York Herald Tribune a week before the Crash with a comment eerily reminiscent of those being heard today, "I believe the breaks of the last few days have driven stocks down to hard rock. I believe that we will have a ragged market for a few weeks and the beginning of a mild bull movement will gain momentum next year."

History has repeatedly shown that the vast majority do not see the start of a bear market coming, they take comfort from supposedly healthy 'fundamentals' and extrapolating the positive market movement that preceded the peak, and see any selloff as a 'healthy' correction and a buying opportunity. It is therefore interesting to look back historically for any period when investors were hearing the opposite advice, that it is a good time to sell. Not surprisingly such advice is never heard anywhere near a peak, when it would be of most value.

Buy the dip or sell the rally?

Just as investors are inundated with seemingly sensible and measured counsel to 'buy the dip' in the early stages of a bear market it perhaps makes sense that the opposite is seen during the early stages of a bull market. After any lengthy bear market expectations on the part of investors have been repeatedly knocked back and so eventually reach a point where, so long as the end of the world doesn't actually happen, whatever does occur is actually better than expected and a positive surprise. This is when markets bottom. Bottoms do not occur because the news suddenly becomes positive, rather they happen because the news, whilst bad, is just not as dire as the majority fear. Understandably these bottoms are not universally embraced as most commentators can only see a continuation of what has already been suffered. This was most recently seen through the early months of 2009. In what can now be looked back upon as being the early stages of the current bull market fear

of financial Armageddon was rampant, economic and earnings forecasts were dire at best and there was a very clear and pervasive conviction that rallies should be sold as two headlines from Bloomberg in March 2009 illustrate;

> ***Morgan Stanley Says Sell Best S&P 500 Rally Since '38*** *March 30 (Bloomberg) -- Investors should sell U.S. stocks following the steepest rally since the 1930s because earnings are likely to keep weakening, according to Morgan Stanley.*

> ***Bank of America's Bernstein Says Sell Bank Stocks After Rally*** *March 23 (Bloomberg) -- Investors should sell bank stocks after they rallied 12 percent today because the Treasury Department's plan to buy toxic assets won't stop profits from dropping, Bank of America Corp's Richard Bernstein said.*

That sentiment continued to dominate as the headline below from the Daily Telegraph on 7th April illustrated;

> *George Soros warns shares will fall further*
>
> Stock markets slumped for a third day in a row as a welter of warnings that last week's bounce was no more than a "bear market rally" ended hopes of a sustained recovery.

And it continued into July;

> ***Morgan Stanley's Todd Says 'Sell Into' Stock Rally*** *July 22 (Bloomberg) -- Morgan Stanley's Jason Todd, one of Wall Street's two most bearish equity strategists, said investors should "sell into" a rally that has pushed the Standard and Poor's 500 Index to an eight-month high.*

By the time the last of these 'sell the rally' headlines appeared the Dow Jones Industrial Average had surged ahead by almost forty percent. Incredibly, with the markets having rallied for an incredible almost nine years, and having tripled from the point when this July 2009 headline appeared, attitudes have shifted through a full 180 degrees.

Investors should clearly have taken no notice of the caution so widely espoused nine years ago, equally they should not be taking any comfort from the widespread complacency surrounding the last two weeks of turmoil. They should also not be taking any comfort in the idea that somehow what has just been seen, on Wall Street in particular, is the result of high speed computer driven trading and therefore in some way an anomaly that can be overlooked.

Blame the machines?

In the immediate aftermath of the massive falls and swings in the major averages over the last few days the 'blame' has been squarely laid at the feet of those that provide leverage, especially through esoteric leveraged ETF's, and the algorithmic or quatatative traders who apparently can react and trade in a nano second. This is an understandably remarkably similar response to that seen after the so called 'Flash Crash' of 2010. There may be a grain of truth or substance to this view, but it is far from

the whole story. One day crashes have occurred in the past, long before computer driven trading, and intraday swings such as that seen on Monday 5th February and Tuesday 6th February, when the Dow Jones Industrial Average swung in a range of nearly 1600 and 1200 points respectively (6.5% and nearly 5%) have certainly been seen before.

A study of the largest one day percentage falls reveals that 12 of the 20 largest one day falls occurred before the 1980s when computers began to get involved in trading. These included the massive falls in 1929 around the crash and the subsequent very volatile period into the 1930s, but also included more isolated plunges such as the 12% fall on December 18th 1899 and a more than 8% fall on 14th March 1907. An even more extreme history can be seen on the upside where 17 of the 20 largest one day gains occurred before the advent of computer driven trading.

It should also be remembered that so called Flash Crashes occurred in the pre computer era. On the 28th May 1962 the Dow Jones Industrial Average went into apparent free fall, memories of the crash thirty nine years earlier were raised as the market plunged and it was standing room only in the customer rooms of brokerage houses. The market ultimately closed down 5.7% on the day and then fell further the following day before rallying close to 5% by the end of the day. Violent intraday swings are nothing new and they certainly can't be simply dismissed as the dark side of high frequency computer driven trading.

Writing about the Flash Crash in 2010 Jason Zweig of the Wall Street Journal presciently concluded;

> The crash of 1962 is a reminder that markets always have been messy and that investors' morale always has been fragile. What's more, the problems the regulators sought to solve nearly a half-century ago are still with us today. They probably will be tomorrow, too.

Markets are messy, they are not neat or orderly reflections of the overall economy or business conditions, rather they are reflections of the aggregate expectations of investors and the ebb and flow of those expectations as surprises and disappointments are confronted. Technology at the margin may accelerate or exaggerate some market moves, but over the long haul markets have always moved from being historically very cheap, when expectations are historically depressed, to historically very expensive, when expectations are through the roof. Recently many stock markets, but the US in particular, have been historically very expensive and when the consensus starts to forecast a melt up one would have to say expectations were very stretched. Amid such an environment even tiny disappointments can produce major market reactions.

Bitcoin FOMO, a further follow up

Bitcoin peaked at $20,000 just days after my comments urging caution in the December edition of Strategy Thoughts. I followed those comments up last month when the crypto currency had by then fallen by 40% in less than two weeks, a crash that wiped $130 billion of its total capitalisation, with still further cautionary remarks. I wrote;

> If this had been a market, or even a stock whose market capitalisation had fallen by $130 billon the headlines would have been dire. This wasn't the case for Bitcoin. On Christmas Eve Bloomberg ran the following story;
>
> **Wall Street Strategist Sees Bitcoin's Friday Price Plunge as 'Healthy'**

Since then Bitcoin has fallen even further. On the 6th February it traded briefly below $6,000 wiping another almost $100 billion from its value. But still this fall is seen as healthy, on the 8th February Sputnik news in Moscow reported;

> A steep drop in the value of Bitcoin and other cryptocurrencies is a short-term correction that is useful in the long-term for the market stability as regulatory moves attempt to bring rationale and encourage cryptocurrency prices to reach new records in the future, experts told Sputnik.

Perhaps it is healthy, although I am far from convinced. If it gets any 'healthier' there will be nothing left. As I wrote last month about the Bitcoin crash;

> Beware the 'healthy correction'. Every bear market in history has begun as nothing more than a so called healthy correction.

This is true not only for Bitcoin, no one should be taking too much comfort over the supposed healthiness of the current market setback.

Conclusions

Markets have clearly changed over the last few weeks but expectations so far have not, this leaves great scope for further disappointments. Bear markets always begin with a downdraft that is dismissed as being healthy and a chance to buy the dips, so far this current move has followed that script perfectly. From here there will eventually be a rally that will reinforce in the majority's minds that they were right not to panic and that the anticipated melt up is back on track, but the first rally in a bear market eventually dashes that hope and fails to deliver a new high. As markets start delivering lower highs and lower lows, instead of the ever higher highs that investors had become accustomed to, the slide down the 'slope of hope' begins.

Last month I concluded with;

> Caution and preservation of capital, so one in is a position to take advantage of a bear market, continues to be the most appropriate strategy for those not currently invested.

This remains the case as it is quite possible that eventually this equity bear market may become as 'healthy' as that so far suffered by Bitcoin.

Kevin Armstrong

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