Strategy Thoughts

December 2016

The Trump Rally Continues!

But for how long?

Introduction

The last month has seen the equity markets surge and not just in the US which has recorded multiple new all-time highs, all, apparently, on the back of Donald Trump winning the US election. In this month's Strategy Thoughts I look at the continuation and extension of the remarkable reversal in attitudes and expectations that this historic election has brought about and raise the possibility that the heightened expectations now so apparent only increase the risk of disappointment. I also look at the effects this attitudinal shift has had on the US dollar and consumer confidence.

Finally this month I look at the danger of year ahead forecasts and take a look at the experience of the Philippines market through a period that has seen tremendous economic growth but disappointing equity market returns. All of which highlights the importance of understanding just what it is that really drives markets.

Trump is good!

Following on from last month's Strategy Thoughts the proliferation of 'Trump is good for the economy and markets' stories has accelerated. Bloomberg ran two stories in early December quoting research from both Goldman Sachs and J P Morgan;

JP Morgan Most Bullish on US Stocks in 2017 Thanks to Reflationary Trump and Dovish Yellen

Goldman says Trump's Presidency Will Benefit Stocks in Almost Every Sector

More recently others, including Russell Investments, have joined the 'Trumponomics' fiscal party.

> "Trumponomics is directionally pro-growth, pro-inflation and our central scenario is a net addition of half a percentage point to real U.S. GDP growth," said **Paul Eitelman**, investment strategist for North America at Russell Investments.

On the 7th December Harvard economist Ken Rogoff wrote an article for project-syndicate.org titled;

The Trump Boom?

> With an incoming Republican administration hell-bent on reflating an economy already near full employment, and with promised trade restrictions driving up the price of import-competing goods, and with central-bank independence likely to come under attack, higher inflation – likely exceeding 3% at times – is a near-certainty. And output growth could surprise as well, possibly reaching 4%, at least temporarily

As I noted last month this enthusiasm and heightened expectation for better economic times and higher markets is a marked reversal from the overwhelming consensus view of an unlikely Trump

victory ahead of the election. And now it's not just economists and strategists that have a new found optimism thanks to president elect Trump, consumers have a new found buoyancy too.

Bloomberg reported on the 9th December

Consumer Confidence in U.S. Surges Thanks to Optimism About Trump

> Consumer confidence jumped more than forecast this month as Americans expressed the sunniest picture of their financial situation in 11 years, extending a boost following Donald Trump's election victory.

Investors that are backing this new found confidence, on the basis that it is somehow a sign that things will continue to improve, are leaving themselves open to the possibility of a major disappointment. I discussed consumer confidence at some length in a Thoughts and Observations article eight years ago;

> *The important point is not that the market is driving consumer confidence or vice versa, rather that they both, virtually simultaneously, reflect a broader deep seated optimism or pessimism. Looking for changes in consumer confidence to provide some hint as to what markets might do is probably futile, just as believing that movements in the market affect confidence, they don't. Both are driven by and reflective of basic levels of social mood, and its swings from pessimism to euphoria and back.*

Measures of consumer confidence are at best coincident indicators and are frequently slightly lagging indicators given the delay from the survey being conducted to the results being published. At market peaks, for the reasons I outlined eight years ago, confidence is almost always at a peak and the reverse is seen at important troughs.

What has been seen in the weeks since the US election has been a remarkable relief rally in both markets and confidence, both of which are signs of heightened enthusiasm and expectation about what a Trump administration may mean. Unfortunately these heightened expectations only increase the probability of a disappointment.

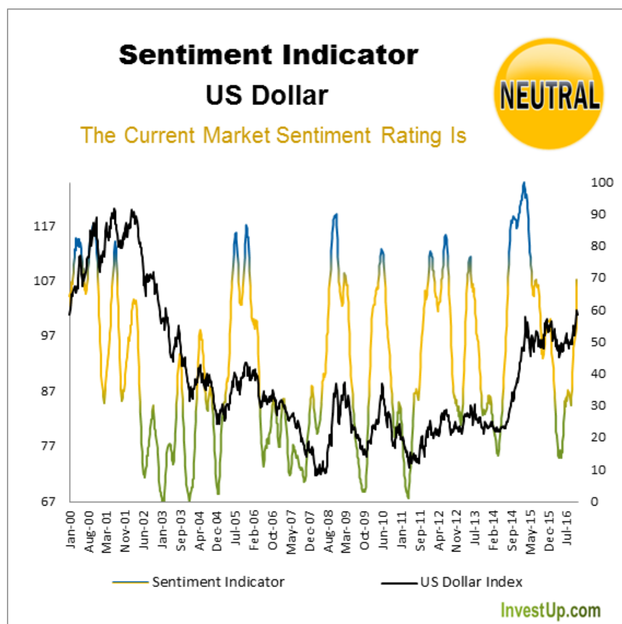
It should not be surprising that measures of consumer confidence are rising as the US market is making repeated new highs. Such behaviour has always been seen as markets approach a peak. Rather than embracing the broad support that economists and strategists are now giving to this current rally a long term disciplined investor should be noting just how different the environment is now to that endured in early 2009 when consumer confidence was at multi decade lows, markets had suffered their worst bear markets in decades and the time was right to be embracing equity markets.

Just as US equity markets and consumer confidence have been rallying in the post-election world so too has the US dollar.

US Dollar

Towards the end of May, in the May – June edition of Strategy Thoughts I highlighted the depressed expectations the majority had for the US dollar. At the time sentiment toward the US dollar, as can be seen in the chart below, was as depressed as it had been for five years and hedge funds were reported as being net short the US dollar. I commented:

> The intraday low in this index was the 3rd of May, the same day as headlines were reporting on the extent of the decline that had already occurred. Given that expectations towards the



dollar were recently as bleak as they have been since 2011 it is quite possible that the last few weeks of rally in the dollar index may only represent the beginnings of the next important move in the US dollar, a move that will see the dollar index break out to new bull markets highs. Certainly there is far greater room for a positive surprise than further disappointment.

Since then, as can also be seen in the chart left, attitudes have gone through something approaching a 180 degree reversal. The dollar index has rallied sharply and sentiment is once again approaching the greed zone having languished in the 'fear' zone just six months ago.

Given this reversal I recently reduced my exposure to the US dollar by selling half my position in the ETF, UUP as it rallied to a new high.

I still believe that further strength in the US dollar is possible and weakness in the Kiwi is likely, however, my conviction is naturally reduced given the attitudinal shifts that have already been seen.

Long dated yields

In the August edition of Strategy Thoughts I wrote the following about the recent record lows in long term treasury yields;

> Currently sentiment towards US Treasuries is as optimistic as it has been for four years. Obviously this does not mean that bond yields are necessarily set to surge higher but it should raise a cautionary flag, particularly for those investors chasing yields in lower quality instruments. There are also a couple of other aspects of the current environment in fixed income that should be raising further cautionary flags. One is the recent action in the Japanese Government bond market and the other is the reversal in expectations for long term bond yields that may soon be seen.
>
> Underestimation that is then eventually followed by overestimation, sadly at just the wrong time, is something that has regularly been seen over the years in both analyst and economist forecasts. Once a market or economic trend becomes established forecasters tend to struggle to be confident enough to forecast just how strong the trend is going to be and so their forecasts consistently underestimate how far a move will go. That is until their confidence eventually reaches a point where they manage to jump ahead of the trend with their forecast, but sadly that point is invariably just at the wrong time, just as the trend is reversing.

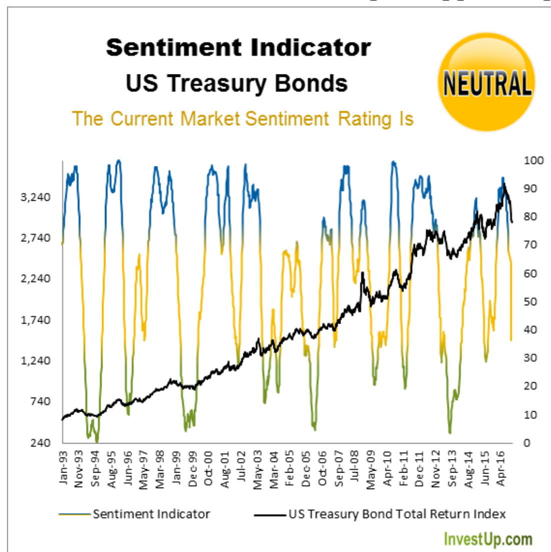
I highlighted that bullishness towards long dated treasury bonds was at an historic extreme and the risk of disappointment was far higher than the possibility of a positive surprise for those investors charging into bonds of all credit quality at the low in yields six months ago.

A few weeks later, as bond yields surprised the vast majority and rose Ambrose Evans Pritchard wrote in the Daily Telegraph

Bond yields are surging despite deflation, and that is dangerous

The article concluded:

> Bond yields in Europe are clearly not rising because growth is picking up and inflation looms. Industrial output slipped 1.1pc in July. France and Italy are in stagnation. The share of items in the eurozone inflation basket increasing at less than 1pc is spreading, a precursor of deflation. In other words, yields are rising for the "wrong reason" in Europe.
>
> We are entering dangerous waters. Markets are losing faith in the central bank "put", but governments are not yet willing to step into the breach with fiscal stimulus to keep the global show on the road. This is how accidents happen.



Since that extreme indication of bullishness appeared attitudes have changed, and so too have the yields on longer dated treasuries.

This reversal in attitudes, following the trough in yields (peak in bonds) may have worked off an extreme, and a rally in bonds may be at hand. My fear is that it will be nothing more than a dead cat bounce that produces a rally that should be sold.

What has perhaps been overlooked through this is how the bond yield crutch for equity markets has been removed but no one seems to care.

Back in July record low bond yields were used as a seemingly reasonable crutch for higher equity prices as highlighted in an article by CNN Money:

> But the best thing stocks have going for them right now may be how ridiculously expensive bonds are. They've never been pricier, thanks to a combination of emergency central bank programs (like negative interest rates) and a post-Brexit rush to the safety of government debt. Just this week the U.S. 10-year Treasury yield plunged to a record low. All of this matters because investors who feel the need to put their money somewhere may be forced to conclude that stocks look like a better deal than bonds. "The stock market is fairly priced in absolute terms, but cheap relative to bonds and cash. I'd be a buyer," said David Kelly, chief global strategist at JPMorgan Funds. Rates could stay extremely low because Brexit appears to have further derailed the Federal Reserve's plans to raise interest rates several times this year. Few see more than one rate hike this year and some even think the next move may not happen until the middle of 2017 -- or later.

Back then the broadly held expectation was that bond yields would remain low for the foreseeable future and that therefore otherwise expensive equities were cheap, but only compared to 'ridiculously expensive' bonds.

Since then bond yields have rocketed higher, but rather than whipping the crutch from underneath equities they too have rocketed higher. This has been particularly apparent over the last six weeks.

The other question that soaring bond yields raises is why are they rising? The immediate answer that is given to this question is inflation, and yet, as noted months ago in the Telegraph headline, yields continue to surge 'despite deflation'. Whilst the US only briefly flirted with deflation inflation still remains anchored at very low levels. In Europe inflation rates continue to be historically low at just 0.6% and yet generic ten year euro area Treasury bond yields has doubled since August.

It seems that the real surprise for many may be, notwithstanding a near term correction in what has been a dramatic surge in yields, that treasury yields will continue to rise and inflation rates will remain stubbornly low. This will not be a healthy environment, and as the Telegraph concluded 'This is how accidents happen'.

It is also worth noting that the broadly held assumption that a close link exists between inflation and long term bond yields is not something that should be relied upon too heavily.

In early 1952 the US inflation rate was 4.3%, a level from which it would steadily fall, and long term bond yields were just over 2.5%. Through 1952 the inflation rate averaged just 2.25%, the following year the average inflation rate was less than 1% and by 1955 the average inflation rate was negative, despite this long term bond yields rose to 3.5%. Over the next ten years inflation remained very low averaging just 1.6% and by December 1965 the monthly inflation rate was still only 1.6% yet long term bond yields had risen to 5%. Despite a very low inflation rate that averaged less than 1.4% from the beginning of 1952 through to the end of 1965 bond yields rose from 2.5% to 5%.

Undoubtedly a relationship does exist between inflation rates and bond yields, however, it is far looser than many would like to believe. Bond yields can rise in the face of stubbornly low inflation, particularly if concern regarding the apparent impotence of the central bank 'put' continues to grow.

The Philippines

Over the years I have repeatedly written about the futility of basing an investment decision upon an economic outlook. No matter how sensible such an approach may appear the facts are that it is just not a sound approach. Firstly the forecast has a far greater possibility of being wrong than right and then, even if it does turn out to be broadly correct, the market's response is highly likely to be different from that expected given the forecast. I was therefore intrigued by the following Bloomberg headline in mid-November;

Philippines Posts Strongest Economic Growth in Asia at 7.1%

The article went on to point out;

- The third quarter growth of 7.1% easily beat the median forecasts of economist which were just 6.7%
- Economists are now forecasting that the country will be among the fastest growing in the world with growth in excess of 6% until at least 2018.
- Growth has been between 5% and 8% every quarter since Q1 2012

All this is obviously intended to be interpreted as great news for investors in the Philippines, and yet investors have fared far worse than most would have expected had they known how well the economy would do.

Since its peak in April 2015 the PSE index has fallen 15% and is down 13% in just the last four months.

This should raise the question, where were expectations at the peak?

In late April 2015, with the market up four fold over the prior six years, enthusiasm and confidence was high. An article on Interaksyon.com was titled:

3 Reasons foreigners can't get enough of Philippine stocks

This headline on its own should have been enough of a warning to investors as foreign buying always comes late in any bull market and the article pointed out that net foreign buying was at its highest level in three years. The article went on to point out:

> The joint research team of First Metro Investment Corporation (FMIC) and University of Asia and the Pacific (UA&P) is still not calling the top on the Philippine stock market.
>
> Pricey stocks notwithstanding, there is room for local equities to rise further at least in the second quarter. For one, it expects foreign portfolio investments to keep flooding the Philippine market.

The article then went on to (quite correctly as it turns out) describe how robust the Philippine economy was. The article concluded with a forecast of 8,300 – 8,500 on the index and the recommendation;

"We prefer to remain invested and take advantage of market corrections to increase exposure."

At all market peaks forecasts tend to be extrapolations of the recent past, this was clearly the case in the Philippines, and 'experts' all urge investors to 'buy the dips'. Unfortunately for investors that initial 'dip' in mid 2015 turned into something far more damaging, a 25% bear market.

By early January 2016, with the Philippine market the worst performing South East Asian market, foreigners, rather than being the fuel for further gains, were being targeted as the reason for the painful bear market as seen in this headline from Bloomberg on 10th January 2016;

Philippine Stock Index Enters Bear Market Amid Foreign Selloff

The key messages that all investors should take from the experience of the Philippines are;

1. Foreign buying tends to accelerate into market peaks
2. A great economy in no way means a great market, it is almost certain that whatever good news the economy may deliver has already been factored into what by then will be an expensive market.
3. Investors are always urged to buy the dip at market peaks, and so as this advice is heard more often the disciplined investor should instead start to sell the rallies.

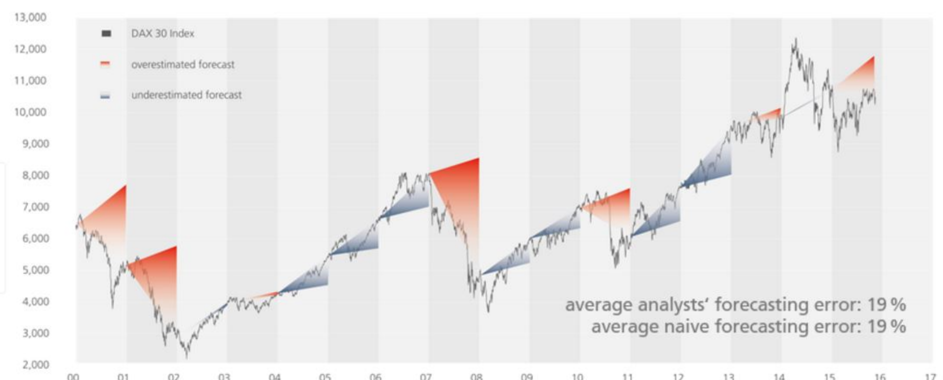
The Danger of Forecasts!

On a similar subject to that raised above, about the danger of forecasts, it is always fascinating, and interesting, to hear the year ahead forecasts that proliferate at this time of year. What has to be borne in mind is that so many of these forecasters have fairly recently performed a remarkable about face on the implications of a Trump presidency and that year ahead forecasts have historically had a terrible track record. On the 7th December Market watch ran an entertaining story;

Warning: Wall Street can't predict where the S&P 500 will go in 2017

The story drew on research by Star Capital

Banks' forecasts are not more precise than assuming a constant yearly stock market return of 9%. This result remains true for every arbitrarily chosen return between 7% and 19%," said Star Capital, as shown in the following chart.



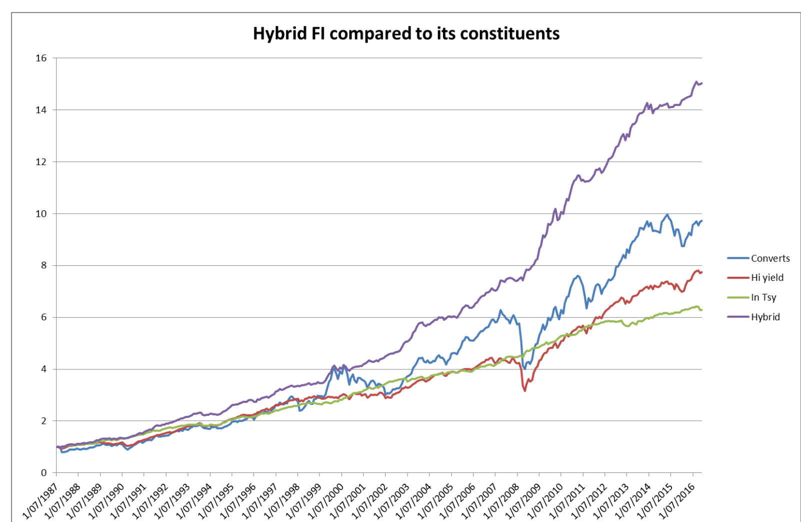
"Taken into account that the average error of analysts' 12-month forward EPS forecasts since 1973 is 30%, nearly any company value — and hence any stock value — could be justified based on discounted cash flow models," they said, in a note.

The challenge an investor faces if they do choose to rely on an arbitrary assumption and then stick to it year after year is that it doesn't feel right. Despite the evidence that relying on forecasts produces the same results over the long term the naïve forecast would leave an investor feeling 'different' to the majority for possibly extended periods. Unfortunately most investor enjoy the 'comfort' of following the herd and as a result can only ever hope for average results at best.

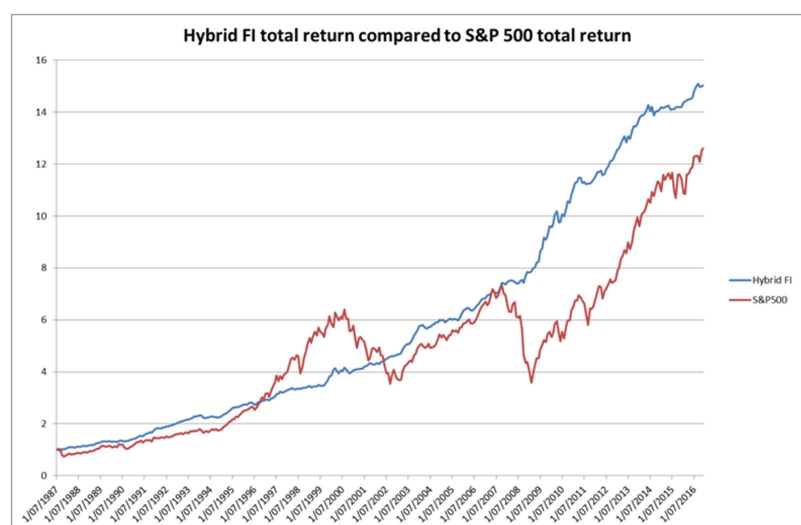
Equity returns without equities!

Over the last eighteen months I have written extensively on various forms of rules based portfolios. This, along with the chapters in 'Investing: The Expectations Game' outlining some of the basic rules I would apply to a disciplined portfolio, has resulted in a substantial amount of interest and enquiry from readers, particularly given the low interest rate world that has dominated for so long and the underlying long term risk I have repeatedly highlighted in equity markets. I have therefore spent some time over the last month augmenting what I have in the past referred to as my fixed income hybrid portfolio. This invested in two Vanguard funds that have both been around for several decades and have very low fees, the intermediate treasury fund and the high yield corporate bond fund. This hybrid fixed income portfolio has been the default for all the broader STA portfolios for the periods that equities and other assets were ruled out.

Vanguard also have a convertible bond fund that has been around for several decades. The effects of including an exposure to convertibles in the hybrid fixed income portfolio are shown in the chart, right. The results, utilising the same basic rules I have outlined in the past, are shown in the chart, right, going all the way back to just prior to the 1987 Crash.



This revised hybrid fixed income instrument clearly delivers a superior return than its three constituents, and what is particularly pleasing is how well it avoided the major drawdown suffered in 2008 by both the high yield and convertible funds.



What is perhaps most interesting for investors is how well this enhanced fixed income hybrid has performed compared to the S&P500.

The chart, right, shows the comparable cumulative returns of investing passively in the S&P 500 compared to investing in the rules based enhanced fixed income portfolio that is made up of intermediate treasuries, convertible bonds and high yield bonds.

The compound average total return of the hybrid fix income portfolio is 9.65% and its average rolling twelve month return is 9.9%. The S&P 500 over the same almost thirty year period delivered a compound average total return of 9% but an average rolling twelve month return of 11%. This difference is accounted for by the huge range in returns the S&P has delivered, its best twelve month return was up 53% while its worst twelve month return was down 43%. The comparable figures for the hybrid fixed income portfolio were down 1.4% and up 27% and so not surprisingly the standard deviations of returns are quite different, just 6.1% for the hybrid fixed income portfolio and 16.5% for the S&P 500.

The downside of the hybrid fixed income portfolio is that for lengthy periods it underperforms the S&P 500, however, this discomfort is far easier for an investor to deal with than the lengthy painful drawdowns that an equity investor has faced.

The ideal book for Christmas for any would be investor!

Investing: The Expectations Game was very favourably reviewed in The Sunday Star Times. Readers can access that review at; http://www.stuff.co.nz/business/opinion-analysis/87044737/Martin-Hawes-Reviewing-your-finances-like-a-book

At just 152 pages it is an ideal holiday read. Signed copies are available at www.strategythoughts.com

Conclusions

The remarkable rally since the US election may have further to run but investors should not view this rally as a sign that all is well with the world and that now is the time to jump into riskier assets. Rather the dramatic increase in expectations on the back of so many reversals in views since early November should be seen as a sign that the risk of disappointment has dramatically increased. Markets do not peak because the news suddenly reverses from good to bad, they top out amid good news and constructive forecasts from analysts and economists, but eventually the news is not good enough to satisfy the by then highly extended expectations.

2017 will likely be a very uncomfortable year for any investor currently seeking the comfort of the herd and relying upon things working out positively as so many now forecast. On the positive side it will likely be a year that presents some of the best investment opportunities of the last seven years for the disciplined investor who is currently prepared to sell the Trump driven rally, rather than buy any dip.

Kevin Armstrong

12th December 2016

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