Strategy Thoughts

March 2016

What have we learned in eight years?

Introduction

Since last month's Strategy Thoughts equity markets have stabilised and in many cases rallied, commodities have generally done the same thing and measures of volatility have fallen. This probably makes many investors feel somewhat more comfortable now that markets are once again 'behaving', and perhaps most worryingly, at least for me, is that the driver of the market seems to now be clearly understood, oil.

In this month's Strategy thoughts I will examine the supposed relationship between oil and the stock market, look at how easily we humans forget lessons we learned, just when remembering them would be so valuable and take a look at a number of markets from a longer term, secular, perspective. But perhaps the most important message in this month Strategy Thoughts, and an answer to the question in this month's title, is encapsulated in the famous quote from German philosopher Friedrich Hegel:

"The only thing we learn from history is that we learn nothing from history."

How easily we forget

Back on 1st February 2008, with junk bonds having struggled for a number of months along with the market, the following recommendation appeared on Seekingalpha.com;

Lehman High Yield Bond ETF: JNK in the Trunk

The author recommended adding some high yield debt on the back of the fall that had already been seen. At the time the JNK ETF was trading at $47, thirteen months later it had collapsed to $26 amid the worst economic and market rout in seven decades. You would think that such a purging experience would have taught market participants something, but this raises the question of how long we remember what it is we have just learned. Sadly, most of our views and opinions are shaped by our recent experiences, and extrapolations of these are what build our expectations. I vividly remember reading GMO's Jeremy Grantham's comment in the wake of the GFC that in the short term we will all have learned a lot, in the medium term we may have learned a little but over the long term we won't have learned anything. I always wondered how long the long term was, now it seems to be becoming clear that just seven or eight years is plenty of time for most investors to forget.

Now, the same JNK exchange traded fund which featured in the article mentioned above in 2008, is once again featuring among expert recommendations given that it had fallen from $41 to $32 over the prior eighteen months. Bloomberg on 17th February ran;

Nervous Market? Now's Time to Buy Junk, Alliance Bernstein Says

The recommendation was a view apparently shared by both PIMCO and Goldman Sachs and since then the price of JNK, along with most other assets, has risen. The price of JNK also rallied quite sharply in March of 2008, as many undoubtedly 'bought the dip', before plunging through the balance of the GFC.

It may be a stretch to claim that history is repeating, but there are, as Mark Twain might have put it, a number of echoes. The underpinnings of the high yield bond market certainly do not appear to be improving as the following Bloomberg story on March 1st highlighted

Global Junk-Bond Default Rate to Rise to '09 Level, Moody's Says

> Global junk-bond defaults will rise to the highest level in seven years in 2016 as a prolonged downturn in commodity prices continues to wreak havoc on company profits and balance sheets, according to Moody's Investors Service.

That reference to 'seven' years set me thinking that perhaps it is seven or eight years that is 'the long term' for most of us, and long enough for us to forget whatever it was we swore we would remember at the depths of the previous moment of market misery. As a result I looked at the long term history of a number of markets and looked to see how soon after one collapse another could occur. The examples I looked at were;

- The 1929 crash in the US. The market peaked in September 1929 and fell 89% over the next two and a half years. From there it rallied sharply but once again peaked in February 1937 and plunged 62% over the next 31 weeks. **7 years 5 months**
- The UK market in 1999. The peak in December 1999 preceded a 50% fall in the market. From that low point the market rallied into July 2007 and then another 50% fall. **7 years 8 months.** The most recent peak in the UK market was in April of last year and it has fallen almost 15% since then. The peak in 2015 was **7 years 9 months** after the prior peak**.**
- The US market in 2000. The peak occurred in March 2000 and the next, pre GFC peak was in October 2007. **7 years 7 months.** The most recent US peak was in May of last year, **7 years 8 months** after the last peak.

I am not a firm believer in market cycles, or that history repeats itself, but the rhymes over seven and a half to eight years did strike me as interesting. Clearly we humans do not need any more than eight years to forget what we wanted, and needed, to remember.

A short term perspective

Listening to the financial media over the last few weeks, and even months, it would be easy to believe that the only thing driving the markets has been the price of crude oil. This morning the following headline was on Bloomberg;

Oil prices rally; S&P 500 up for a fifth session

The article began;

> Oil prices jumped on Monday as optimism rose that major producers might reach a price support deal, helping U.S. stocks to notch a fifth straight session of gains.

The article went on to point out that;

> U.S. stocks have posted gains in each of the last three weeks, thanks in part to the rebound in oil prices, after a steep sell-off at the start of the year.

Almost a month ago CNN Money reported that the connection was even stronger;

Stocks dive to lowest level in nearly 2 years

> The crash in oil prices continues to ruin your portfolio. U.S. stocks took another punch to the gut on Thursday as investors freaked out over oil diving back below $27 a barrel.

In January The Wall Street Journal highlighted that;

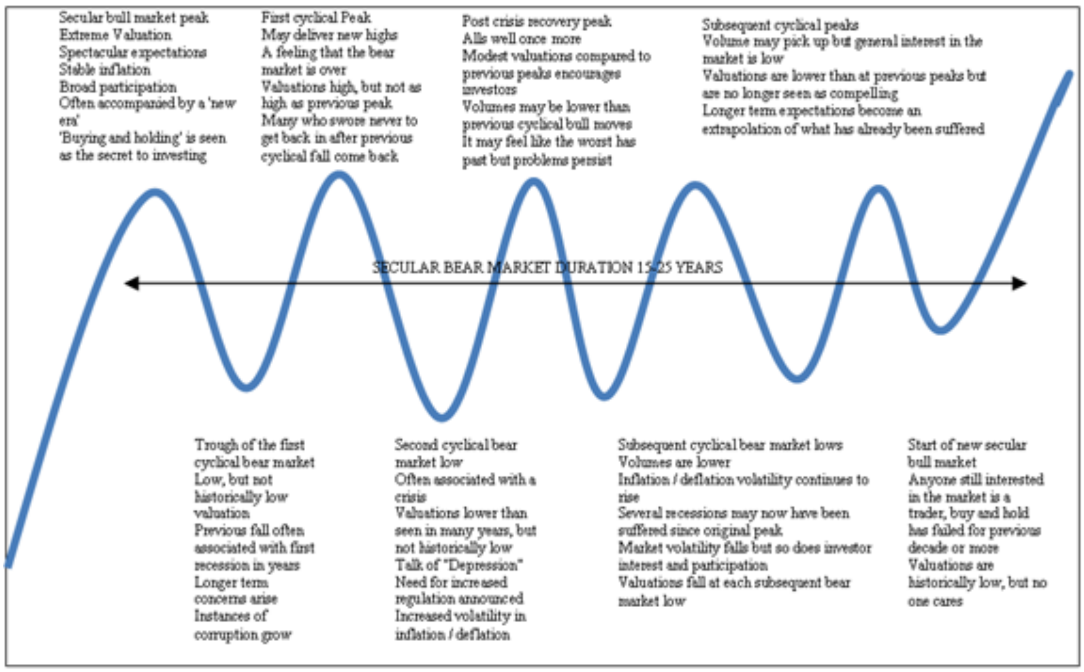
Oil, Stocks at Tightest Correlation in 26 Years

On the back of all this everyone it seems now knows what is driving the market; if oil rises then the market will, if it falls the market will too. Unfortunately history has repeatedly shown that by the time everyone knows, or thinks they know, just what is driving the market then whatever correlation (that by then is seen as causation) may briefly have existed breaks down. Clearly, even over the relatively recent past, this supposed cause and effect relationship between oil prices and the market has not existed. In 2007 the stock market began to plunge, oil continued to soar higher, almost doubling after the stock market peaked. They then fell in tandem once oil peaked in July 2008 and they bottomed within one month of each other in early 2009, but from there their fortunes eventually diverged. By late 2014 oil was at the same price it had been at almost four years earlier, having traded in a very narrow range. Over that same period the US equity market did virtually nothing but go up, and go up in a very steady fashion, almost doubling while oil had done nothing. Through the second half of 2014 and the first half of 2015 oil fell sharply, all while the stock market continued to rise, only mid last year did they once again start falling and rising together.

It may well be that the now conventional wisdom, that lower oil and falling markets are both presaging an economic slowdown, turns out to be right, but don't expect this neat correlation, that many are viewing as causation, is guaranteed to persist.

A longer term perspective

Readers may remember the following chart that I first included in Strategy Thoughts nearly five years ago in June 2011.



Accompanying the chart back then was a series of observations that could be utilised in identifying where markets were as they travelled through the frustrating and invariably protracted process of correcting the previous secular bull market;

The major characteristics can be summarised as follows;

- A secular bear market begins amid extreme expectations, broad participation, stable inflation and a positive economic backdrop. Buying and holding is seen as the secret to investing. Valuations will almost always be at record levels but these are often justified by a belief in 'new era' thinking and that 'this time it's different'.

- After the first cyclical decline valuations will have fallen, but not to record lows, the first recession in a long time may have been suffered and instances of corruption will have emerged.

- The next cyclical peak will revive memories of the previous enduring secular bull market, the worst will be believed to be over and many of those participants that lost so much in the first decline, that swore never to get back in again, come back. Valuation concerns will not be extreme because comparisons will be made to the previous remarkable peak.

- The next decline will often be associated with a crisis of some sort. Another recession, so soon after the last one, and in the wake of this and further instances of corruption that always seem to emerge in the depths of bear market, the demand for greater regulation and tougher laws will be heard. Faith in 'the market' will decline and the volatility of the economy and inflation / deflation will have grown. Valuations will be lower than the last trough, but not yet at historic lows.

- The post crisis bull market peak once again reawakens investor enthusiasm, but to a lesser extent. Again valuations are of little concern as compared to the last two peaks they are modest. Historically they will probably still be high. Volumes may be lower but investors will take comfort that the crisis has passed.

- Subsequent troughs, and there may well be several, will probably coincide with continued economic and inflation volatility, valuations will fall and so too will market volatility as participation and interest in the market dwindles after a decade or more of net price stagnation.

- Subsequent peaks will be less euphoric than previous peaks and valuations will be more modest. So too will investor expectations given all that has been suffered. They will be higher than at the trough but not as high as previous peaks. Interest in the market will be subdued and media coverage will be far less frenetic than at previous peaks.

- The final low, and so the start of a new secular bull market, will be greeted with very little fan fare or hype. Few will be interested given that the only investment approach that has worked over the previous decade or more has involved some form of market timing. Time horizons on the part of those still involved will be dramatically shorter than those shared by so many fifteen years earlier. The mood will be far less depressed and fearful than that at previous lows, particularly any crisis lows, and will probably be characterised by disinterest rather than disgust. Valuations will be the lowest in many decades, but no one will care.

Five years ago I asked the question, where are we now, and answered as follows;

> I continue to believe that the developed markets of the US and Europe are currently enjoying, to varying degrees, their second cyclical bull market in a still unfolding secular bear market, and, referring to the above, it is the post crisis bull market. My concern is that attitudes and expectations towards this bull market have moved through something approaching the 180 degrees that are described in the schematic of a cyclical bull market. Bulls would argue that optimism and valuations are not at anything like the extremes seen at the last two peaks, and I would agree, but this is where a secular perspective is so important. Valuation, as I have said many times, is only useful in indicating future market direction over secular time frames. It really should not be used within a cyclical move.
>
> The time for taking risk was in the first half of 2009, now, I continue to believe, is the time for an increasing degree of **caution and conservatism**. (Emphasis added)

I concluded those observations with;

> Whilst the US and Europe may be close to or at the peak of their second cyclical bull market within a secular bear market this is not the case for all other markets. Many of the emerging markets of Asia appeared to complete secular bear markets earlier this decade and Australia may only have completed its secular bull market in late 2007. Nonetheless, despite what may be differing secular positions for the various regions of the world I continue to expect cyclical bear markets, whether within a secular bull or bear, to occur somewhat simultaneously.

Now, almost five years later, it is worthwhile, through a series of charts, reviewing how markets have progressed, particularly within the framework of a secular bear market.

Europe

The UK FTSE index, shown left, is almost a perfect replication of the stylised secular bear market described above. The major secular bull market peak occurred in early 2000, this was followed by a cyclical bear market and bull market that then rolled into another bear market that was certainly associated with a major crisis. Since then the post crisis cyclical bull market has followed the 'script' well. There is certainly a sense of relief that the crisis has passed, valuations are not extreme, certainly when compared to the major 2000 peak, and volume, as can be seen in the chart, is lower. But there is still substantial interest in the market and longer term optimism as demonstrated by the UK's Motley Fool website which wrote at the end of 2015;

> The index appears to be in great shape to deliver excellent capital gains in 2016 and beyond.

Finally, despite its valuation plunging in 2009 it is highly debatable that it ever became truly historically cheap; the secular bear market is still unfolding.

France

As can be seen from the chart on the left, everything that was said about the UK can also be applied to the French market. Broadly, the only difference is that each subsequent cyclical bull market peak has been lower whereas for the UK the peaks were almost identical to those drawn in the original schematic. As in the UK market, a third cyclical bear market started in2015 and still has further to fall.

Germany

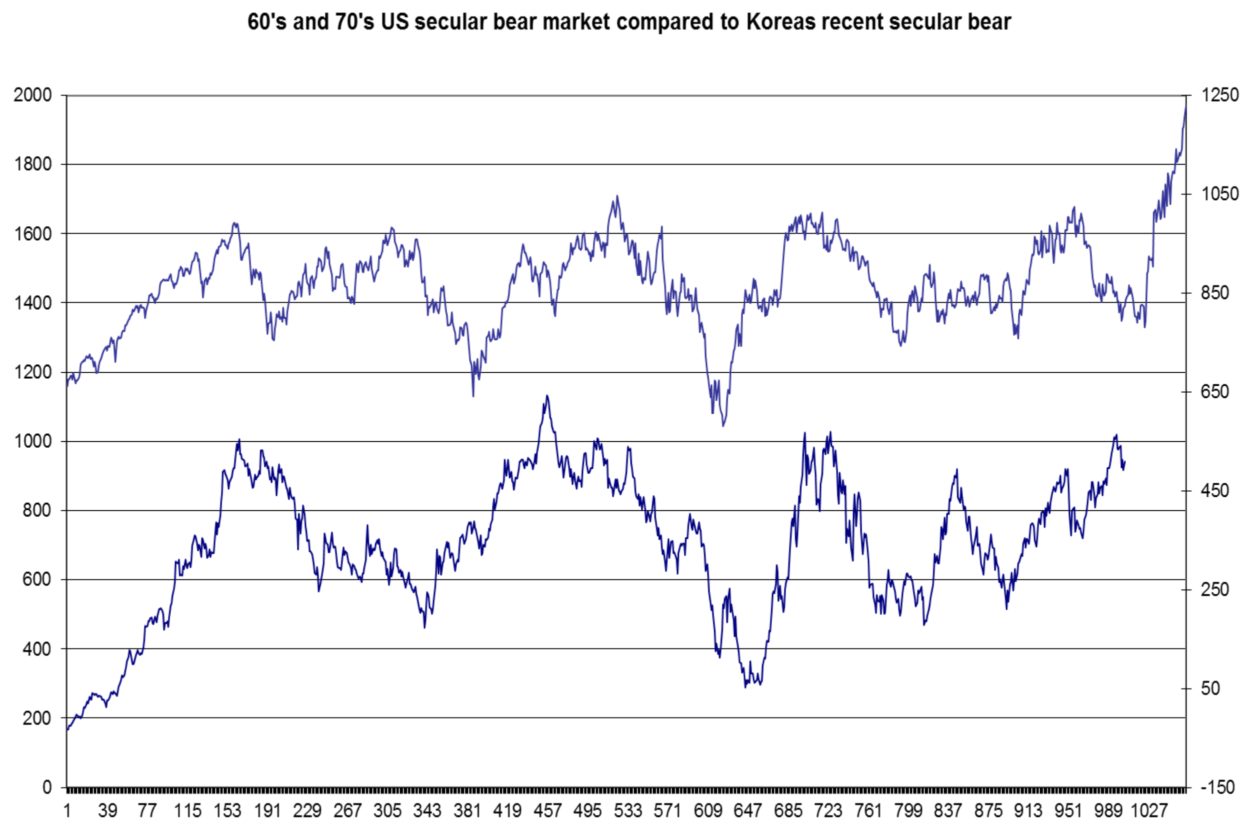
The situation with the German market looks quite different to that of the UK and France, at least at first. In the widely followed DAX index each subsequent cyclical peak has been higher; however, the DAX index is a total return index rather than just a price index like the CAC or the FTSE. When looked at on a price only basis the characteristics of a secular bear market become more apparent.

The smaller chart to the left shows the performance of the price only DAX, the DAX Kurs index, since the secular peak in 2000. Whilst the early 2015 peak was higher than the pre GFC peak it was almost identical to the level achieved fifteen years earlier. As with the UK and France, it is unlikely that the secular bear market is over in Germany

At the end of last year Forbes included European equities as one of their top three picks for 2016 from 'Top Investment banks'. They cited the better earnings prospects that Europe had compared to the US, the UK and Japan and the more attractive dividend yields. It is highly unlikely that a secular bear market would end accompanied by that measure of optimism and enthusiasm.

Emerging Markets

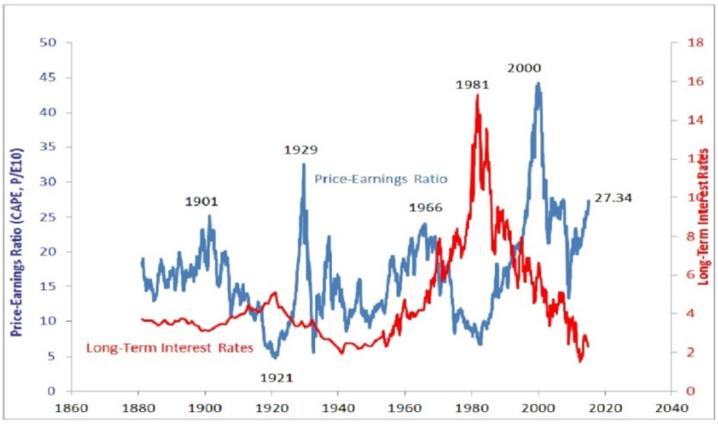
A little over ten years ago I illustrated the concept of a secular bear market already having run its course in a number of the emerging markets by comparing the experience of the Korean market to the secular bear market the US endured in the 1960s and 1970s with the following chart.

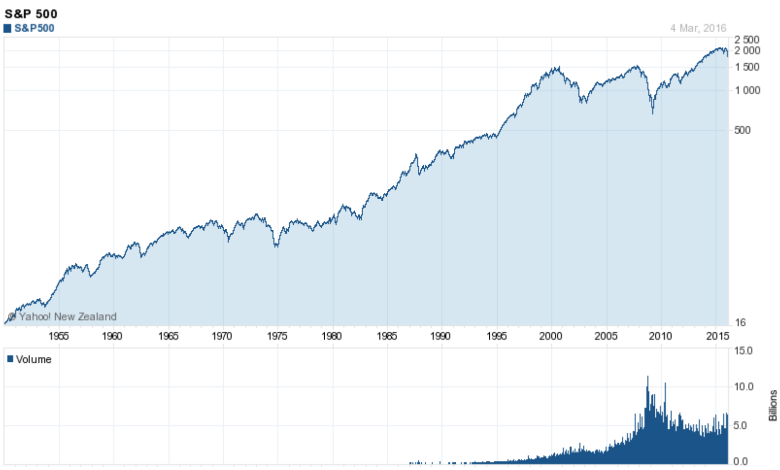


The scale was obviously different as far as price moves were concerned but the timing of each cyclical bull and bear market was remarkably similar (and also similar to the schematic secular bear market). After that point in early 2005 the KOSPI went on to more than double over the next two and a half years. It did suffer a major setback during the GFC but it never fell back to the lows of the previous secular bear and has since recovered and moved broadly sideways over the last few years. Nonetheless, it is likely that the current secular bull market in Korea does still have further to run

The US

The US secular bear market does not fit the schematic as well as some of the other markets described above, nonetheless, I continue to believe that a phenomenal secular bull market ended in 2000 when US valuations achieved record levels that will likely not be broken for many decades, as can be seen in the Shiller CAPE chart (left). The first two cyclical bear markets and the intervening cyclical bull market did follow the typical secular bear pattern as described above, but the bull market since the 2009 low has lasted longer and travelled further than one would have expected. Not surprisingly this action has resulted in many describing what has been seen to date as being the early stages of a new secular bull market. Unfortunately, very few of the characteristics one would find when looking back at the start of a secular bull move were present in 2009, particularly valuation as can easily be seen in the Shiller CAPE chart.

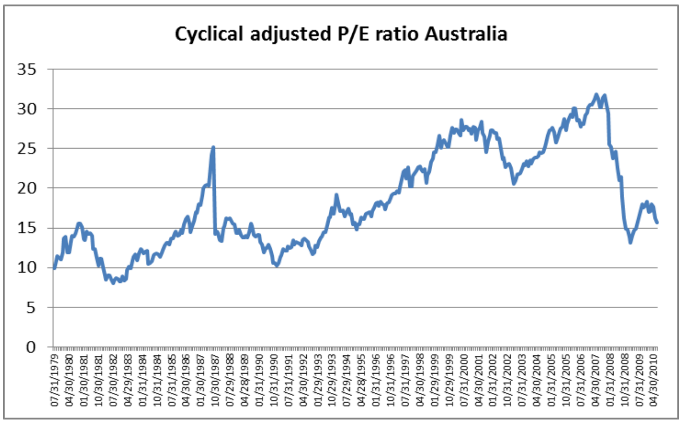




A better perspective of the last sixteen years of secular bear market in the US can be gained looking at a very long term chart of the S&P500.

The previous secular bear market began at the valuation extreme in 1966, again clearly visible on the Shiller CAPE chart. From there the first cyclical bear market saw the index fall 22%. The next cyclical bull market added 48% to the index pushing it comfortably above the secular peak's value, before the next bear market knocked 34% off the index. The second cyclical bull market added 67% to the index and pushed it 30% above the secular peak from seven years earlier. In many ways what has been happening in the S&P500 for the last sixteen years is a larger version of the previous secular bear market. The first cyclical decline took 47% off the index; the bull market that followed recorded a slight new high after rallying a little over 90%. A cyclical bear market followed that knocked the index down by 57% before this latest rally drove the index up to a point 40% above the secular peak's level. In the 1970s what followed was the worst bear market since the 1930s as the index fell 50% over the next seven quarters. That marked the price low for the secular bear market but the valuation low was still eight years in the future as interest in the market waned until the early 1980s.

Australia



The chart to the left shows the ASX going back as far as Yahoo Finance has the data, unfortunately the history shown only contains one secular bull market, which probably began in 1982, and the start of one secular bear market that began in 2007.

These dates are arrived at not from looking at the price action, although the acceleration into the 2007 peak was very impressive as were the accompanying expectations, they come from a long term assessment of the markets valuations at those extremes. Very long term CAPEs are difficult to construct for Australia, nonetheless, the chart to the left is one I constructed a number of years ago and goes back to the late 1970s. At the low point in 1982 the CAPE for Australia was clearly in the single digit area and it then rose, albeit in a very volatile fashion, through to 2007 to a peak in the low thirties. Unfortunately there is no historical comparison for this level in the available Australian history so all we can do is compare it to those historic price peaks seen in the longer term US history. Australia in 2007 was not quite as expensive from a long term perspective as the US was in 2000, but it was comparable to the 1929 peak and more expensive than the peaks seen in 1966 and 1901. Since then, despite falling , rising and starting to fall again, the Australian market has not become historically very cheap, or despised, or attracting little interest. All characteristics that will be present at the next, great, long term, buying opportunity.

Observations on the 'value' of value

I have often pointed out the danger of utilising valuation measures in anything but the longest term assessments of a market's return potential. It is useful as a tool when looking at markets from a secular standpoint as at secular peaks markets are always historically very expensive and at troughs, when they are totally overlooked, they are historically cheap, unfortunately in between these extremes valuations tell one very little about what a market may do even over periods of a year to eighteen months. This was brought home to me when I was researching historic valuations for my upcoming book and I stumbled across a great piece of work published in the UK's Daily Telegraph back in June 2014. The article looked at the valuations of more than thirty markets around the world on the basis of price earnings multiples, long term cyclically adjusted price earnings multiples and price to book value measures. It concluded that on all three measures only four markets were outright expensive and seven were outright cheap.

The four expensive markets were; Indonesia, Pakistan, Sri Lanka and the US and the cheap markets were; Greece, Turkey, Russia, Japan, Hong Kong, China and India. Interestingly the average performance since June 2014 of the four expensive markets has been a slight rise of about 4%, but the range of returns has been narrow, three of the markets are largely unchanged and Pakistan is up about 15%. On the other hand the experience of the cheap markets has been quite different, but probably not in the way the majority would have expected. Among the cheap markets the range of experience has been vast with Greece falling a further 73% and China rising 30% (although at one point since June 2014 it was up over 100% before a 45% decline). On average, had one been tempted by the 'cheap' assessment, a loss of 9% was suffered. Not exactly what many would have expected but again this highlights that there is little value in value measures, except over very long periods.

Apple

On the 18th march it will be a year since Apple replaced AT&T in the Dow Jones Industrial Average and I have periodically been monitoring their comparable performances since the switch took place. In the April edition of Strategy Thoughts last year I reviewed this switch and the history of such switches that clearly showed that the unloved company that was dropped typically outperformed the loved newcomer by more than 20% over the first twelve months after a switch. I concluded that discussion with the following question;

> The history of the Dow 'Index Committee' clearly demonstrates that their decisions, when they are finally made, reflect what everyone already knows. Given this, plus the totally different price histories and the relative optimism or pessimism that are currently reflected in AAPL and AT&T the question does arise; where is there scope for the biggest surprise and where is the biggest disappointment most likely?

It is not quite twelve months since the switch but the answer to this question seems clear. I couldn't resist including the chart (left) which shows that the unloved AT&T has delivered even more out performance than one could have expected, given the historic average, over the last year. While Apple has fallen 20% AT&T has risen 10%, over the same period the Dow has fallen about 7%. It is almost amusing to consider how much better the Dow would have performed had the switch not been made!

Conclusion

For many months I have been urging readers to focus upon capital preservation and to avoid the temptation of chasing yield or return, whether it is touted as being available in junk bonds or anything else. This has not been a particularly exciting message, nor has it been particularly rewarding, but then chasing returns in high yield bond has seen capital lost as has exposure to many equity and commodity markets.

The US market has obviously held up well over the last few years, but investing in the emerging markets has been a disaster, they have been trending down since 2011 and were recently at the same level as they traded at in mid 2009. Exposure to Europe has been mixed, as a number of the charts in this month's Strategy Thoughts illustrate, nonetheless, broad exposure to Europe via the Euro Stoxx ETF has been sliding in value since last April and recently was at the same level as five years earlier, and the Australian market has been sliding for almost a year and, like Europe, was recently back to levels seen as far back as 2011. It would be fair to say that the last few years have been challenging for most investors. Unfortunately I continue to believe that it will only get more challenging before real, long term, opportunities are once again available. This aggressive focus upon capital preservation has been something of a lonely occupation so I was intrigued when Bloomberg recently reported that HSBC were pushing a similar line with a focus on the attraction of cash.

HSBC Says 'Cash Is King'

Slower earnings and stubborn valuations still weigh on stocks.

The contrarian streak in me made me somewhat cautious when I saw the headline as an increasing level of company is not what an investor should really be looking for; however, on reading the article it became clear that this move on the part of HSBC was just a 2% tactical shift in favour of cash. No changes were made to their strategic asset allocation. By the time a real low is seen across asset classes expect a substantially more cautious outlook on the part of the vast majority of commentators. We are not there yet.

The Expectations Game

Firstly I would like to thank all those readers who have expressed interest in my new book. The title has now been finalised, **INVESTING IN TURBULENT TIMES, How to win the 'The Expectations Game' and Why Most Investors Fail**, and the draft manuscript is now 95% complete. It has been a fascinating and enjoyable process putting this together over the last few months and I can assure readers that the finished product, that we hope to have out early in the second half of the year, will be quite different to any of the hundreds of investment books that I have read over the years. Something I would really like to include in the book would be some feedback or comments from readers of Strategy Thoughts, particularly those that have been following this commentary for a number of years. If you would like to put some thoughts down, either attributed or anonymously, I would very much appreciate it and look forward to hearing from you at k.armstrong@clear.net.nz

Kevin Armstrong

8th March2016