Strategy Thoughts

August 2016

It is still all about Expectations

But what a two months!

Introduction

For most of June and all of July we were travelling (and golfing) through France and England. It was fascinating to be there for the build up to, what will forever be remembered as, the 'Brexit Referendum', and almost more interesting to witness the aftermath. Understandably there was some extreme sensationalism both before and after the vote, and markets displayed the expected volatility. There has been an enormous amount of debate as to what the referendum result means for economies and markets going forward, this is understandable, however, my major concern is that this is just another illustration of the confusion between cause and effect that is repeatedly seen in markets. The decision to leave the EU on the part of the UK was an understandable outcome of the declining social mood that has been apparent throughout most of Europe and the UK for more than a decade. It will no doubt be seen as being a cause of whatever may happen next, I firmly believe that this is the wrong position for anyone, but particularly investors, to take.

In this edition of Strategy Thoughts I will review two topics at some length and bring one other to a close. Firstly I will review the Brexit decision, how it may fit into the longer term outlook for Europe and attempt to clarify the confusion over what may be cause and what is effect and between causation and correlation in markets. The second subject is one I have addressed in the past but is of particular importance now, the danger of chasing, or reaching for, yields. With long term yields still close to record lows, and negative yields becoming commonplace, it is understandable that investors are looking to junk and emerging bond markets for solutions but the recent action in the Japanese bond market and the extremes of optimism currently present in bond markets should be seen as cautionary flags for investors.

Finally I will bring my tracking of the price performance of Apple versus AT&T to a close. It has been a wonderful real time illustration of the value of looking at markets from an expectational point of view.

Brexit (cause and effect revisited again!)

A little over four years ago, in the April 2012 edition of Strategy Thoughts, I discussed the often misplaced ascribing of, and confusion over, cause and effect in markets;

> **Cause and effect in markets**
>
> I wrote in last month's Strategy Conclusions;
>
> *It is also important to remember that difficult decisions that ultimately resolve problems tend not to be made with markets near peaks, they are more likely found at market troughs amidst a very bleak general mood. Ultimately, after markets rise those decisions are often looked back upon as having been the 'catalyst' for the rise whereas in fact the market had probably fallen as far as it was going to fall and the exceedingly desperate mood that prevailed allowed the decision to be made. As human beings we like to ascribe cause and effect, but, as*

Micahel Mauboussin described in 'Think Twice' (I mentioned this book in this month's Strategy Thoughts) in simple systems this is easy, but in complex and adaptive systems like a share market, this is always almost impossible.

It is easy to understand why we look for cause and effect, if we find a relationship that seems to endure then it surely must make sense to ascribe a cause to the outcome. If we are able to do that then a veil of uncertainty and mystery has been lifted, and armed with that new understanding we are briefly empowered. I say briefly because in my experience in markets when an outcome is generally accepted to be the result of a particular cause it stops working.

There is also an enormous difference between causation and correlation. This can be illustrated by a ludicrous example; if you monitored the number of ice cream sellers out on the streets of Manhattan and graphed that number each day against temperature you would certainly find a very strong positive correlation between ice cream sellers and temperature, but that doesn't mean that more ice cream sellers deliver a hotter day. Often the two things that are highly correlated are in fact both the result of some other cause.

That final sentence is highly applicable to the discussion that has been taking place for several weeks, and will likely continue for many more, regarding the economic implications of the British Brexit vote on June 23rd.

Having spent most of June and all of July in Europe and the UK it was fascinating to watch, as something of an outsider, the build up to and the immediate aftermath of the Brexit referendum. It is also worth commenting that the result was certainly not as large a surprise, at least to me, as the mainstream media played it up to be. Not because I had any particularly astute insights as to how the vote would go but as a result of the numerous conversations that I had with locals while travelling and playing golf in France and the UK in the immediate build up to the referendum. My estimation would be that two thirds of those voters I questioned were intending to vote leave. Now it may well be the case that I did not meet with a representative sample of the UK population, in the main they would have fallen in the 'older' demographic. However, it was a gross oversimplification on the part of the media to describe the split between leavers and remainers being primarily along education and age lines. Many of those I spoke to were very highly educated. Nonetheless, whether the result should have been anticipated or not is largely irrelevant and even if an investor had correctly forecast the result it is unlikely they would have profited from that forecast. Most assets, with the exception of Sterling, behaved in what can only be described as a quite contrary manner in the days and weeks after the vote. Ahead of the referendum the forecasts of what would happen to the UK, European and world economies if the vote was in favour of leaving were almost universally dire.

In Britain The Mirror focussed upon the implications for beneficiaries:

1. Brexit will hit the nation's finances

Economists differ on how far Brexit could affect the economy, but most agree it will make a significant dent on GDP by 2020 .

In the event of a Brexit, the NIESR expects the Government's fiscal deficit to widen by 2.35% by 2020, but in the worst-case scenario, by as much as 6.19%.

2. The Government will make cuts

The Tory Government has set itself the target of cutting "public sector net debt as a percentage of GDP" every year to 2019-20. In other words, if we're not making more money, the Government needs to cut spending.

3. The cuts will be to welfare

What the Government decides to cut is a matter of choice. But in the past year we've seen it attack working-age benefits like tax credits, disability benefits and Universal Credit. It's quite likely welfare would be for the chop again.

NIESR have looked at the scenario of a Government passing on 25% of cuts to the welfare budget, but also what would happen if that portion was 50%, or 100% of the cuts.

And in the US Barron's reported a week ahead of the vote that US Treasury Secretary, Jack Lew as saying;

> "I see only negative economic outcomes. A Brexit would also put geopolitical stability at risk."

And J P Morgan Chase CEO, Jamie Dimon was quoted;

> "Brexit will result in years of uncertainty and I believe that this will hurt the economies of both Britain and the European Union."

Nine days ahead of the vote the Chancellor of the Exchequer, George Osborne delivered a miserable, and punishing, warning as reported in The Guardian;

> Chancellor delivers stark warning of £15bn tax rises, increase in fuel and alcohol duties and £15bn cuts to health, education and defence if Britain leaves the EU.

These sentiments were also supported, somewhat controversially, by similar warnings from the Governor of the Bank of England, Mark Carney.

Finally, a consensus of economists (always something to be concerned about) warned that a leave vote would do serious damage to the UK economy. The Financial Times summarised this consensus with the following warning;

> Third, economics itself is on the line. If leaving the EU turns out to be beneficial, the profession will enter a crisis that will dwarf its inability to see the global financial crisis coming. More likely, if economists are right but had insufficient influence, few will find satisfaction in saying, "we told you so". This is a pivotal moment for Britain. It is also a crucial time for economics. For once Britain's economists have spoken with one voice. Britain should not leave the EU, they say. You have been warned.

In the wake of these perilous warnings it is worthwhile reviewing what markets and the UK economy have done in the six weeks since the referendum.

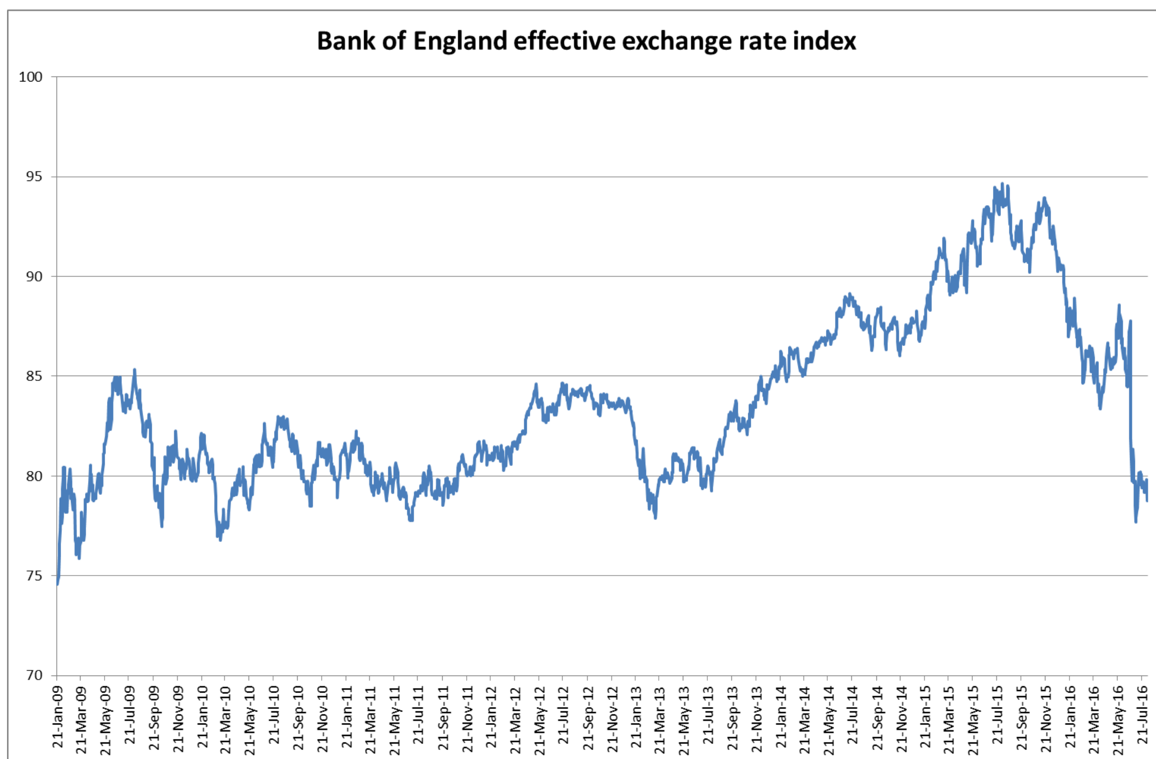
- The UK market. In the immediate aftermath the FTSE fell sharply, but was still higher than it had been nine days ahead of the referendum. It then reversed course and rallied more than 13% to its highest level of the year.
- Europe. A larger immediate fall was seen in European markets and the subsequent rally has been more muted. Nonetheless, the Euro Stoxx 50 index is still at the same levels it traded at in mid January.

- US. In the US the selloff post the vote was almost immediately reversed and the uptrend since February resumed.
- The UK economy. Economic confidence and some economic data has weakened post the Brexit vote and Sterling has fallen sharply, however, this raises a very important question that comes back to the original question of what is cause and what is effect; was this weakness going to occur anyway and is the Brexit vote merely a convenient scapegoat?

To try to answer this critical question a longer term perspective is required.

Both the UK and broader European markets had been falling for more than a year ahead of the referendum. In April of last year the Euro Stoxx 50 recorded its highest level in more than seven years but by February of this year had fallen more than 25% in value. Over the same ten months the FTSE 100 index fell by 20% from its all time high. Both European and European markets were locked in bear markets long before the Brexit vote, and the same is true for Sterling.

By early April of this year Sterling's trade weighted index had fallen by 12% over the prior eight months, it then rallied ahead of the referendum, recovering almost half of this decline by late May, before resuming what can be seen in the chart below was an already established declining trend. This most recent bout of weakness post the vote has brought Sterling all the way back to where it was in 2013, 2011 and 2010, but is still above where it traded in early 2009 at the depths of the Global Financial Crisis. The important point here is that Sterling was already suffering a bear market; a bear market that began long before the referendum and one that began despite polls showing near certainty of a remain victory. Through the first half of last year opinion polls consistently showed a remain vote in the high fifties percent and a leave vote of little more than 20%. On the back of this enthusiasm it is now clear that the Sterling bull market got well ahead of itself and it is quite likely that the Sterling bear market would have continued, perhaps not in as rapid a fashion, irrespective of the referendum result.

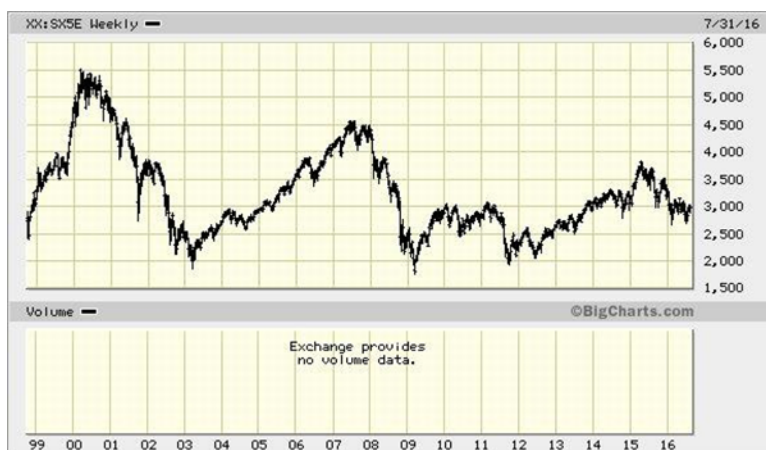


In attempting to identify cause or effect or establish a causation rather than just a correlation it is important to understand what it is that is reflected in markets and what it is that drives markets. In the introduction to my latest book 'The Expectations Game' I summarise what I believe the answer to this question is;

> At the heart of this book is the belief that all market movements, whether over many years or just a few days, are attributable to the changing expectations of all those involved in that particular market. At any moment in time the price level of a market must be a fairly accurate representation of the average, and aggregate, expectations of all those involved in the market. This has to be the case as, if it were not, and a large number of market participants considered the market either very cheap or expensive, then they would either jump in and buy at what they considered bargain prices or sell what they thought was extremely overpriced. As a result the market would move to reflect those aggregate expectations. Obviously this is a gross simplification but it is a useful illustration of the importance of aggregate expectations in setting a market price.
>
> The next step is understanding why a market moves and again it comes back to expectations. Given that at any time a market's price level is a reflection of aggregate expectations, if the expected happens then the price should not move. For the price to move something other than the expected needs to occur. There needs to be a surprise or a disappointment, something that results in a change in expectations.

Markets are a fairly immediate reflection of aggregate expectations, or social mood, economic data is an extremely lagging reflection of where expectations and mood have been, this is why markets are far better at forecasting the economy than the other way around. Yet still we like to look for causality from the economy to markets. The truth is actually they are both the product of and driven by mood and expectational changes but these are apparent in markets months before they show up in economic data.

I have long made the case that the peak in expectations and mood for many developed markets, the long term secular peak, occurred in 2000. That this was the case in Europe can easily be seen in a long term chart of the European stock market;



Mood and expectations on the part of European investors have been declining for more than sixteen years. Obviously there have been some cyclical bull markets along the way but the decline continues. In the past I have raised the possibility that this secular bear market will not finally end until the

'European Experiment' finally falls apart, that would be the kind of news backdrop that would mark an absolute nadir in expectations for the region and lay the foundations for a new secular bull market from extreme lows in valuation. In January of this year, after the World Economic Forum in Davos the Wall Street Journal highlighted this very possibility;

European Experiment Comes to a Reckoning

Stagnating growth and multiple crises show member countries' self-interest trumps the cohesion of the union

Obviously markets are not there yet and neither are expectations, there still exists the hope that the ECB's 'whatever it takes' approach will be enough and that recovery and cohesion can be just around the corner. Sadly this highlights that the slide down the 'slope of hope' continues and that further disappointments for the majority lie ahead.

This 'slope of hope' in Europe has been apparent for several years and I discussed the probability of Brexit and the possibility of European disintegration almost two years ago. In late November 2014, after spending a couple of weeks travelling through Europe, I wrote the following;

The tragedy of the European Union, The great degeneration

> While travelling over the last month I picked up and read the collection of George Soros' essays that have been put together in a book 'The Tragedy of the European Union, the great degeneration'. I would strongly recommend it to all readers. Having read most of what Soros has written over the years this was particularly easy to read, especially when compared to his 'Alchemy of Finance', and I certainly share many of his concerns. One in particular was brought home while in the UK and I witnessed the wave of support that was emerging for the UK Independence Party**. I fear that if Prime Minister Cameron's promised referendum on membership of the EU (dependent upon the conservatives winning in May and currently not planned until 2017) were held now the overwhelming result would be to leave.** (Emphasis added)

The Financial Times reviewed the book favourably and included the following extract and comment;

> "The window of opportunity to bring about radical change in the rules governing the euro has closed," he admits. In the absence of a grand step towards more integration, the relationship between creditor and debtor countries brought about by the crisis has crystallised. Failure to act decisively will push Europe into deflation and allow the "process of disintegration" to gather momentum. It is tempting to share this pessimism. After all, in May's elections to the European Parliament, anti-EU forces are set to make large inroads.

After the referendum Soros wrote that the decision by Britain to leave the EU made;

"the disintegration of the EU practically irreversible"

George Soros certainly does not hope this will occur, and this time around he was not betting on a Sterling collapse but you do not become a billionaire investor by backing your hopes. In fact the largest gains are invariably made by investing against extremes of hope or fear on the part of the majority while attempting to manage one's own emotional leanings and biases. As Warren Buffett famously said;

“Be Fearful When Others Are Greedy and Greedy When Others Are Fearful”

The peak of expectations towards European markets was seen in 2000 when the EuroStoxx 50 index recorded its all time. This peak was accompanied by the excitement of the supposed ‘New era’ ‘technological revolution’ that resulted in amazing highs in most markets of the world, but on top of this, in Europe there was the hope of a ‘new era’ spawned by the launch of the single currency and the belief in the benefits of the world’s largest trading block.

The euro was officially launched in January 1999 and the physical currency was adopted in 2002. This period perfectly book marked the crescendo of excitement surrounding Europe. It is unfortunately probable that the opposite emotional extreme will be seen when Europe’s secular bear market ends and that both the EU and the Euro will be seen as having been failed ‘experiments. If that is indeed going to be the eventual outcome then no one should be surprised with the Brexit vote and it should be looked at from this longer term perspective. It should be seen as a merely being a part, an outcome, of the secular unwinding of an enormous emotional peak sixteen years ago. It should not be seen as a cause of whatever may lie ahead. Importantly it should be seen as indicative of markets getting a little closer, at least in terms of time, to an historic buying opportunity. Ironically, it may even be the case that such a point is reached within the next two and bit years that it is going to take for Britain to actually leave the EU. The point of ‘irreversible disintegration’ may actually arrive before Britain actually leaves!

On a lighter note an update on Apple is warranted

Apple (and the value of an expectational approach)

Almost three months ago, in the last edition of Strategy Thoughts, I concluded an update on Apple’s stock price with;

> Given this reversal in expectations, at least on the part of the media, towards the prospects for Apple, now may be a sensible time for any trader that instituted the historically justifiable trade of buying the stock leaving the Dow and shorting the incoming stock to take at least some of their gains off the table.

A little over a year earlier I had described in some detail how when changes are finally made to the constituents of the Dow Jones Industrial Average it is usually a reflection of something that ‘everyone already knows’ and that unfortunately what everyone already knows, even if it is right, is of zero value to an investor. It is surprises and disappointments that drive markets, not the expected happening. With that in mind I had been tracking the performance of AT&T, the departing stock, and Apple, the incomer, since the switch was made on the 18th March 2015. At the time of the switch expectations for Apple were through the roof and AT&T had virtually no fans what so ever, this left the possibility for meaningful disappointment on the part of Apple and surprise for AT&T. Over the next year that is indeed what indeed. By early May Apple had fallen more than 30% from its all time high, and almost 30% since the day of the switch, and AT&T had rallied, ironically, 30%.

Perhaps not surprisingly the miserable performance on the part of Apple was accompanied by a remarkable deterioration in expectations for the stock and the company and it was that almost total reversal in attitudes towards Apple that I was highlighting back in May. It is interesting to note that since that low point for the Apple stock price it has recovered 20% while over the same period AT&T has gained only another 10%.

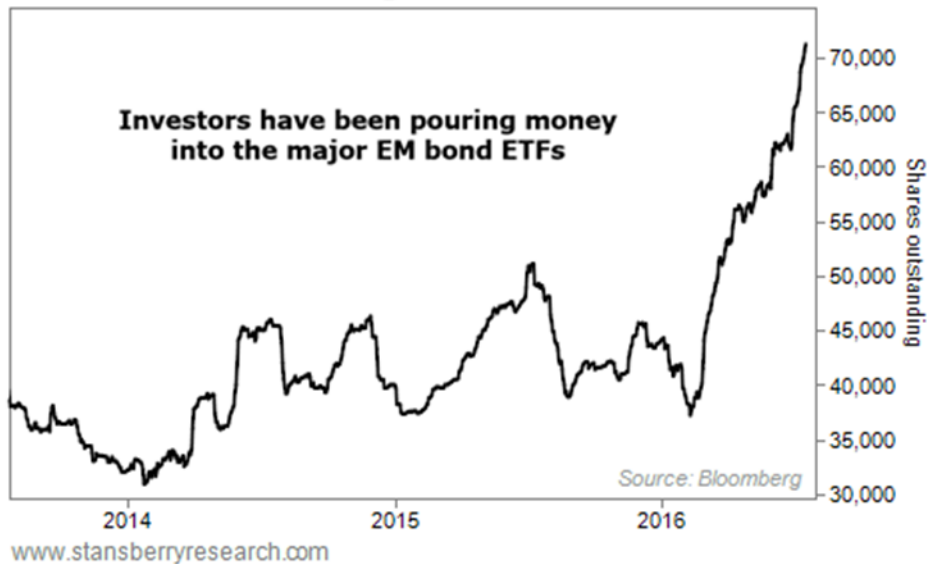
I will probably no longer monitor this pair as closely as I have for the last year and a half; however, this has been a wonderful real time illustration of the value of looking at investments, and the act of investing, from an expectational standpoint. That is, not relying upon the extrapolations of analysts, economists and the media but rather looking at these 'forecasts' and attempting to discern where they imply expectations may lie and whether or not an extreme is at hand. Clearly this is far from 'scientific' but ultimately it will allow an investor to break away from the herd and it is only by being different to that herd that something other than average performance can be achieved.

The danger of chasing yield!

"More money has been lost reaching for yield than at the point of a gun" Ray DeVoe Jr

I have discussed the danger of chasing, or reaching for, yield on numerous occasions over the last fifteen years and have frequently referred to the quote above, originally coined by analyst and news letter writer the late Ray DeVoe. The spirit of the quote is undoubtedly true and it is a lesson that all investors have had the opportunity to learn many times, most recently during the Global Financial Crisis when hard to understand CDO's and CDO's squared, that were supposed to just as good as AAA bonds only higher yielding, turned out to be nothing of the sort. Unfortunately the majority of investors' memories turn out to be not quite long enough, and they manage to forget whatever it was they swore they would never forget just as that lesson would be of most value and needed to be remembered. There has, perhaps understandably given the historically low interest rate environment that has prevailed for the last few years, undoubtedly been yield chasing behaviour over the last few months. Higher dividend paying stocks have outperformed broader indices and money has flooded into lower quality bonds as can be seen in the chart below of the high yield bond ETF, JNK, which has rallied more than 15% over the last six months.

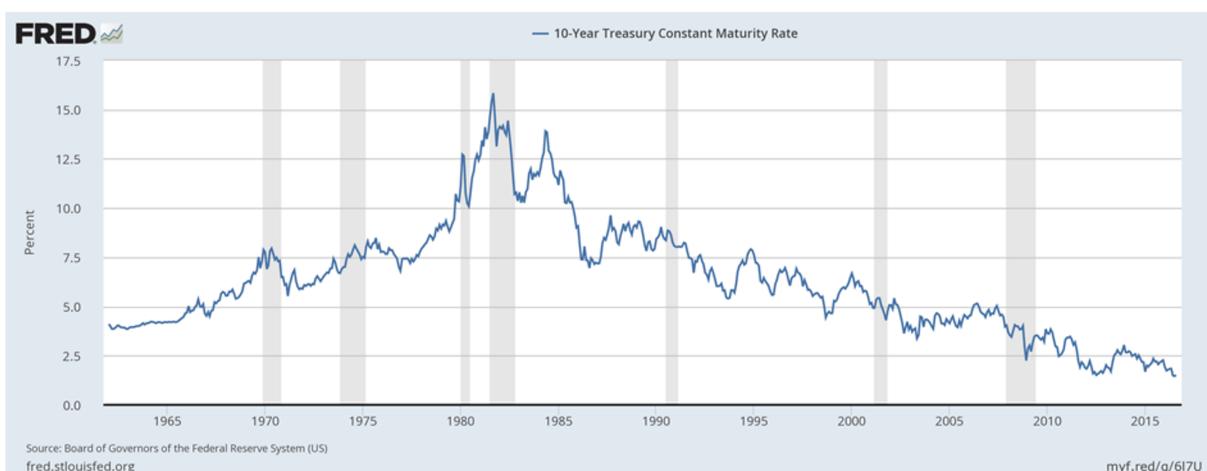
A similar move has been seen in the bonds of emerging markets, which is not surprising given the massive increase in demand for EM bond ETFs.



What this last six months shows is that the massive losses suffered in 2008 and the bear market in high yield bonds that only ended earlier this year have either been forgotten, or, in the desperate search for some meaningful yield, deliberately been overlooked. Neither of which should provide any comfort to investors currently, particularly as higher quality yields may finally be bottoming out.

The long term picture

Long term treasury bonds as represented by US Treasuries have been in an incredible bull market since the very early 1980s as can be seen in the chart below of the yield on ten year US Government Bonds. Riding that yield down from the high teens to the very low single digits has been an incredibly profitable secular bull market, but all secular bull markets do eventually end.



I first thought that this 'end' may have arrived in 2012 when yields fell well below 2% and it seemed that the majority of commentators had given up looking for higher rates fuelled by central bank money printing induced inflation.

In the August 2012 edition of Strategy Thoughts I wrote:

For a very long time I have proclaimed the virtues of long dated US treasury bonds, and anticipated that yields would go lower than virtually any economist was forecasting. I also didn't expect long dated yields to rise until the consensus view had given up on looking for higher rates and accepted low rates for a very long time. In June I wrote;

"Until the fear of deflation and ever lower yields becomes widely embraced and discussed it is likely that further surprises on the downside in yields, not a sudden reversal to the upside, are in prospect."

At the time ten year treasuries were yielding a little over 1.7%, over the next eight weeks yields plunged, briefly falling below 1.4%. As a result there has been an interesting shift in investor expectations and attitude. Two days ago Bloomberg ran the following story;

Treasury Bears Submit To Fed As Bond Optimism At High

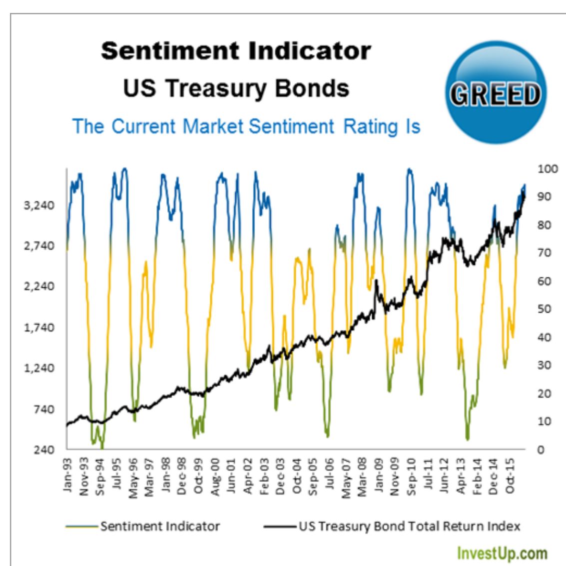
As a result of those record low yields, the flood of money that then like now was chasing yield in junk and emerging market funds, and the extreme optimism and confidence in lower for longer that had emerged I raised the probability that the secular bull market in bonds may have ended and that a new secular bear market, that would see gradually rising yields, had begun. Such an environment would be damaging for bond investors of all varieties but particularly so for those that had chased those higher 'junk' yields.

Two months later I wrote;

I continue to be concerned about the prospects for bond investors chasing yield and believe that the chances of the low, seen in late July in ten year treasury yields, being an important long term secular low as very high.

From late 2012 the Junk Bond ETF, JNK, did continue to rally a couple of more percent but then began a bear market that saw it fall 25% in value until the recent low earlier this year. Long term treasuries also fell with yields more than doubling to over 3% by the end of 2013.

Since then, however, as the feared inflation failed to appear treasury yields once again fell and by July the ten year US treasury yield had fallen to a fractional new low of 1.37%, marginally lower than what I had thought would be the all time low of 1.44% four years earlier. These new low yields and the understandable increased interest in higher yielding bonds has resulted in a remarkably similar expectational backdrop to that seen in the second half of 2012 as can be seen in the sentiment chart from Investup (left).



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, jusr as the trend is reversing. This behaviour can clearly be seen in the chart below produced by James Montier eight years ago. It shows actual earnings for the S&P500 compared to analyst forecasts. If the red line were the forecasts then it would show analysts provided some real foresight as to where earnings were going, unfortunately it is the other way around. What it shows is that actual earnings are a brilliant predictor of where analysts will forecast earnings will be, interesting but of no investment value. It is clear that analysts only reverse there forecasts once a reversal has already become well established.

A similar behaviour was apparent in bond yields back in 2012. As I commented back then I only became concerned as to the possibility of a low in yields having been seen once the majority of forecasters gave up forecasting a reversal in yields and created the overwhelming chorus of lower for longer. As with the analyst estimates above, this was just at the wrong time.

It is possible a similar surprise may be setting up in the yield on ten year US Treasuries.

The chart above from Bloomberg shows the average forecast for where ten year yields will be at the end of the year and the actual level of ten year yields. Sadly it only goes back to the beginning of this year but a similar behaviour to that of the analyst forecasts can be seen. The steepest cuts in forecasts are only made after the actual yield has already fallen but importantly those cuts never show confidence in the decline continuing. That is until now. Finally, with yields having hit those new lows in July described earlier and confidence in the outlook for treasuries having risen sharply, the median forecast has seen its largest cut year to date. Unfortunately those cuts have been made just as actual yields have risen and the two lines have crossed for the first time. Another potential whipsawing of forecasters may well be in the making.

Finally, the recent action in the Japanese bond market should provide another potential warning sign to fixed income investors.

The long term picture of Japanese bond yields shows the massive decline that has been seen, particularly over the last twenty five years, as the authorities have attempted time and again to reverse the deflationary trends that have bedevilled Japan. It is also just possible to see that earlier this year those long term Japanese yields slipped into negative territory.

This is easier to see on a shorter term chart.

The plunge below zero was quite dramatic in the first quarter of this year, but of perhaps greater importance has been the recent spike upwards from record low levels to close to zero. It may just be another sign on the part of the market that yields are going to rise irrespective of whatever further stimulus measures may be thrown at it.

Rampant yield chasing behaviour, extreme confidence at highs in price and lows in yield along with yields beginning to rise should all be warning signs that the current trends are unlikely to continue. It has always been dangerous to chase or reach for yield, now, despite near record low yields this is particularly true. All investors should remember that just because they may require a particular level of return they should not expect that level of return to be available and that even if it is it may very well not be sustainable.

Conclusions

I had intended to address a number of other issues in this month's Strategy Thoughts including the US dollar and importantly an outstanding book that I read in my travels, "Other People's Money, Masters of the Universe or Servants of the People" by John Kay. It was a terrific read and touched upon a number of issues that I have raised in "Investing, The Expectations Game" but space and time means that this will have to wait until next month.

My longer term views on the relative positioning of markets and the absolute priority of preserving capital have not changed as a result of what has been seen over the last few months. My fear is that the possibility of disappointment, rather than surprise continues to be the greatest risk for investors and that the secular bear markets that began in 2000 are still very much in place. This is especially true in Europe where I fear that the Brexit vote was merely another symptom of a long term decline in social mood, one that will ultimately see markets substantially lower and the 'European Experiment' seen as a failure.

Finally, from a very long term perspective I think that the possibility that the recent lows in US treasury yields may well be seen as having been THE low. I know I attempted this once before in 2012 and given that those lows were fractionally bettered in July that forecast was wrong, however, in years to come if this time I am correct then the difference between the low having been 1.44% in 2012 or 1.37% in 2016 will be of little concern.

Kevin Armstrong

11th August 2016

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