Strategy Thoughts

April 2016

The Slope of Hope

And why you should worry!

Introduction

World equity markets rallied throughout most of the month of March, continuing the rally that had begun in mid February, and investors breathed a collective sigh of relief. After one of the worst starts to a year ever, something that no one it seems was anticipating, the mood of investors has been rapidly transformed from fear to hope. There is a growing feeling that 'the worst is over' and that now things can get back to more of what the majority think of as normal, rewarding bull markets.

Unfortunately the alacrity with which investor mood has swung through 180 degrees should be seen as a cautionary rather than an encouraging sign. In this month's Strategy Thoughts this eagerness to become positive is looked at from the perspective of Chinese and the broader emerging markets, and also the US market where the situation now is an eerie echo of the hope seen in May 2008. Needless to say, the conclusion this month continues to be one of caution. Investors' focus should continue to be on capital preservation rather than chasing the increasingly popular, and understandably comfortable, hope.

Hope

On 23rd March Bloomberg ran the following story;

Chinese Small-Cap Stocks Enter Bull Market as Margin Debt Jumps

One Chinese fund manager was quoted;

> "The environment for stocks seems to be getting better, with domestic economic data stabilizing and U.S. refraining from raising interest rates, while the rise in margin trading is also fueling buying, There is still room for the rally to continue, particularly the ChiNext and small-cap stocks, and their valuations may rise to a pretty high levels in this speculative environment,""

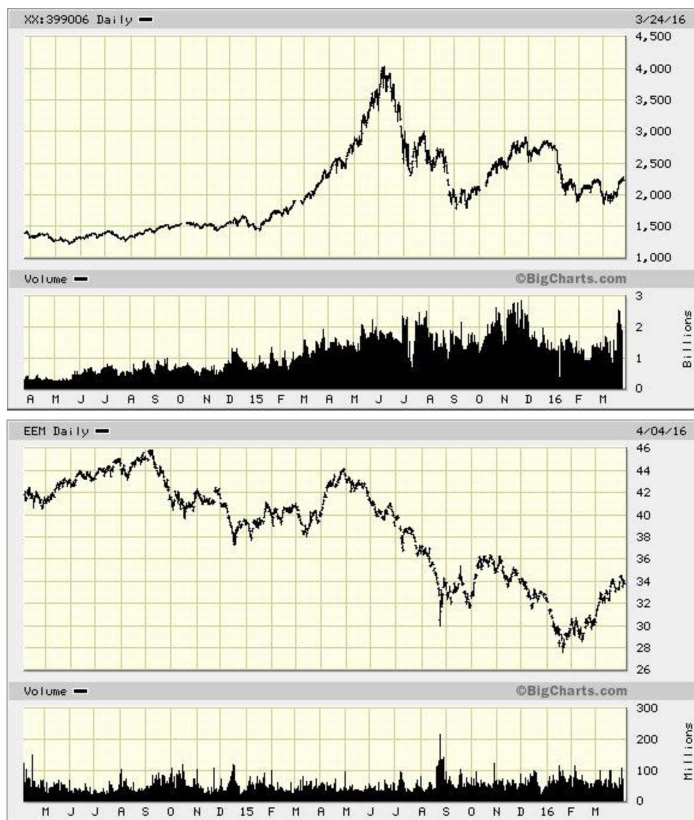
Ten days later the bullish excitement was being fanned by Bloomberg in other emerging markets as on the 4th April they ran the story;

Emerging- Markets Stocks' Historic Rally Breaches Barriers

The article went on to describe how March had been the best month for the Emerging Markets index in six years.

It really is important to provide a little context to these descriptions of 'Bull Markets' and 'Historic Rallies'.

Spot the bull markets!



The two charts left are the ChiNext index when the earlier Bloomberg article appeared and the emerging markets ETF the day the latter article was published. Clearly there has been some strength in both these markets, as there has been in most markets of the world since the early year sell off, however, a more proportionate commentary would probably be more prudent. That being said, the enthusiasm and speed with which reporters, and I presume editors, are keen to jump on the bullish bandwagon does provide a useful insight as to the currently heightened level of expectations and the very strong sense of 'Hope' that the worst is over and that things can return to what the majority would like to think of as 'normal' after the hiatus at the beginning of the year.

That level of 'Hope' towards the emerging markets was also apparent in another Bloomberg article on the same day;

Emerging- Market ETF Inflows Surge to $9 billion in Record Month

Last year prompted by stories like the following;

> **Look at how today's wild Chinese stock market boom compares to the insane explosion of 10 years ago** BUSINESS INSIDER JUN 11 2015
>
> Aside from the inflation fuelled Venezuela Stock Market Index, China's Shanghai Composite is the top performing stock market in the world so far in 2015. The Shanghai Composite is up 58% year-to-date, and 151% year-over-year. However, if the bull market that occurred from July 2005 until October 2007 is any indication**, the rally is just getting started** (emphasis added)

I urged extreme caution given the then unprecedented excitement and optimism towards China, particularly as displayed in the performance of the ChiNext index which had risen almost exactly six fold from its previous low.

It would be fair to call that rise a bull market, however, it is also important to recognise that the obvious excitement then was coming after a sextupling in price. What has been seen over the last few weeks is really stretching the definition of a bull market almost certainly far more reflective of hope than reality.

New bull markets do not get readily identified and named until long after they have begun and the record inflows usually take a very long time to materialise as fear and doubt dominate the minds and memories of most investors in the early stages of bull markets. Their beginnings are always dismissed as just another dead cat bounce and a sucker rally, particularly in their first few months. For those investors that have apparently been flooding emerging market ETF's with new money headlines like those above may instil some degree of comfort, unfortunately, history is not on their side and the risk of disappointment is high.

Trust your gut

In mid March the Wall Street Journal ran a terrific article on investor sentiment and the value of being a contrarian

> http://blogs.wsj.com/moneybeat/2016/03/18/the-three-worst-words-of-stock-market-advice-trust-your-gut/

The article was titled;

The Three Worst Words of Stock-Market Advice: Trust Your Gut

Contrarian investors remember that when stocks fall, they become safer--even if they feel riskier

It concluded with the following advice;

> To be a true contrarian investor, remember that you have to act contrary to what others are doing — but also to what you feel like doing yourself.

This is a great question for all investors to be asking right now. With markets having recovered markedly from their early year selloff is now the time to feel that 'the worst is over' or should what has been seen be looked at as just another dead cat bounce. Certainly in Europe and many of the emerging markets it is easier to look at the bounce this way, given that these markets have been making lower lows and lower highs for some time. In the US this is harder to say.

In many ways the picture in the US looks more like mid 2000 or mid 2008.

2008 all over again?

In May 2008 edition of Strategy Thoughts I wrote;

> Last month's Strategy Thoughts was titled, "Do Dead Cats Bounce?" and since it was written there seems to have been a growing ground swell of opinion that, yes they do bounce, and more recently that perhaps the cat isn't dead after all. Most share markets, with the notable exception of China, have now rallied something between ten and fifteen percent from their low points in March. These strong bounces have precipitated, and in turn been fed by, a growing bullish sentiment and increasingly constructive commentary. The majority of this commentary falls into one of three categories; firstly, economists are now urging that investors should now be looking 'across the valley' to the upcoming recovery, this is certainly a positive outlook, however it should be remembered that these economists are telling us to look across a valley that they never told us was there until it was clear we'd fallen in. Secondly, senior executives are now forecasting that the worst of the write-offs associated with the bursting of the credit bubble have also been seen. Like economists it should be

> remembered that these are many of the same executives under whose watch the now clearly irresponsible practices took place and who failed to see the magnitude of the problem once it was clear there was one.
>
> Both the economists and the executives may be right, however, neither of their recent track records should inspire confidence and yet at least over the short term it appears to have done just that.

In many ways this is very reminiscent of the hope that is currently being seen after the bounce from the early year sell off.

Morningstar wrote in late March;

> ## Stock Market Outlook: Stocks Start to Look More Attractive
>
> We view the overall market as slightly undervalued, based on our fair value estimates for approximately 1,500 global companies.

The comparison to May 2008 also extends to the performance of financial stocks which provided something of a ‘canary in the coal mine’ in 2008. This is particularly true of the performance of US broker dealers when compared to the performance of the overall market. The chart below shows the performance of US broker dealers (in blue) compared to the performance of the broader S&P500 (in green) over the last year. What is clear is that the broker dealers price performance has been more like that of many of the other major markets of the world, that is lower lows and lower highs, rather than the broader US market that has meandered in a broad trading range. This is just as it was eight years ago.

The US broker dealers peaked in June of 2007 and then fell in a zig zag fashion, eerily reminiscent of the chart above, to a low in late March 2008 down 37%. Over that same period the S&P500 fell just 14%. More recently the broker dealer index has fallen 29% from a high last July to a low in February this year while the S&P500 fell just 13%. From that low point in 2008 the broker dealers rallied 19% to the end of April 2008, markedly outperforming the broader market that only rallied 7%. That rally brought the broader market back to levels it was at just three months prior to the peak and only 8% below the level when the broker dealers peaked. The broker dealers remained 25% below their peak levels. Similarly this year, during the recent rally the broker dealers have outperformed the broader

market rallying 16% compared to the S&P's 13%, but still the broker dealers are down 20% from their peaks whereas the S&P has rallied back to be down only 5%

It is now hard to remember what it was like to be an investor in May of 2008. At that time most asset markets had started to correct, but that was all. No one had ever heard of the GFC and no one knew that the US had actually entered a recession. The official start of the recession was eventually placed by the NBER in December of 2007, but this was not determined and announced until December of 2008. Hope was still in plentiful supply and no strategist at any major investment bank was forecasting anything like what actually happened.

In mid May of 2008 the UK's Daily Telegraph captured the hopeful mood at the time;

> **As glimpses of recovery appear, with necessary caveats Myra Butterworth says it's time to be looking for good value investments and gets the experts' best advice**
>
> Investors may soon see the green shoots of recovery if the Bank of England's declaration that the worst of the credit crisis is over comes to pass.
>
> In its Financial Stability Report, Sir John Gieve, the Bank's deputy governor, says "the most likely path ahead is that confidence and risk appetite will return".
>
> Several investment professionals are positioning themselves to make the most of any recovery – if and when it comes. They claim that the prices of some investments have fallen so dramatically that they may now represent a bargain for long-term investors.

And at the end of May the Wall Street Journal joined the 'worst is over' chorus;

> **One Bold Analyst's Latest View: Worst Is Over for Economy, Stocks**
>
> During five decades on Wall Street, Barton Biggs has probably made as many predictions as Nostradamus, some of them almost as dire. Many times, he has been right.
>
> In late 1999, as global chief investment strategist at Morgan Stanley, Mr. Biggs predicted the tech-stock bubble would burst, which it did three months later.
>
> In May 2004, he said crude-oil prices, then $49 a barrel, would collapse. They didn't, and since have surged. Those who bet big with Mr. Biggs lost big.
>
> Now, Mr. Biggs, 75 years old, believes the worst is over for the economy and for the stock market. While the market is likely to move sideways for the rest of 2008, he says there will be no recession -- and with the remaining poisons purged from the system, stocks should move upward next year.

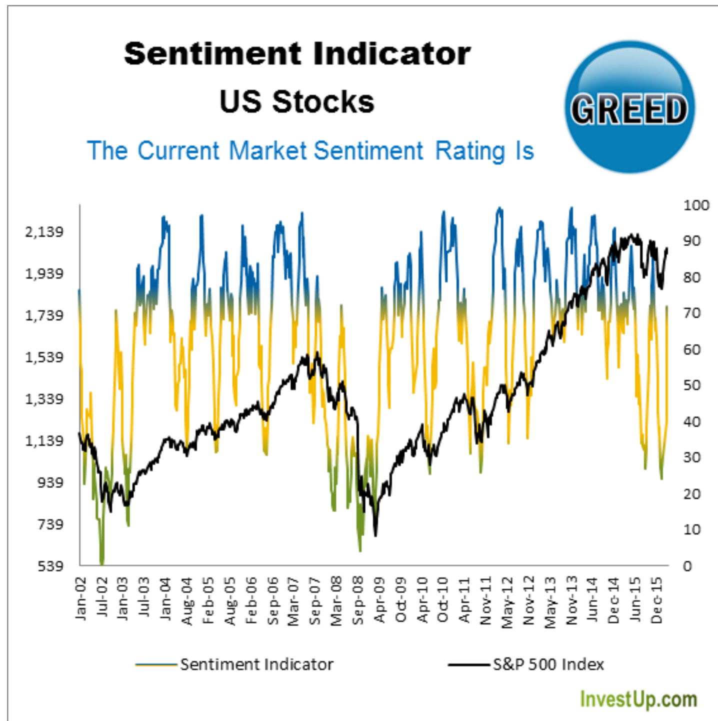
I did not join that particular party. In late May of 2008 I wrote the June edition of Strategy Thoughts and titled it 'Has the eye passed over' a reference to the previous month's Strategy Conclusions that had been titled 'The eye of the storm?' in which I commented that it was highly unlikely, despite the rally that had been seen and the hope that had been expressed, that the worst was actually over. I concluded the June edition with;

> Now is not the time to throw caution to the wind. Markets have rebounded and volatility has subsided but it is possible that all that has been seen is a relief rally, or a

bear market rally. We are hearing every day that the worst is over but markets are not behaving like they tend to at the start of new bull markets, and we must remember that new bull markets are rarely recognized as such in their early stages, they are dismissed as just another bear market rally.

As it turned out the 'eye of the storm' analogy proved to be highly appropriate.

It is a great concern that now, almost eight years later, we are once again hearing that the 'worst is over' on the back of the rally that has been enjoyed over just the last couple of months.



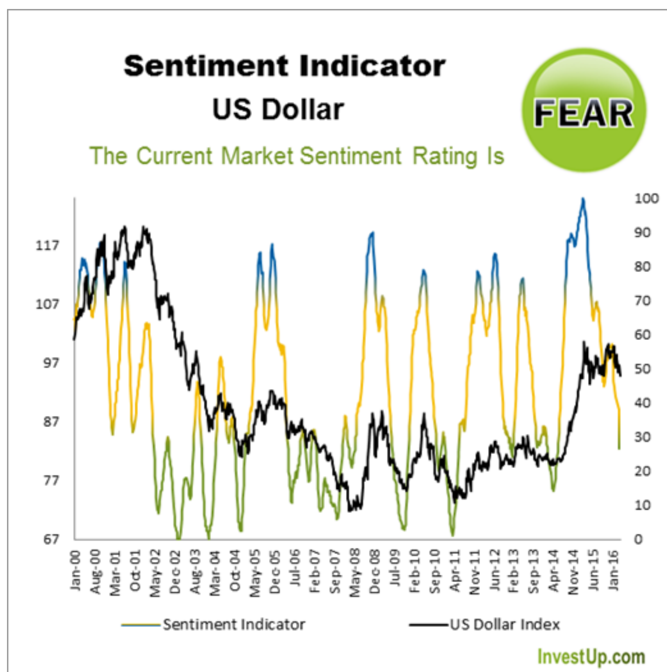
It is interesting to note that Investup.com's measure of sentiment to the US market has, over the last couple of months, jumped back from the green tinged fear to once again entering the blue tinged greed zone, much as it did in May of 2008. It is also noteworthy that the successive lows and highs in sentiment over the last year have been sequentially lower, again, just as they were in late 2007 / 2008.

Obviously history never repeats exactly but unfortunately investors seem to find it very easy to continually repeat the same mistakes, especially at market extremes. The majority seek the comfort of the crowd, take encouragement from supportive media commentary and they 'hope'. Currently, as in May 2008, there is a lot of hope, hope that the worst is over and hope that things will get back to 'normal'. History has repeatedly shown that excessive hope leads to disappointments; it is excessive fear that results in surprises.

The US dollar

Long time readers will know that I have favoured the US dollar as a store of value in the pursuit of capital preservation for some time. I did sell half my position in the long US dollar ETF more than a year ago after the dramatic run up the dollar enjoyed in 2014; however, I continued to feel that further upside was still possible. After that dramatic run up I included Investup.com's sentiment indicator for the US dollar which had just reached the highest possible level of 100. At the time in late January 2015 I wrote;

> I am far from convinced that the dollar bull market is over and I don't think that what we have seen recently is the extreme extrapolation and overestimation that is seen at long term turning points, however, the move over the last few months has been extreme as has the shorter term shift in sentiment that has accompanied it. On the back of this, and in the interests of full disclosure, I have now sold half of my long US Dollar position and brought the dollars back into Kiwi dollars. I fully expect that on a meaningful US dollar correction I will reestablish my full position and hold it until something similar, only in reverse, to that which was seen in late 2007 occurs.



I did not ever get the opportunity reinstate the position largely due to the fact, as can be seen in the updated Investup.com chart (left), the dollar has been meandering in a relatively narrow trading range since it reached that extreme sentiment peak fifteen months ago.

What is interesting now from a sentiment standpoint is that this sideways consolidation has been sufficient to work off all that record breaking enthusiasm for the dollar and sentiment measures are now, for the first time in two years once again entering the fear range. None of this means that the dollar is set to suddenly rally higher, however, with expectations diming for the US currency it seems that the most likely surprise would be a dollar rally over the coming months. This is particularly the case given that now it seems everyone knows why the US dollar has been so weak and why this should continue, as reported by Reuters on 30th March;

> **Why the US Dollar Is Suddenly Worth Less This Week**
>
> **It's on track to post its biggest quarterly percentage decline in 5 years.**
>
> The U.S. dollar hit its lowest level against the euro in nearly seven weeks on Wednesday following dovish comments from Federal Reserve Chair Janet Yellen that pushed out expectations for the central bank's next interest rate hike.

It is expectations that drive markets and the diminishing expectations for the US dollar described in this article highlight that the possibility of a surprise, rather than the disappointment that currently seems more likely for equity investors. The Investup.com chart shows that hope is now as absent toward the US dollar as it has been since mid 2014, however, it can clearly become even more absent. A rally of significance may not be just around the corner but if the dollar continues in the trading range it has been in for the last year, expectations will likely continue to diminish as they have throughout the trading range to date and this in turn will lay the foundations for another leg up in the dollar.

Just how kind have markets actually been?

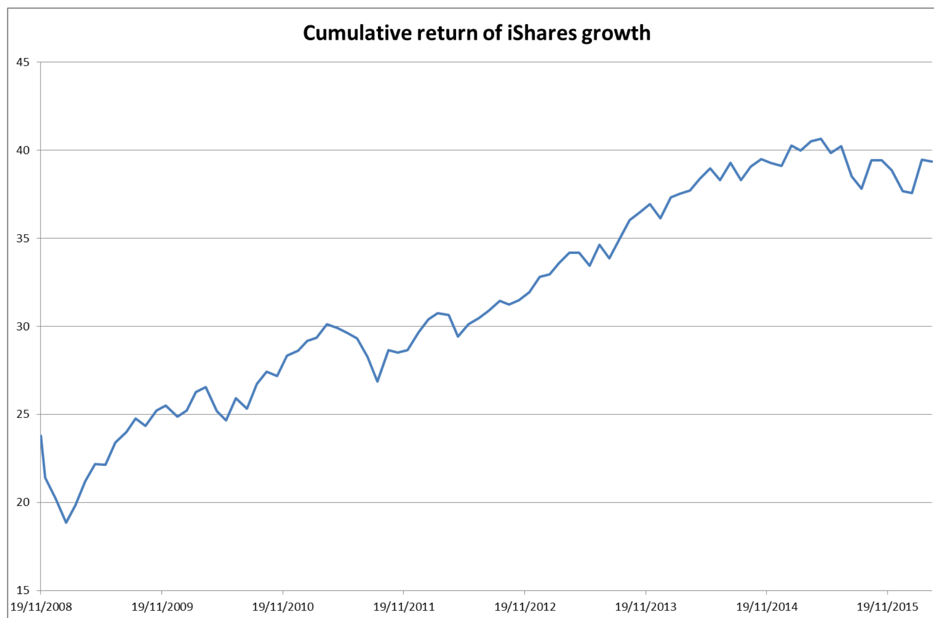
Listening to the mainstream financial media it would be easy to think that the last few years have been particularly rewarding to investors. It is clear that the GFC and its aftermath have now been largely forgotten but for many investors the bull market from the 2009 lows was actually very short lived and even in those regions where the bull market lasted several years the more recent past has actually been very disappointing.

As of early April markets have made no progress for the following lengths of time;

- Dow Jones Industrial Average: sixteen months.
- Germany: twenty two months.

- UK: thirty three months.
- Hong Kong: almost seven years!
- Japan: twenty seven months
- Australia: thirty seven months.
- China: seventeen months (and five years)

In some ways it is a little surprising that hope remains so strong given the frustration that can understandably grow out of markets that make no net progress for lengthy periods. To gain a better perspective of how real investors may have fared through this period it makes sense to look at what a typical portfolio may have delivered.



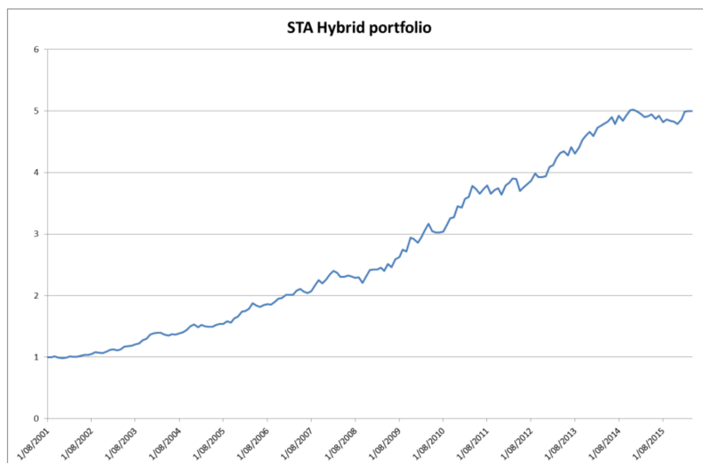
The chart above shows the cumulative return of a US investor who opted for the low cost alternative of the iShares core growth allocation ETF when it was first offered in November 2008. This ETF has an asset allocation of about 39% in fixed income and 61% in equities. Obviously the investment suffered through the last few months of the GFC but then it rose handsomely through the bull market. However, since August of 2014, the last twenty months, the investor has made no return whatsoever, and the US has been one of the best performing markets. Some degree of frustration would be understandable and this was probably extreme at the recent lows and no doubt paved the way for the relief (and hope) that is now being felt.

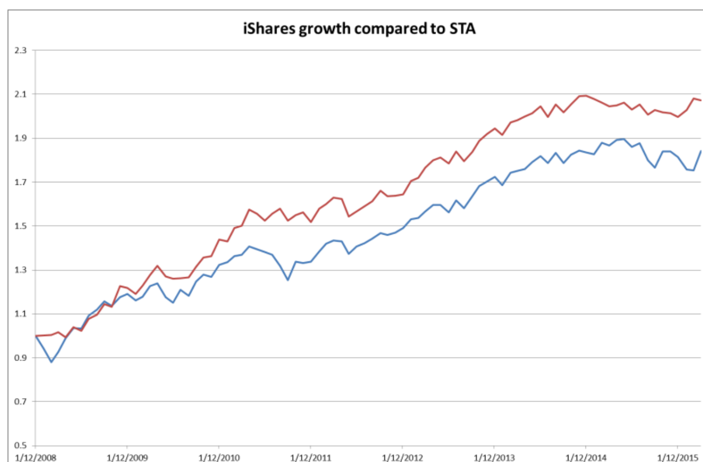
In the UK Vanguard offer a similar fund with 60% exposure to equities for UK investors and its sterling price is flat over the last thirteen months, however, in order to compare this with the US investors experience currency movements need to be taken into account, when this is done the UK passive investor in the Vanguard fund is actually down about 5% in US dollar term since June 2014.

The New Zealand equity market has been a stand out performer rising spectacularly over the last few years, this has driven healthy returns of 6.5 -7% over the last twelve months to balanced investors in Kiwisaver funds that have a similar asset allocation to those described for the US and UK. However, as with the UK example, a fair comparison as to how well any investor has done needs to take currency movements into account and over the last two years the New Zealand dollar has depreciated about 20% against the US dollar. The effect of this is to wipe out all the gains a Kiwisaver has made over the last twenty four months.

Superficially returns for the last couple of years look reasonable in a number of markets, however, most investors have actually received little or nothing in the way of returns despite sitting in a market hoping for good things to happen while exposing themselves to potentially frightening bouts of volatility such as was experienced in the early weeks of this year. A capital preservation focussed investor may have only made very slight gains over the last couple of years but they have outperformed many investors, all while avoiding risk and volatility

The STA portfolio





A number of readers have been asking about the STA portfolio as I have not given an update for some time, this has largely been due to the focus I have had on my new book for the last four months. To the left is an update of the performance of the STA portfolio since the iShares employed in this latest model became available. Understandably it has struggled over the last year, but this will happen when no asset classes are making any real headway. The important thing is that drawdown suffered has been less than that experienced by pure equity investors or those invested in the iShares growth portfolio which has a broadly similar average asset allocation.

It is important to remember that the STA rebalances each month to whatever the model determines is the correct asset allocation and this could result in the portfolio at any time being fully invested in fixed income, which could be all in intermediate treasuries or all in high yield bonds, or it could have zero in fixed income and be entirely invested in equities and gold. The current asset allocation of the STA portfolio is; 33% in gold, 55% in equities and 12% in fixed income all of which is in Treasuries. As recently as September last year the portfolio was invested entirely in Treasuries.

The rationale and methodology of the STA portfolio is discussed at some length in my new book **'INVESTING IN TURBULENT TIMES, How to win the 'The Expectations Game' and Why Most Investors Fail'**

The Expectations Game

I am delighted to be able to inform readers that the draft manuscript of **INVESTING IN TURBULENT TIMES, How to win the 'The Expectations Game' and Why Most Investors Fail** is now complete and with the publishers, hopefully we will be able to keep to the schedule I outlined last month and have the book available early in the second half of the year. I would like to thank those

readers that responded to my request last month for comments and feedback on Strategy Thoughts, I am hopeful that some of these will be used in the final publication. I also want to thank those readers that I asked to proof read the manuscript, your feedback has been most valuable and some of it has certainly resulted in changes to how some points will be made in the book. The result is, as I commented last month, a book on investing that is quite different, but then that is what all investors need as the only path to real success in investing is by ‘daring to be different’. Doing the same as everyone else may be comfortable but it will not be successful.

I will keep readers posted as to the price and availability of the book as its release date gets closer.

Conclusion

Last month I concluded with;

> 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.

Since then, as commented earlier, markets have continued their post February rally and levels of optimism and hope have continued to grow. Unfortunately this is not the foundation upon which long term investment returns are built. It may build short term comfort but that is all, sadly it will ultimately result in disappointment.

I continue to prize capital preservation, I am not chasing yield and I do believe that the US dollar will eventually break out of the long trading range it has been in to the upside. Eight years ago this happened once the May 2008 proved to be nothing more than another dead cat bounce and rolled over, from there the dollar index rallied more than 20%.

Kevin Armstrong

5th April 2016

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