Strategy Thoughts

August 2015

Europe, China and Gold

Introduction

For much of the last two months I have been travelling through Europe, the UK and Japan. Although this trip's primary focus was golf it was certainly fascinating to watch the unravelling of the Chinese bubble and the repeated bouts of brinksmanship in Greece. It has also been interesting to witness the almost total give up now being displayed by the business media towards gold as the price has fallen almost 15% since mid May and now languishes at its lowest price in more than five years.

My overarching caution towards most investment assets has not altered since late May, in fact in many assets the action of the last two months has only served to reinforce that caution, however, gold may now present the best investment opportunity that has been seen for quite some time. In this month's Strategy Thoughts I will review what has been happening in Greece, and compare it to previous Greek Exit scares, question what the bursting of the Chinese bubble might mean and also explore the investment case for gold.

Thoughts from Europe

In early August 2011 my wife and I arrived in London at the start of an extended walking holiday around the south west coast of Britain. Markets globally had just begun to falter and the general mood was beginning to sour but nothing could prepare us for the scenes of rioting that we saw on the news the day we arrived. For the UK this was at about the mid way point through a 15% correction, however, for much of the rest of Europe the decline would prove to be far more severe with the broader European indices falling by about 35% through the summer of 2011 as questions about the survivability of Greece in the Euro and the European union grew.

Having again been travelling through Europe whilst the latest Greek Exit fears have been growing it is intriguing to compare the difference in attitudes and mood between the two supposed panics, and a useful lens through which to do this is the old adage that bear markets slide down a 'slope of hope'. The central idea behind this saying is that so long as market participants cling on to hope through a market decline, whether it is that the fall seen so far is just another healthy correction and that dips should be bought, or that central bankers will somehow prevent any further decline, or anything else, then the slide will continue. It is only when all hope has been expunged and nothing but further decline and misery can be seen anywhere on the horizon that the decline can stop and a new bull market begin. With this in mind it is clear that by late September 2011 'hope' was virtually non-existent. Unfortunately the same thing cannot be said of the most recent Greek driven hiatus.

At the depths of the last Greece crisis, in September 2011 bookmakers were taking bets on which country was most likely to leave the Euro. At the time the second 'favourites' were Ireland and Portugal at odds of 5-1 with Italy and Spain closely following at 6-1 and 8-1. However, the odds on and very clear favourite at the time was Greece. The betting odds were just 8-13 indicating that there was a huge amount of money expecting a Greek exit from the Euro. With the benefit of hindsight it is clear that this was a terrible bet, and the odds offered were lousy, but more importantly it reflected the overwhelming attitude at the time; it was generally seen as a near certainty that Greece would leave the Euro.

Sentiment was generally bleak in Europe at that time with 'hope' very hard to find. Headlines such as the following predominated;

UBS Declares "The Euro Should Not Exist" In A Monster Report On The Odds Of An EU Breakup Business Insider 6th September 2011

Greece Should 'Default Big' to Address Crisis, Blejer Says Bloomberg 14th September 2011

At the same time, on the back of this very depressed sentiment, markets were cracking as the following Bloomberg article describes;

Stocks, Euro Tumble as Credit Risk Surges on Greece Debt Concern
September 9th 2011

Stocks sank, while the euro touched a ten-year low versus the yen and a six-month low against the dollar, as concern grew about Greece's debt crisis. European bank and sovereign credit risk reached all-time highs as 10-year Treasury yields slid to a record. Oil fell 2 percent.

The MSCI All-Country World Index retreated 2.9 percent and the Standard & Poor's 500 Index slipped 2.7 percent to 1,154.23 at the 4 p.m. close in New York, wiping out a weekly gain. The euro sank as much as 2.1 percent to 105.3 yen and fell 1.8 percent to $1.3627 before trimming losses. Ten-year Treasury yields slid as low as 1.89 percent. Credit-default swaps signaled a more than 90 percent probability Greece will default.

Stocks extended losses as three German officials said Chancellor Angela Merkel's government is preparing plans to shore up banks in the event that Greece defaults. The European Central Bank said Juergen Stark resigned from the executive board, suggesting policy makers are divided over how to fight the debt crisis. U.S. President Barack Obama called on Congress last night to pass a $447 billion plan to boost employment after jobs growth stalled last month.

"There's that nagging thought that we can continue to have a downward spiral in Europe," James Dunigan, chief investment officer in Philadelphia for PNC Wealth Management, said in a telephone interview. The firm oversees $109 billion. "There's concern of a default, of risk in banks, of a liquidity crisis. In the U.S., even as President Obama made an effort to put that plan together, there's not a whole lot of confidence that Congress will pass."

As the fear reached a crescendo in late September 2011the bottom was hit and European markets rallied strongly, rising 30% over the next six months and almost doubling over the next three and a half years.

This time around the sell off on the supposed fear of a Grexit has been substantially more benign and the attitude, which the FT described as 'cool maturity' certainly appears to be more one of hope than fear!

Euro currency calm counters Greece fears FT June 29

Queues at cash machines, emergency bank holidays, introduction of capital controls and a hastily convened referendum — a cocktail of events that would normally be guaranteed to induce market heatstroke. And yet the way the euro reacted to these seemingly seismic events in Greece on Monday suggested the market was displaying a rare outbreak of cool maturity

Further evidence of the difference in attitude this time around can once again be found in the betting markets. The same publication that almost four years ago, amid rampant fear, declared in a headline that 'the Euro should not exist' now reports that Greece is not even the clear favourite in the 'leaving the Euro or European Union stakes' declaring that it is now seen as more likely that Britain will leave the European Union than Greece;

> **The betting odds suggest Britain is more likely to leave the European Union than Greece** Business Insider 6th July 2015

My major concern is that the Greek situation is far from resolved and that a far bleaker backdrop, even than that experienced four years ago, needs to be endured before it is. The current 'hope' is understandable, but sadly it will likely prove to be badly misplaced.

China, the power of six and 'the plunge protection team!'

I know this will make me sound like a Monday morning quarterback but I very nearly did publish a brief update to Strategy Thoughts ahead of my recent overseas trip. We left the country in mid June and as we were getting ready to go stories such as the following were appearing all over the media;

> **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)

There was understandably even greater excitement about Chinese technology stocks as represented in the ChiNext index. This index had more than doubled in the first five months of the year, was understandably attracting more and more attention, and seemed to rising in an ever steepening parabolic manner. This alarmed me greatly, particularly when I looked back at where this remarkable bull market had begun. Back in late 2012 the ChiNext was languishing at 607, down more than 50% from where it had been two years earlier, but by early June the index had surpassed 3700, slightly more than a six fold increase.

Long time readers may remember a special report I wrote back in October 2007 titled 'The power of SIX! Or, How big can Bubbles Get?' In it I reviewd a long history of manic investment bubbles and the levels at which they peaked. These included; the New Zealand share market peaking in 1987, the Japanese share market peaking in 1989, Gold peaking in 1980, the NASDAQ peaking in 2000, US shares through the 1920's, the Taiwanese market peaking in 1990 and the infamous "South Sea Bubble".

I pointed out that;

> 'All these markets shared the similar characteristic, seen in all manias or bubbles, of accelerating prices driven by an ever increasing number of market participants who all think they're long term investors. Generally they have become aware of the apparently riskless profits that can be made in whatever market that may be accelerating. Naturally the peak occurs when the ever growing throng of investor's insatiable appetite is finally sated.'

I then went on to illustrate that whilst history, even in clear bubbles, doesn't exactly repeat itself, the 'echo' can be very strong. One of those 'echoes that most bubbles appeared to share was that from the point they began to rise in a parbolic manner they usually managed to attain a six fold increase in price. This was certainly not the foundation upon which I would want to build an investment forecast, however, it did highlight that if any market did rise in a parabolic manner by a factor of six it would probably pay to be more than a little circumspect.

With this in mind I then went on to highlight that the Chinese market had, by early October 2007, risen by a factor of six from its prior low. With hindsight we can now see that some caution was indeed warranted.

Three and a half years later, in May of 2011, I provided a similar perspective on the then accelerating price of silver;

> At its intraday low, in late 2008, having more than halved over the preceding nine months, silver traded at $8.46. A six fold multiple of this low point would target silver getting to $50.76, last week at its intraday high silver traded just fractionally below $50
>
> None of this, the six times appreciation or the explosion in retail volume, means that silver is about to collapse. Neither does the fact that justifications for silvers continued rise include conspiracy theories, about major banks being aggressively short and so vulnerable to a 'short squeeze', and arguments about there actually being a shortage of silver. However, when all of these ingredients appear together it is hard to believe that the mood and expectations of silver market participants are not being stretched, and stretched a lot.

Since silver achieved that six fold increase in value its bubble has substantially deflated as it has fallen by more than 70% in value.

With that backdrop it is hopefully understandable why I was alarmed when I saw the ChiNext surging through its six fold increase. Since then, while I have been travelling, like so many other six fold accelerations, the ChiNext has reversed, so far falling by more than 30%, clearly ending the market's parabolic uptrend.

Whilst the ChiNext has been deflating so too has the broader Chinese market and its decline so far, even though it is barely two months old, has provided some text book examples of behaviours and attitudes found along 'the slope of hope', but so far nothing to indicate that anything close to the bottom has been seen.

Early in the decline, that has now seen more than three trillion dollars of value wiped off market valuations, expectations were that it was just another of those oxymoronic 'healthy corrections';

> **Chinese stocks suffer 'healthy correction'** CNBC 19th June

Then, as the decline continued the expectation grew that somehow 'the authorities' would do something to prevent further decline.

It has never ceased to amaze me that so many market participants and commentators find it so easy to believe that 'the authorities', whoever they may be, can reverse a bear market. Over the years I have frequently reviewed the efforts, and the belief in, the so called 'plunge protection team' that was established in the US after the Crash of 1987. The goal of this 'team' was to prevent anything similar to 1987 happening again. Since then we have, over the last fifteen years, witnessed two of the largest bear markets of all time in the US, and yet still investors believe that the ‘plunge protection team, or the Fed or some other body will somehow prevent a bear market. Bear markets happen after markets have risen too far, often too fast, on ever inflating and increasingly ill-founded expectations, optimism and hope. The natural reaction to that is that they eventually fall and the reverse attitudinal and emotional extremes are eventually seen. Markets cannot be held up at irrational levels perpetually just because it would suit most people.

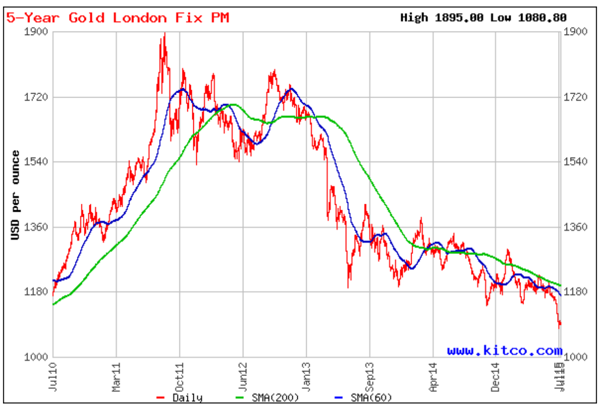
Once the Chinese market began to fall seemingly daily the media was full of reports as to how the authorities were going to prevent further decline. They cut various interest rates, they restricted the issuance of new stock, they made it illegal for large holders to sell their stock, and yet still the market declined!

China markets slump despite central bank rate cut The Guardian 29th June

People’s Bank of China cuts rates to stem sell-off amid growing fears for health of Chinese economy

Despite all the authorities best efforts the broad Chinese market is still down about 25% over the last six weeks. As long as the hope persists that something will reverse this decline it is unlikely that the current bear market has anything like run its course.

As an aside, and in no way intended to be a forecast, I thought the chart to the left, that appeared a couple of days ago in USA Today, offered a different outlook for China than is currently being portrayed in most of the mainstream media.



Gold, an opportunity?

The chart to the left shows the last five years of price action in Gold. It peaked a little after silver in 2011 with its near vertical acceleration up to $1900. Understandably at that point expectations, and hope, for where the gold price may eventually get to were extraordinarily high.

In December of 2011, just months after the all time high in gold and with the price having slipped to $1650 Deutsche Bank were very optimistic, as reported in the Christian Science Monitor on the 22nd December;

> What gold's decline since March "has really shown us is that in periods of extreme risk aversion, gold is not unscathed," Soozhana Choi, a commodities analyst at Deutsche Bank, told CNBC Monday. "We find that gold trades lower across the board with every other financial asset out there." But "we do believe that over the course of the next year, we will see a recovery in gold prices," she added. Deutsche Bank forecasts that gold prices will hit $2,000 an ounce in the second half of 2012.

In October of 2012, with gold having slipped briefly below $1600 and then rallied back to almost $1800 Deutsche Bank raised their forecast for the gold price as reported in Market Watch on the 2nd October;

> Deutsche Bank AG Tuesday raised its outlook for gold and silver prices in 2013 and 2014, citing support from stimulus measures by central banks such as the U.S. Federal Reserve.
>
> The bank raised its 2013 gold forecast by 3% to $2,113 a troy ounce and its 2014 outlook by 11.1% to $2,000/oz. Next year, the price of gold could exceed $2,200/oz, it said.

In the November 2012 edition of Strategy Thoughts I wrote the following;

> I think we can look back to the early 2000's and be shocked at how 'inexpensive' gold was then, at least compared to current prices, but I believe it is more likely that gold is far closer to a peak than a trough and last year's high may turn out to have been that peak. Certainly it has spawned an enormous industry in gold investment vehicles that barely existed ten years ago and is now spawning extravagant book titles.
>
> A Wall Street Journal blog on 24th October was headlined;
>
> ## Gold: Do We Hear '36,000'?
>
> The blog went on to describe a soon to be released book; *$10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven*, by Canadian gold manager Nick Barisheff. The book forecasts that gold will hit $10,000 'before too long'.
>
> The blog then went on to point out that similar extravagant claims have been made for other asset classes in the not too distant past.
>
> *"The resemblance may be purely coincidental, but the advance publicity for the book reminds us of what happened back in 1999, when a series of popular books forecasting sky-high stock "prices came out one after another."*
>
> *The authors and publishers vied to outdo each other's titles like drunken sophomores at a college football game yelling "We're No. 1!" and "No, we are!" The low bid was Dow 36,000 by Kevin A. Hassett and James K. Glassman. Then there was David Elias' Dow 40,000. Finally came Charles W. Kadlec's Dow 100,000.*

I concluded that piece with following warning;

> In the meantime it should be enough to learn to avoid whatever books are hitting the best seller lists with extravagant forecasts, whether it is how to get rich in property, internet stocks or gold. These forecasts are far more a reflection of what has already worked, and a reflection of where collective expectations already are, than where future returns will be found.

The back drop is certainly different now!

With Gold having fallen by more than 40% from its all time high in 2011, and by almost 40% from its initial bear market rally high in 2012 attitudes and expectations have, perhaps understandably changed. This is particularly clear in the forecasts that are now emanating from Deutsche Bank, the firm that less than three years ago had a forecast of $2200 (about 25% above its then price) is now looking for a much more modest $750 (about 30% **below** its current price);

Deutsche Bank says gold's fair value is $US750 an ounce

But this is far from the bleakest of forecasts for gold that have been making headlines recently as the price has been sliding.

On the 24th July Bloomberg ran the story;

Gold Looks Like a 'Textbook' Short

Two days later Market Watch publicised HSBC's increasingly cautious outlook for gold;

HSBC cuts 2015, 2016 gold price forecasts

The next day the headline;

Here's why gold is doomed

Appeared originally in the Washington Post but was picked up globally, and then two days later, on the 29th July, Bloomberg proclaimed;

Gold Is Only Going to Get Worse

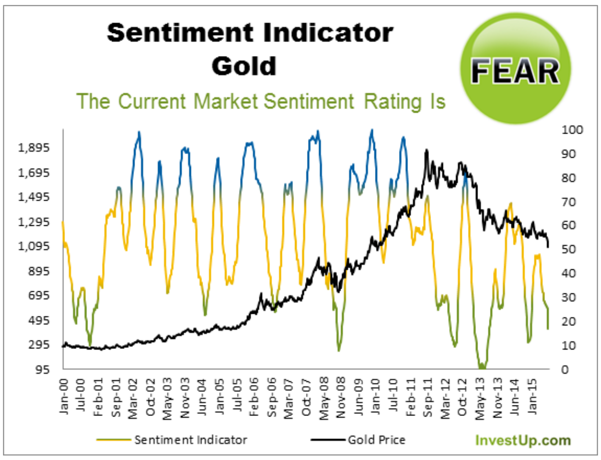
Our survey shows a majority of traders and investors aren't optimistic

On the same day Market Watch came out with a story that seemed certain to beat any other bearish forecaster out there;

Opinion: Two reasons why gold may plunge to $350 an ounce

To be fair to Deutsche Bank it seems that the majority of banks were engaged in a game of leap frog as they attempted to keep their forecasts ahead of the price rise four and five years ago. Now those same banks are doing the same thing, only in reverse, as they struggle to keep their downward targets relevant.

None of this means that gold is set to head off to the races right now, however, it is very important that all potential investors realise that the current backdrop is a world apart from that witnessed in 2011 and 2012. Then the opportunity was to get off what turned out to be a runaway train before it crashed. Now the opportunity is to realise just how unloved gold has become and that the news for gold now merely has to be less dire than the majority expect for the slope of hope to be over and the climb up a wall of worry to begin.



Supporting the idea that gold may surprise on the upside from here is some research from Mebane Faber picked up by Casey Research. They report that he looked at stock markets that had fallen three years in a row and found that on average in the fourth year they rallied by 30%. More importantly for this discussion on gold he found a similar pattern across asset classes that had fallen three years in a row; in the fourth they rallied on average 34%. Gold has now fallen for three years in a row, and, as I have outlined above, the attitude upon the part of most investors is now a mirror image of that found three or four years earlier.

A rise of any degree from here would be uncomfortable for the majority of forecasters, who have all been lowering their targets in an extrapolation of the preceding decline, just as the declines of 2013 and 2014 were no doubt uncomfortable given the extrapolating that had been going on around the peak in the metal.

Apple update (or the value of what everyone already knows!)

I titled the April edition of Strategy Thoughts 'What everyone already knows doesn't help! The Wonder of Apple?' The point I was attempting to make in that edition was that by the time everyone knows something, even if it is correct, it is of absolutely zero value from an investment perspective because by definition it has to already be reflected in market prices. I extended that observation by highlighting that by the time a stock is considered eligible and worthy for inclusion in the Dow Jones Industrial Average the entire world is probably more than familiar with the virtues of that company. Similarly any stock that is removed has likely been a poor performer for an extended period, again evidence that the majority are probably more than familiar with its shortcomings.

On March 18th the largest company in the world by market capitalisation, Apple, replaced a tired old 'Ma Bell', AT&T. Over the last four months this switch has followed pretty much the pattern that has been seen throughout history, the new comer has struggled and the dumped stock has recovered. Since Apple replaced AT&T in the Dow Jones industrial Average, Apple has fallen 4% in value, AT&T has risen 2% and the Dow itself has fallen a little less than 2%.

Naturally I will continue to monitor this but hopefully it is already clear that the comfort of the crowd, and not standing out, may be alluring but it is not the position from which investment success is found.

Conclusion

Taking comfort from economic forecasts when investing is unfortunately fraught with problems. Firstly, the forecasts are highly likely to prove wrong, particularly ahead of important inflection points, and secondly, even if they are right it is likely that the markets were forecasting that outcome long before the forecaster. It really is a case of putting the cart before the horse. Successful investing requires an appreciation of crowd psychology and herding and an acceptance that the most successful long term investment decisions probably feel very lonely and uncomfortable for a long period of time. It also comes down to what Keynes described as 'anticipating the anticipations of others'. It is therefore an art and not a science, but it is an art that one can get better at through application, discipline and avoiding the siren call of the crowd.

Over the last couple of months there have been a number of important moves in markets, particularly in Europe, China and gold, and all have been down. Currently only one of these markets is beginning to show signs of offering a real, albeit uncomfortable, opportunity, and that is gold. I have long held a bullish position on the US dollar, I reported that I halved that position several months ago and now I am considering switching into gold in US dollars. I will keep readers posted. The other two markets I believe still have further to decline before the bottom of their 'slopes of hope' are even close. I therefore continue to favour an investment strategy that has a strong focus upon capital preservation. There will be many new opportunities in the months ahead, but probably from much lower levels.

Kevin Armstrong

31st July 2015