Strategy Thoughts

February2015

More Extrapolation and Overestimation!

Introduction

Last month I reintroduced and re-explored the tendency that market commentators and economists have for underestimation of the magnitude and durability of a move in a market; that is until it becomes firmly established and accepted, at that point extrapolation and so overestimation become the dominant traits. I described at some length the history of this behaviour in the oil market and the futility of attempting to forecast a move in oil based upon supply and demand, this month I will update that analysis and question whether sufficient over estimation of how low oil could go has been seen in the price of oil to allow for a significant bottom. But first I will highlight some dangers in the, until very recently, still high flying US equity market and highlight the possibility of some meaningful reversals in currency markets. Needless to say I continue to believe that a heightened state of caution is still absolutely warranted.

Complacency?

After this year's Davos World Economic Forum global insurer Zurich posed the following question on Bloomberg;

> When was the last time that economic risks did not rank as the highest percentage of global risks in terms of impact?

Based upon their survey of hundreds of the Davos attendees they concluded that;

> '2015 denotes the first time since 2007 that economic risks were not considered the highest percentage of global risks in terms of impact.'

Some may take this as a comforting assessment, and perhaps it is, or perhaps it is because there are so many natural and geopolitical issues to worry about that economics has slipped down the rankings as a source of worry. However, it could also hint at a fairly high degree of complacency, something that has been seen at Davos before! When economic worries rise to the fore they easily displace all other man made or natural threats and comparing the current period to2007 should not necessarily be seen as a reason for comfort, the 2007 WEF was the last one before the beginnings of the worst global bear market since the 1930's, and sadly attendees at Davos are just as likely as the rest of us to succumb to extrapolation and overestimation.

At the end of the 2009 WEF, and with global stock markets having plunged 50% or more over the prior fifteen months, Bloomberg reported the events at the WEF as follows;

> **Gloom deepens among executives, economists at Davos**
>
> 'Gloom is deepening among business leaders and economists, casting a pall over this year's World Economic Forum in Davos, Switzerland.'
>
> 'The crisis is getting worse.'
>
> 'The problem confronting us today is significantly larger than in the 1930's

Grimmest Davos ever brings anger, finger pointing at Bankers

'Everyone I spoke to says it is the grimmest Davos they've ever been to'

'We're in a multi-multiyear problem.'

'The mood has been very depressed. It is a low burn depression.'

These sentiments were understandable given the carnage that had already been witnessed, but raising such understandable fear and concern was not helpful to investors. These headlines appeared at the end of January 2007, five weeks before an incredible explosion upward in global equities was about to begin.

Two years later, with most markets having approximately doubled or more from their lows the mood at Davos was understandably more upbeat;

Super cycle leaves no economy behind

'It's a win win situation'

'The whole world is going to be rich by the end of this century'

This was the reporting of the same Bloomberg journalist speaking to the same or similar Davos delegates. A doubling in equity markets will change individuals' expectations but it can result in comfortable extrapolation and overestimation. The 'super cycle' has unfortunately left many economies and markets behind since early 2011, notably Europe. Almost immediately after that Davos meeting the European markets began to fall in a new bear market and by mid September had plunged 35%. Even now, four years later, the broad European indices are barely 10% above where they were after the 2011 Davos with many countries feeling like it has been anything but a 'win win situation'.

Almost the same experience befell emerging market investors. Just weeks after the 2011 Davos meeting the broad emerging market indices peaked 150% above where they had been mired after the 'Grimmest Davos Ever'. But from there, despite the promised 'Super Cycle', they fell by thirty percent to their September 2011 lows. Since then, like Europe, it has been anything but 'win win', with the broad EEM (emerging market ETF), still twenty percent below where it was four years earlier.

The fact that economic concerns were not the major worry on the part of Davos attendees this year does not in any way mean that an economic calamity is inevitable, however, it should also not be taken as a cue, consciously or subconsciously, to allow complacency to slip in, particularly given some of the overestimation that has been seen recently.

Underestimation to overestimation and back again

Having written as much as I did last month on the trend to overestimation I was alarmed to read the following Bloomberg headline in mid January.

Morgan Stanley's Parker Sees Equity Bull Market Lasting to 2020 Jan 16

"This is going to be the longest expansion ever,"

That such a forecast would grab headlines is immediately understandable, but after a near record breaking, almost six year long, US equity bull market it did sound and feel a lot like extrapolation and overestimation, so I reviewed some of the archived stories I could find that were attributed to or quoted Mr. Parker.

At the end of 2011, after a miserable second half of the year on the back of European worries the same Adam Parker issued his year ahead target for the S&P500, it was 1167. This was seventy points higher than the low point it had fallen to at the depths of that correction, but bravely, more than 7% below where the market was when the forecast was made. The market never fell back below that year end level but Parker maintained his bearish view;

> **Morgan Stanley Expects A Horrible Finish For The Market This Year**
>
> Last December, Morgan Stanley's Adam Parker set an S&P target of 1167 on global GDP slowdown, weak corporate earnings, a rising dollar and companies' bearish inventory-to-sales ratios. But the market has been strong, so has he thrown in the towel? Today, he announced he is going 1167 or bust.

The market actually closed the year at 1426, 22% ahead of Parker's forecast.

After being so wrong through 2012 he finally reversed positions and became bullish in April of 2013and by the end of the year very bullish about 2014, correctly forecasting that the S&P500 would hit 2014 in 2014.

> **Morgan Stanley's Adam Parker: The Most Bullish Strategist on Wall Street**

As I commented earlier, this does sound like an analyst that has publicly delivered overestimation on both the downside, and now on the upside, in less than a handful of years. His comforting and encouraging forecast for another five years of this amazing bull market may be delivering what the obviously bullish majority want to hear, but history shows that what the majority want rarely happens in markets, particularly when accompanied by extreme overestimation and extrapolation.

Some perspective both as to the magnitude of the bull market that America has already enjoyed and the obvious complacency amongst 'experts' was provided in a recent St Louis Post Dispatch article;

> If this bull market lasts until mid-January, it will become the second-longest in U.S. history, ahead of the Roaring Twenties and behind only the 1990s. Those eras ended, respectively, in the Crash of 1929 and the bursting of the technology bubble. Most investors don't want to repeat either experience, so human nature makes us worry when things have gone so well for so long. Market experts aren't among the worriers. Dan Heckman, a senior strategist at US Bank in Kansas City, says this bull's age doesn't tell us anything useful about how much further it might run. "Typically, bull markets don't end unless they are ended by a recession," he says. "We had a severe economic contraction (in 2007-09), and we certainly have not had an explosion in economic growth since then. Perhaps the new normal will be steady but below-trend economic growth and less of a boom-and-bust cycle." Almost no one, he adds, expects a recession in 2015. The consensus among forecasters is that growth

should even pick up a bit, with unemployment continuing to fall and workers finally seeing some wage increases.

I would simply comment that a consensus of forecasters is dangerous, not encouraging, and that virtually no ‘experts’ forecast, or even acknowledged, the Great Recession from 2007 to 2009 until long after it was obvious and with a bear market already well underway.

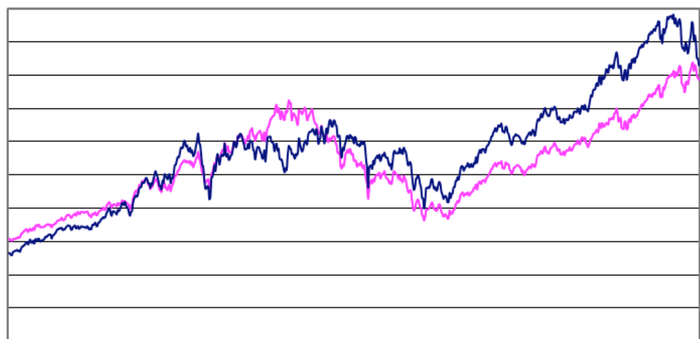
Financial stocks

The stock market did give some advance warning of the impending Great Recession; it began falling two months before the official onset of the Great Recession in December 2007, and thirteen months prior to the beginning of the Great Recession being officially declared as December 2007 in December 2008. On top of this there was one sector that highlighted there may be trouble ahead even before the broad market did, the financial stocks.

In the December 2007 edition of Strategy Thoughts I wrote the following;

> **Are Financials telling us anything?**
>
> It is a little hard to see on the chart below but globally financial companies have been markedly underperforming the broader averages for most of this year. This is perhaps not that surprising given the multibillion dollar write offs being, almost continually, announced in the wake of the subprime and related unwind. However, what is clear from the chart is that financial underperformance is not necessarily a healthy sign for the market. The last time such financial weakness was seen while broader averages continued higher was in the late nineties. Admittedly the financials did then out perform in the subsequent bear market but financials weakened for more than a year before the final speculative peak in the market.

World index compared to world financial stocks since 1995



With the benefit of hindsight we all now know that financials were indeed saying something, and it was something of global significance!

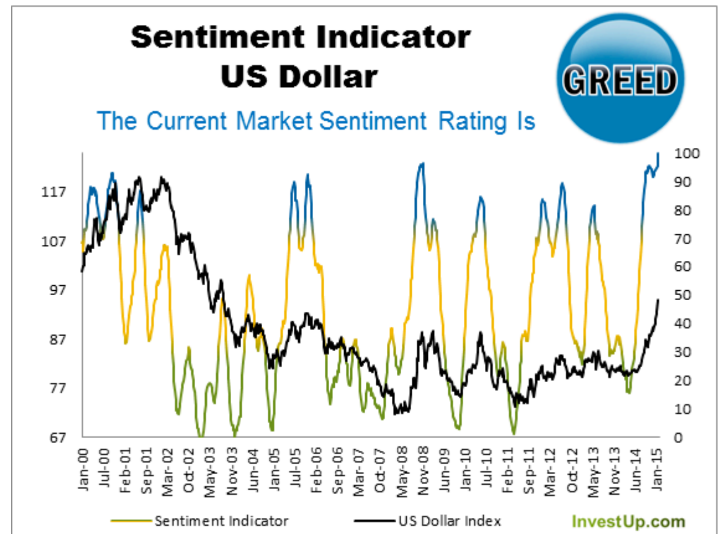
The chart below shows the performance over the last two years of the ishares that track the broad MSCI world all country index and the global financial stocks. Up until the beginning of 2015 the two have

tracked each other almost perfectly, since then, however, there has been a wideneing underperformance by the financial stocks. Like the overestimation and extrapolation described above, this does not guarantee a replay of the Great Recession stock market and economy, but it should discourage complacency and certainly bears watching.

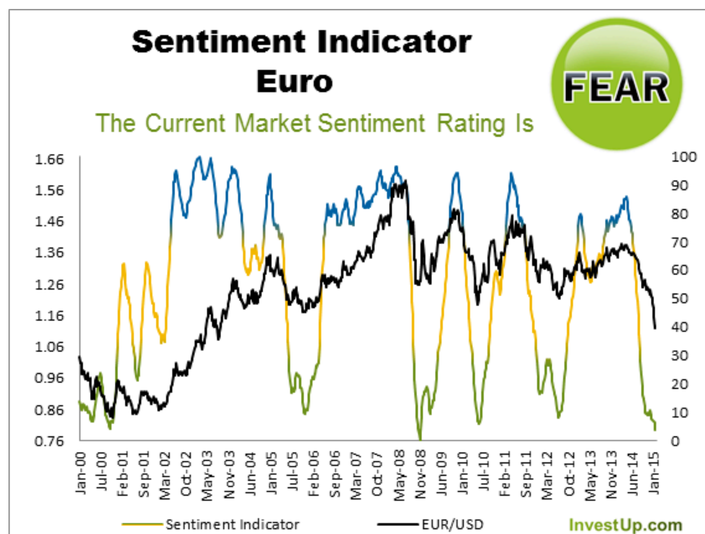
Currencies

The US Dollar

I have been discussing the US dollar and its price action for several years and have personally held a position in the US Dollar via the ETF UUP which broadly tracks the US dollar index. For most of the time I have held this US Dollar position the Dollar has been deeply despised, however, things have changed dramatically over the last six months as can be seen in the sentiment indicator to the right.



As of the end of January the Investup.com sentiment reading toward the US Dollar hit a new all time high, 100! I am not sure exactly what this reading means but I do know that it can't go any higher and that from less extreme sentiment readings in the past the dollar has endured meaningful corrections.



At the same time sentiment toward the Euro has plunged to its lowest level since late 2008 and there are some signs that overestimation may be entering the fray, at least when it comes to how low the Euro can fall.

Just a few days ago CNBC ran an on line poll;

Poll: How fast will the euro hit parity with the dollar?

79% of respondents voted in favour of parity being achieved this week, month or year. Four days later, with the dollar having strengthened further, the same network was giving advice on how to play the apparently almost certain move to dollar euro parity;

Trend trader: Playing a euro fall to parity滙 Friday, 30 Jan 2015

The same theme was echoed by other news sources;

Bet on Euro-Dollar Parity with These ETFs - ETF News And Commentary By Zacks.com, January 29, 2015,

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.

From the long term US dollar chart above it can be seen that the end of a very long Dollar bear market occurred in late 2007 early 2008.

In October 2007 I wrote;

> Like not fighting the Fed, a weaker dollar on the back of lower cash rates seems intuitively obvious, again, unfortunately, things aren't quite that neat or simple. Since late 2001, early 2002, the US dollar has done nothing but fall, although there was a brief rally in 2005. Over that period cash rates in the US have been slashed, moved sideways, raised, moved sideways and, most recently, cut. The dollar through all of this has fallen almost 40%, on a trade weighted basis, to a new low. Looking back further it is hard to find a consistent causal link between the direction of US cash rates and the direction of the dollar.
>
> In early 2000 the Fed were tightening and the dollar rose, yet five years earlier the Fed was also tightening and the dollar fell close to 20%. Between those two tightenings there were two brief easing cycles and the dollar, ironically, rose through both of them.
>
> Perhaps the dollar will continue to fall, this would certainly satisfy the majority, unfortunately pleasing the majority is something that markets rarely do for long.

In late 2007 extrapolation of the US Dollar weakness was the broad consensus view, overestimation was everywhere, and it was even reaching into the, rarely outspoken on economics and finance, businesses of fashion and music.

BBC News reported in late 2007 that super model Giselle Bundchen had a strong dislike and distrust of the US Dollar;

Supermodel 'rejects dollar pay'

The world's richest model has reportedly reacted in her own way to the sliding value of the US dollar - by refusing to be paid in the currency. 6 November 2007

Ten days later the same news service reported that Rapper Jay-Z was also disillusioned with the US dollar;

Rapper Jay-Z dissing the dollar

Wads of dollar bills are usually as much a part of rap as fast cars, diamond-encrusted jewellery and scantily-clad models.

> But in an apparent nod to the low value of the dollar, rapper Jay-Z's new video Blue Magic features another currency.
>
> He is seen cruising the streets of New York in Bentleys and Rolls Royces (now owned by Germany's Volkswagen and BMW) with a briefcase of 500 euro notes.

On the 9th November 2007 Bloomberg reported on the risks of the dollar losing its reserve currency status;

> *Dollar Weakness*
>
> *Concern is increasing that the dollar's weakness may augur the end of the U.S. currency's reign as the world's main international currency for trade, financial transactions and central-bank reserves. The dollar's share of global reserves fell from 71 percent in 1999 to 64.8 percent in the second quarter this year, according to a report from the Washington-based International Monetary Fund.*

As can be seen in the chart below, all these concerns were emerging within three months of the end of a massive bear market in the US dollar. The Dollar Index had fallen close to 40% in value over the prior six years and would rally close to 20% over the next twelve months from the point in November when ‘overestimation’ was rife.

At that time sentiment towards the Euro was almost universally positive and the reverse was true for the dollar.

Whilst I do continue to believe that the US Dollar is in a long term bull market from those very depressed lows of last 2007, and that in any turmoil that besets financial markets this year it will be seen as a safe haven, the rise will not be a one way street, just as the preceding bear market wasn't either.

Oil

Last month I illustrated how futile it had been in the past to attempt to forecast oil prices based upon supply and demand and also how extrapolations of the recent plunge were heading towards ‘overestimation’. Further evidence of the difficulty in forecasting and extrapolation of the trend have emerged over the last couple of weeks.

The February 2nd edition of Time magazine has an eight page feature article on the plunging price of oil and gasoline. The IMF's forecasts for oil prices, and the effect higher or lower prices would have on the global economy, are discussed at length. Unfortunately they only further highlight how difficult it is to forecast a price move, and that even if the forecast move occurs the flow on effects are often not those anticipated. Back in October of last year, with oil prices already having begun to fall,

the IMF warned the world of the economic peril of higher oil prices and forecast that crude could rise as much as 20% on the back of the growing influence of ISIS in the Middle East. If that were to occur then 1.5% of global GDP would evaporate. With hindsight we know that rather than rising by 20% oil prices have halved, nonetheless the IMF have still come out and cut global growth forecasts, but only by 0.3%.

The Time article also highlighted that extrapolation and 'overestimation' had really swung into action. They quoted unnamed traders betting that oil will plunge to $20 and gave some hint as to the catch up and overestimation that Goldman Sachs has displayed with its oil forecasts.

Three months ago, with the price of oil already plunging, Goldman Sachs ratcheted down their forecast for where oil would trade in the first quarter of 2015;

> **UPDATE 4-Goldman slashes 2015 oil price forecast as glut grows** Mon Oct 27, 2014

They brought forward their medium term bearish outlook and forecast that WTI would trade, three months in the future, at $75, their previous forecast had been $90. At the time WTI had already fallen to $80 and would fall to below their first quarter 2015 target less than three weeks later and never look back.

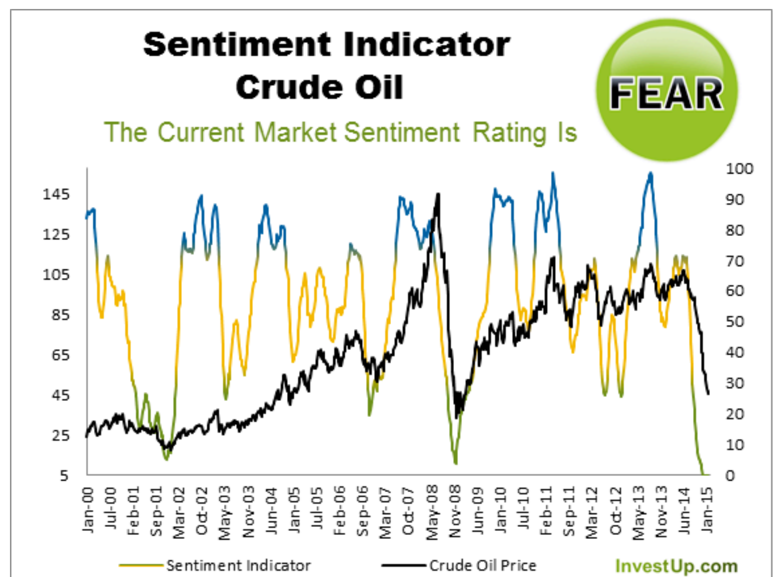
With the oil price seemingly in freefall and in an attempt to at least come out with a forecast below where it had already fallen to (overestimation?) the firm cut their forecast in mid January to $39. This was reported on Bloomberg on 13th January;

> **$40 Oil? That's How Low Goldman Sachs Says It Needs to Go**
> Jan 13 2015 Bloomberg
>
> Oil prices, which have fallen by more than half since June, need to drop even further and stay there for the first half of the year for the market to find a balance between supply and demand, Goldman Sachs Group Inc. says. The bank reduced its six- and 12-month predictions for West Texas Intermediate, the U.S. benchmark, to $39 a barrel and $65, from $75 and $80,

This was the same day that WTI first traded at $44; it fell to the same level again on the 30th January but since then has rocketed higher rising 18% in just a handful of days.

As I did last month, I am not suggesting that anyone should attempt to catch the falling knife that oil has been, however, as I also pointed out last month, no one should be surprised by the rapidity with which oil rallies when it does finally bottom.

Given the speed with which oil has rallied, the clear evidence of recent overestimation and the extremely depressed sentiment as shown to the right it would not be too much of a surprise for the recent low to

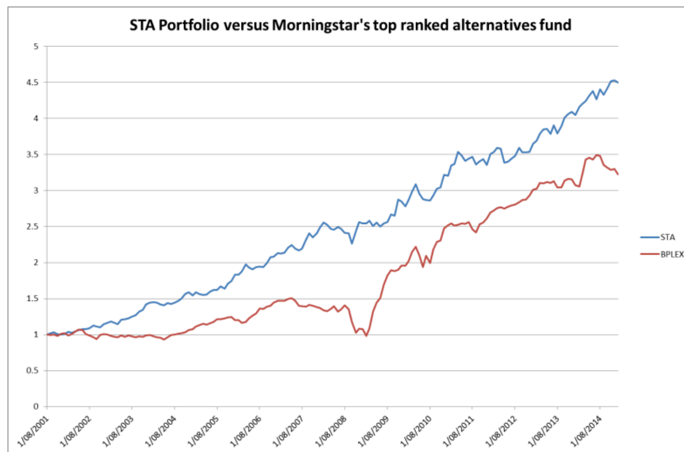


have marked the end of this particularly swift and severe bear market in oil.

STA Update

A substantial amount of my time over the last month has been spent testing and retesting the current design of the proposed STA Portfolio and my intention is that the product will be available to retail investors in the not too distant future. It staggers me just how many things need to be done before the simplest of investment products can be made available. In the meantime I would like to thank all those readers who have expressed their interest in, and support for, the product. I will keep you all posted directly and through Strategy Thoughts as to progress on the product.

While watching CNBC recently an interview was aired with the fund manager of the recently announced Morningstar top ranked alternatives fund. This was a fund that could take long and short positions, was largely unconstrained as to where and what it invested in, and took a different view to that of a typical balanced fund. This intrigued me and I wondered how well it had performed to be awarded such an accolade.



The chart to the left is the total return performance of the STA Portfolio (blue line), which utilises no leverage and takes no short positions, and the total return performance of the Boston Partners Long Short Equity Fund (BPLEX). This fund also has an expense ratio several times higher than what I intend for the STA Portfolio.

Conclusions

With extremes in sentiment and rampant 'overestimation' it is probable that a number of reversals in markets could be seen in the near future. This will be unsettling to those bulls that have become accustomed, particularly in the US, to rising equity markets, a strengthening dollar and ever cheaper oil. Those comfortable US bulls may get a taste of what many of their global counterparts have been suffering since 2011.

It is never sensible to allow complacency to creep into ones investment outlook; however, this is particularly the case now. Extreme caution continues to be warranted with a particular focus on capital preservation in what is rapidly becoming a deflationary world.

Kevin Armstrong

4th February 2015

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