Strategy Thoughts

January 2015

It will Fluctuate!

(J P Morgan when asked what the stock market will do)

Introduction

The New Year invariably begins with supposedly 'expert' forecasts for what the next twelve months may bring, however, the blame for so many forecasts appearing should not be totally placed upon the forecasters. It is important to remember a couple of J K Galbraith's famous quotes. Firstly he said that the only function of economic forecasts was to make astrology look respectable, and then, perhaps more profoundly particularly at this time of year, he pointed out that economists forecast not because they know, but because they are asked. J P Morgan's famous quote, which I have employed as this month's title, is perhaps the most honest assessment anyone can give for what markets may do.

The stock market is a wonderful illustration, and always has been, of man's inability to learn from experience. The same mistakes made by investors now were made at many other times over the past few centuries, what is perhaps most surprising is that when lessons have been cruelly and painfully learned, such as through the GFC when markets fell fifty to eighty percent in value, is that such vivid lessons can be so rapidly forgotten. Despite the terrible track record of economic forecasters the same questions about what the next twelve months may hold are asked of the same or similar people at this time of year.

In this month's Strategy Thoughts I will review a number of such forecasts and attempt to see if there are in fact any insights that can be gleaned by looking at them in a slightly different way. I will also revisit a number of topics that I have raised over the last couple of months, namely; Europe, oil and gold and finally I will update the messages being provided by my STA model and the progress that is being made on the STA portfolio product.

Underestimation to overestimation and back again

History shows that most forecasters tend to extrapolate the prevailing trend with a bias towards conservatism. The result is that that their forecasts tend to underestimate the strength of a move as long as the trend remains intact, that is until close to the end when confidence in the trend grows and overestimation replaces underestimation, invariably just prior to the trend reversing.

Each year Business Insider surveys the top US strategists to establish an average forecast for where the market may go over the subsequent twelve months. In 2013 they were positive, but not positive enough, the same was true in 2014 with the majority dramatically underestimating how far the market could rise. With the US market having shown such strength, in the face of more general sluggishness or even weakness in markets, one might have expected a degree of skepticism or caution, however, it is clear that the US market's strength has only fuelled greater confidence and more optimistic forecasts. This year their mean forecast is slightly more aggressive, calling for an eight percent rise rather than the six or seven percent they were looking for last year. Whether this will be able to recorded as yet another example of growing confidence and overestimation at just the wrong time will only be known in a year's time, but it is fascinating to review some of these forecasts.

A Look Ahead!

Late last year Forbes ran an article forecasting rmarkable strength for the US market in 2015 under the title;

A Rational Case For Stocks Rising Another 45% By The End Of 2015

The basis for this forecast of the US market rising 45% by the end of the year is that such a rise would merely get the market back to its 8% annual growth trend line. However, this is only the case if one were to start that trend line at the pre GFC crisis high point. Just why one should start there is never explained.

It is interesting to examine where the S&P should finish 2015 based on this '8% growth from arbitrary starting point' logic employing different starting points.

		8%	Actual
July	2007	1,576	
July	2008	1,702	1282
July	2009	1,838	976
July	2010	1,985	1102
July	2011	2,144	1345
July	2012	2,316	1350
July	2013	2,501	1692
July	2014	2,701	2040
July	2015	2,917	
July	2016	3,150	
July	2017	3,402	

Pre-Crisis High

Current Level of S&P

The projected S&P 500 value if we apply a normal long-run annualized return from the pre-crisis high

Source: BillionairesPortfolio.com

If one started not at the pre GFC high but the post GFC low then the projection would be for the market to end this year at 1120, not up 45% but down 45%. Obviously not so encouraging, it's therefore understandable that the author didn't employ that starting point. What he should have done, if his primary aim was to instill rampant bullishness in his readers, was to have gone back to the pre tech wreck market high at the beginning of 2000. If the market were to achieve an 8% annual appreciation from that point then the year end target would be for a further 150% gain! Going back further, to the 1987 Crash, yields similarly absurd forecasts. If one uses the pre Crash high then the market should rise by 50% this year, if one used the post Crash low then the year would see a fall in the S&P!

There is nothing magic, nor guaranteed, about an 8% annual rise, but to begin such an extrapolation from a point that the majority now look back upon as having been rife with absurdity, is odd, to say the least. The fact that it is published probably tells us more about what people want to hear than what may actually happen.

Other forecasts included Schwab's global outlook which could be summarised as more of what we had in 2014;

> Globally, we are starting to see a shift from fiscal drag to fiscal stimulus in what is still going to be a very stimulative monetary-policy environment. These policies are likely to continue to push asset prices higher around the world in 2015 despite still-sluggish global growth.

This sounds an awful lot like the expected extrapolation!

US Research firm Zacks forecast for the year ahead was certainly succinct, but also an unashamed example of extrapolation;

> next year will be far too much like the past year. That means overall gains in the +10% range with more volatility than you'd like to stomach. Likely 2300 is about where we close out the year. We have a shot at 2400 if all the stars align.

Similarly Barron's Magazines survey of experts concluded that comfortable extrapolation was the best forecast and encouraged investors to 'Stick with the Bull' in 2015.

One regional US newspaper summed up the modest extrapolation they were looking for with the headline;

Moderate stock market gains forecast for 2015

The UK's Daily Telegraph ran an article towards the end of last year that could also have employed the title shown above. They interviewed a number of experts who were on the whole cautiously optimistic but did not want to forecast that the FTSE 100 would record a new high above the 6930 level that was hit fourteen years earlier at the peak of the tech boom. This would only have required a 5% rally from where the index stood at the time. This result is perhaps understandable given that the UK market, unlike the US market, struggled to make any headway through the year. It also displays a stark contrast to the results of the same survey by the same journalist twelve months earlier, after the UK market had recorded a healthy rise in 2013. Then the experts were calling for new all time highs with one quoted as saying that investors should pile into shares as then (the end of 2013) 'was the best time to to buy UK shares since the London Stock Exchange was founded in 1801'. It is amazing what a good year will do for expectations!

Perhaps more telling from the latest UK survey was not that the experts were somewhat more conservative in their optimism after the disappointing 2014 but what the readers view was. The paper ran an on line poll of readers asking for their expectations for 2015 and the outcome was that almost two thirds of respondents expected the FTSE 100 to surpass its old high and the 7000 mark by the end of the year and half of those voting looked for the market to rise to more than 7200.

Economic forecasts have certainly been being raised for 2015, at least in the US, but sadly this is always a lagging indicator.

Bloomberg Business Week's outlook for the global economy in the year ahead was summarised in their headline;

2015 Global Economic Outlook: Better Than 2014—but Not By Much

This could be argued to be another example of comfortable extrapolation

Finally an economics professor writing in the New York Times concluded, amusingly, but not very helpfully, with;

> So instead of a forecast, I'll offer advice: Prepare for the worst, hope for the best and count on being surprised.

Given the professors conclusion, and the comments above about forecasters generally presenting underestimated extrapolations until overconfidence gets the better of them at just the wrong time, it is worth considering where the surprises may be for investors next year.

The contrarian in me makes me think that the US commentators comfort in forecasting continued growth and stock market rises may well be complacent and misplaced. A reversal of the US bull market is a real possibility.

In Europe the overestimation phase was possibly actualy twelve months earlier, much like the UK example above, and now commentatotors are actually suffering underestimation, of how difficult things may get.

I continue to see surprises on the upside for the US dollar, particularly if the two earlier comments come to pass and it is seen as a safe haven. It is a short term concern that bullishness about the dollar has now soared and so some consolidation or correction is possible, however, it is worthwhile remembering just how well the dollar, and US treasuries, behaved through the GFC, even though it is all of seven years ago now.

US outperformance

According to Bloomberg the US market was the best performing 'developed' market in the world last year in US dollar terms, with a rise of 13.68%. This placed it fifteenth overall behind China, Pakistan, India, Sri Lanka, the Phillipines, Qatar, Indonesia, Laos, Bahrain, Egypt, Thailand, Turkey, Dubai and Kenya.

The performance of the US market compared to the rest of the world can easily be seen in the chart above. It shows that over the last five years a global investor, who chose not to invest in the US, has broken even in US dollar terms, while over the same period a US investor has enjoyed returns of about 70%.

More alarming is how the two lines have diverged over the last six months. Since the middle of last year the US investor has gained 5% while the international investor has slipped a further 12% behind. Much of that weakness globally ex the US can be blamed on Europe which over the same six months has fallen 15% in US dollar terms.

Europe

As I mentioned earlier, it is likely the case that the period of overestimation for Europe has already been seen and that the bull market peak has also passed.

In early 2014 Forbes ran the headline;

Land Of Opportunity In 2014? Europe

The article went on to elaborate why, even though the author was expecting healthy gains for the US market, he anticipated European outperformance.

In a similar vein in late 2013, with the European indices having performed well through that year, rising 15%, Market Watch ran the story;

Europe will beat U.S. in stock-market throwdown, the biggest banks predict

> Move aside U.S. stocks, the investor love affair with European equities is still going strong. The Stoxx Europe 600 index may be flirting with a five-year high and a 15% yearly gain, but the infatuation with the region's stock market is unlikely to fade in 2014.
>
> Major international investment banks are forecasting the continent's equities will rise by double-digit percentage gains in the coming year, outstripping the gains for their U.S. counterparts. Low valuations, continued strong central-bank support and anticipated solid earnings growth are all likely to lead the benchmark indexes to multiyear highs in 2014. So forget about weak economic growth in the euro zone, deflation worries and political turmoil — now it's Europe buying time.

This was almost as emphatic, and wrong, as the commentator on the UK describing the end of 2013 as the best time ever to invest. It can also easily be described as the moment underestimation blew out to over confidence and overestimation.

Schroders at the end of 2013 wrote;

What's in store for European equity markets in 2014?

> Europe's economy has stabilised and political risks have diminished. Equities enjoyed gains in 2013 as the risk of a eurozone break-up receded, yet valuations remain compelling and there is still plenty of upside.

At the same time Barron's panel of experts forecast another year of 15% returns from Europe and Bloomberg reported that there was virtual unanimity among experts regarding the outlook for European markets;

Bull Calls United in Europe as Strategists See 12% Gain

The average estimate is the most bullish since at least 2010, with no strategist predicting a gain of less than 3.3 percent

It does appear, with the obvious benefit of hindsight, that the swing from underestimation to overestimation of the bull move in Europe took place late in 2013. Since then, with Europe struggling, most commentators have also struggled as they have consistently underestimated how lackluster the European markets will be. Sadly this hints that the low point for the current bear market in Europe has not yet been seen.

At the depths of the last European sell off, in September / October of 2011, with the threat of a Greek departure from the Euro, the outlook was grim to say the least and expectations were similarly bleak. There did not appear to be any 'underestimation' of how bad things could get as the following Reuters headline and excerpt illustrate.

Europe overshadows the outlook

> "However this plays out, well or poorly, the road will be increasingly bumpy," RBS warned its clients on Friday.

These fears were dominating the business headlines after a massive 33% plunge in the broad European indices over the prior seven months. Given the magnitude of that selloff and the accompanying headlines it is understandable that 'underestimation' of how bad things could be had transformed into 'overestimation', understandable, but not particularly helpful.

Just prior to these stories running the European market had actually bottomed and was in the very early stages of a far from 'bumpy' rally that would deliver more than 50% gains over the next two and a half years.

Oil

CNBC ran the following story as oil broke down to yet another multi year low;

As oil breaks $50, Wall Street getting more bearish

> With more supply hitting the market, Wall Street is getting more bearish on the outlook for oil prices and some strategists see the market many months away from finding a floor.

Again, like the European situation in late 2011 getting increasingly bearish the more a market falls is understandable, but it is important to observe how much attitudes have changed. In Europe back in late 2011 it is clear that they had gone through a 180 degree reversal, so what has happened in the oil market.

Given all the coverage that has been devoted to the collapse in oil prices it seems that virtually everyone now understands why this collapse has occurred, it all revolves around falling demand and over supply. This seems to make sense but unfortunately if supply and demand were truly what drove the oil price then the International Energy Agency and the US Energy Information Administration would be best placed to forecast prices, sadly, but not surprisingly, that has not been the case.

In June expectations for oil were quite different as the following Reuters headline illustrates;

Brent crude oil rises above $110 on global growth prospects

Later in the same month as crude continued to rise forecasts grew more optimisitic as reported in the Business Standard;

Crude oil outlook: Crude oil prices can rise above $120 if Iraq crisis escalates

The US Energy Information Administration in its July 2014 Short Term Energy Outlook report wrote;

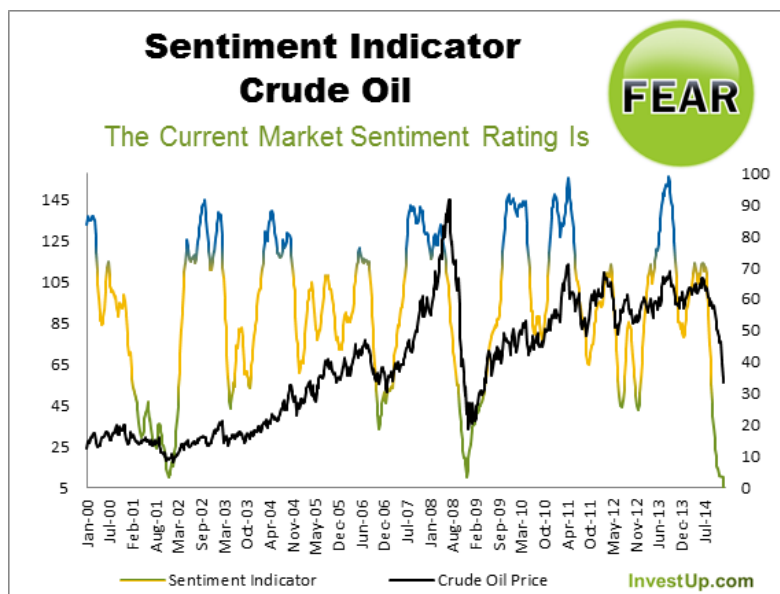
> The forecast Brent crude oil price averages $110/bbl in 2014, $2/bbl higher than estimated for 2014 in last month's STEO, and $105/bbl in 2015, which is $3/bbl higher than in last month's STEO.

Four months later, with prices having begun their collapse, their forecast had dramatically changed;

> The combination of robust world crude oil supply and weak global demand contributed to rising global inventories and lower crude oil prices. The forecast Brent crude oil price averages $83/bbl in 2015, $18/bbl lower than projected in last month's STEO.

One month later their forecasts were once again ratcheted down;

> The forecast Brent crude oil price averages $68/bbl in 2015, $15/bbl lower than projected in last month's STEO.



Last month I showed the extreme position that sentiment towards Crude oil had fallen to. Since then it has fallen even lower to an almost rock bottom level of 0.08 on Investup's measure.

I have no idea what the supply demand picture will be for oil over the coming days, weeks or months but then that clearly is not what is required to successfully forecast the oil price, particularly if an important inflection point is imminent. Not to labour this point unduly but it is interesting to review the US's EIA's forecast around the most significant inflection points of the last few decades.

In their August 2008 report, when oil had made its all time high they wrote;

> WTI prices, which averaged $72 per barrel in 2007, are projected to average $119 per barrel in 2008 and $124 per barrel in 2009.

This showed a nice gentle extrapolation upwards but we now know that this is far from what happened. Over the next few months the price of crude plummeted. By the end of 2008 their forecast for 2009 had been slashed by 60%.

> The monthly average price of West Texas Intermediate (WTI) crude oil has fallen by more than half between July and November, reflecting the fallout from the rapid decline in world petroleum demand. The annual average WTI price is now projected to be $100 per barrel in 2008 and $51 in 2009.

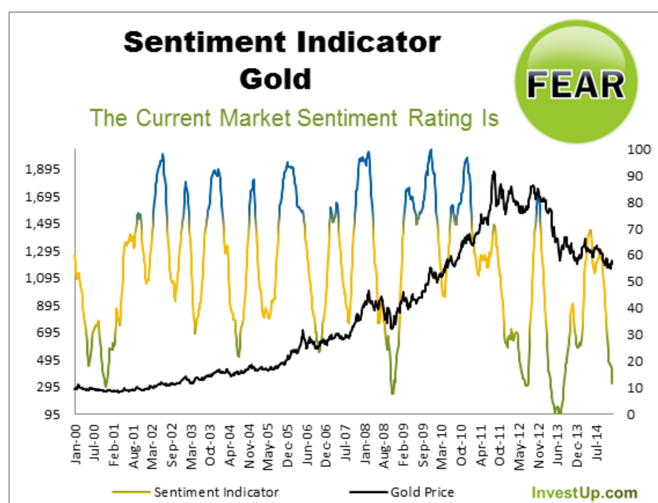
The next month the forecast for 2009 fell another 15% to $43 and a forecast for 2010 of $55 was introduced. By March the 2009 forecast, which just seven months earlier had been $124 was cut to its final low of $42, unfortunately this was several months AFTER the price of oil had actually bottomed and would have to be ratcheted higher throughout the year as the actual average for 2009 turned out to be $62, 50% higher than their forecast just nine months earlier, and 50% lower than their forecast less than eighteen months earlier!

It may appear superficially sensible to believe that the basic economics of supply and demand drive the oil price, unfortunately the truth is actually very different. The oil price, like any market, is simply a reflection of the hopes and fears, the aggregate expectations, of all market participants. This is

obviously harder to measure than supply and demand statistics, in fact it is impossible to measure with any degree of accuracy, that is why investing is, and always has been, far more of an art than a science. Nonetheless, it seems sensible to at least attempt to get a handle on those aggregate expectations and it is certainly more sensible than attempting to get better or more accurate forecasts of supply and demand!

Currently aggregate expectations towards the price of crude oil are as bleak as they have ever been, this does not mean they cannot get bleaker, but it does mean that if there is any sort of a surprise in the oil markets it is far more likely to result in higher oil prices than lower prices. I am not suggesting that one should attempt to catch the 'falling knife' that is oil prices currently, but don't be surprised by the magnitude and speed of any kind of reversal when it comes.

Gold



Last month I included a similar sentiment picture for gold as for oil. At the time the precious metal had just bounced from its lowest price in almost five years that was down close to 40% from its all time high.

Since then, amidst the turmoil of plunging energy markets and with the back drop of a strengthening dollar gold has continued to edge slightly higher. It is obviously far too early to declare the gold bear market over but with expectations for the metal continuing to deteriorate, as shown in the chart left, there continues to be more room for positive, than negative, surprises.

Turns (a further follow up)

Last month I mentioned a number of market 'turns' that may have already been seen. I have already expressed my views on Europe and Gold but a few charts can provide further updates on other assets.

The chart to the left shows UUP, an ETF that allows investors to invest directly in the US dollar index. The strength over the last six or seven months is quite obvious. As I mentioned earlier, I continue to anticipate further strength in the US dollar, however, I doubt that the next phase of its bull market will be as steep and orderly as that which has been enjoyed to date.

I last showed the chart of the Barclays High Yield ETF (JNK) three months ago in the edition of Strategy Thoughts titled 'Has a Turn been seen'. Since then JNK has continued to fall, at times dramatically, this despite the US equity market continuing to rally to higher highs. I continue to look for junk bonds to continue to struggle and quality spreads to continue to widen. Junk bonds did exceptionally well in the immediate aftermath of the GFC but for the last four years have struggled to make and gains.

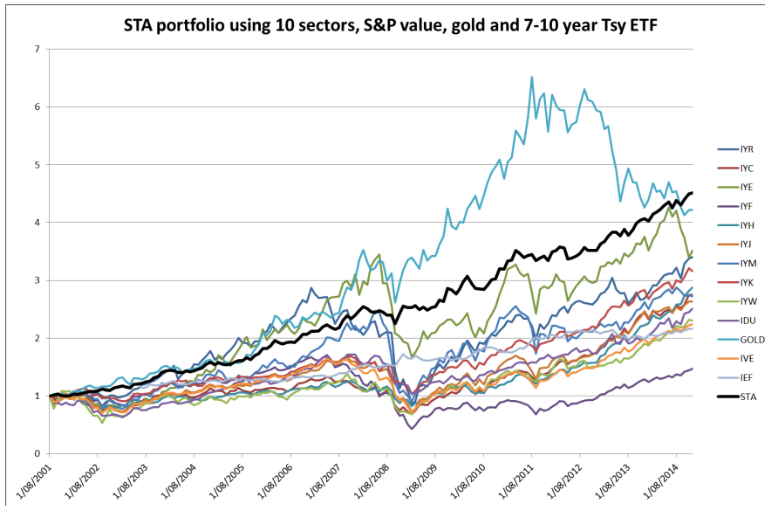
The emerging markets chart to the left was also shown in the October edition of Strategy Thoughts and it too, like the JNK ETF, has continued to decline since then, further supporting the view that a turn has actually been seen.

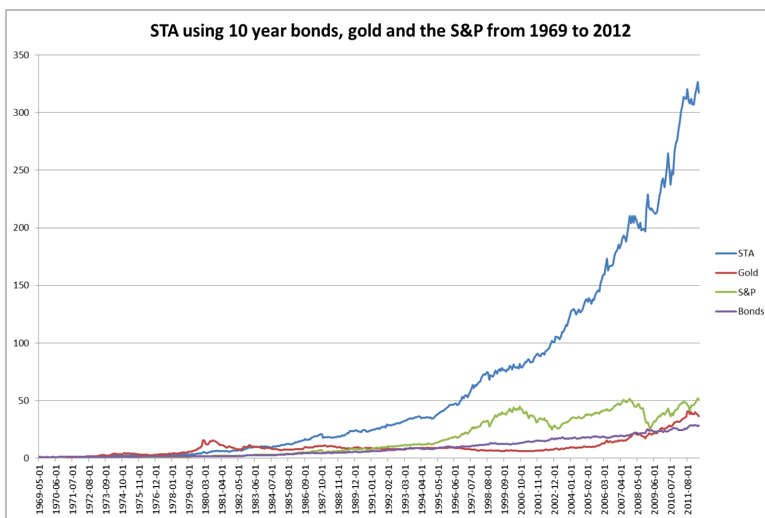
STA update

The more research I have done on my Strategy Thoughts Allocation (STA) portfolio the greater value I have found in a rule based and highly disciplined investment approach that recognises the long term importance of value. Additionally, in what is now shaping up to become an investment product, I have utilised the importance of equal, rather than capitalisation, weightings.

The portfolio will be made up of ETF's representing the ten S&P sectors, The S&P value index, gold and the 7 to 10 year US treasury index. Investment decisions will be made only once a month at the close of the final trading session. The aim of the STA portfolio is not to simply beat 'the market', rather it is to extract a low volatility investment return from this relatively diverse collection of asset markets through either being in or out of each ETF based upon simple, easy to apply, rules. Being rule based the human element of behavioural biases is eliminated and given the passive nature of the underlying investments costs can be kept to a very low level. Work is currently being conducted to enable such a product to be available in the not too distant future, in the meantime I have included a couple of charts that demonstrate the stability and level of return that the STA portfolio would have delivered over the last nearly fourteen years that the ETF's have been available and over a longer time period utilising the same rules but over index returns.

The first chart below shows the performance of the STA portfolio (thick black line) compared to the performance of all the underlying elements. The portfolio delivered an average annual return of 12.33%, a compound annual return of 11.9% and a median annual return of 12.75%. Out of 149





rolling twelve month periods there were only five that were negative with the worst being -5.8% and the best twelve month period was 27%. The worst rolling twenty four month period delivered a return of 8.9%.

Throughout this period the average asset allocation was 27% in treasury bonds, 27% in gold, and 46% in the S&P through sectors and the value ETF. A portfolio rebalanced on a monthly basis to exactly these exposures would have delivered a CAGR of 8.76% with far greater volatility. Rather than just five negative rolling twelve month periods the fixed exposure version delivered twenty two and the worst twelve month fall was -23%.

The second chart shows the result of the STA method applied to 10 year treasury bonds, the S&P 500 and gold for the forty three years from 1969. Volatility of returns and the chance of a negative return were similar to the shorter sample.

Obviously there would have been periods where the STA portfolio markedly underperformed one or more of the underlying assets but one of the disciplines of the STA approach is not to chase those assets. This ensures that the portfolio is not exposed to the most popular, and so vulnerable, assets as the primary goal of the STA portfolio is to deliver meaningful low volatility returns to long term investors.

Clearly there is a growing dissatisfaction with high cost, supposedly active, managers as the excerpt below on the success of Vanguard last year illustrates.

Vanguard sets record funds inflow

> Investors gave stock pickers a resounding vote of no confidence in 2014, pouring $216 billion — a record inflow for any mutual-fund firm — into Vanguard Group, the biggest provider of index-tracking products, according to preliminary figures from the mutual-fund group.
>
> Those large inflows accentuate a trend away from fund managers and toward so-called passive investments that mimic indexes and other benchmarks for a fraction of the cost of the typical mutual fund.

However, the key to long term success, as the STA portfolio illustrates, is not just utilising low cost index funds but employing, and managing, appropriate asset allocations. Every low cost fund is not always the best thing to own.

Finally I would like to thank all those readers who have expressed support and interest in the STA portfolio. If any readers have further questions regarding the development of this product please feel free to contact me directly.

Conclusions

The outstanding performance of the US market over the last few months has masked some of the weakness that investors across geographies and asset classes have actually been suffering. Whilst this has been a positive for those investors solely focussed upon US dollar assets and returns in US dollars it is a far from healthy situation. As I have discussed many times in the past (often employing Dr Marc Faber's 'San Juan Hill' theory that the generals only reach the peak in a battle long after the troops have retreated), healthy bull markets enjoy broad participation, when the breadth of a move diminishes, and only the largest capitalisation stocks are advancing, then the risk of a major reversal increases. This is the situation that is found across the world's markets as the biggest general of them all, the US market, is almost alone in continuing the current bull market.

This, added to the fact that in the US underestimation may be giving way to over confidence is a cause for concern.

My primary aim continues to be to preserve capital. Six years into a bull market is not the time to be taking increased risk, it is the time for increased conservatism, caution and importantly, discipline.

Kevin Armstrong

8th January 2015

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