Strategy Thoughts

November 2015

Cause, Effect, Risk and Deflation

Introduction

This month's Strategy Thoughts was originally going to be titled Cause, Effect and Risk, however, in the last few days I have studied the latest World Economic Outlook from the IMF and have become increasingly concerned regarding the global risk of DEFLATION. Interestingly I am not alone. The IMF's chief economist just last week commented that he was worried about 'deflation globally'. I have written about the risk of deflation many times over the years and it is clear that this risk has only grown, particularly given the extreme falls commodity markets have suffered.

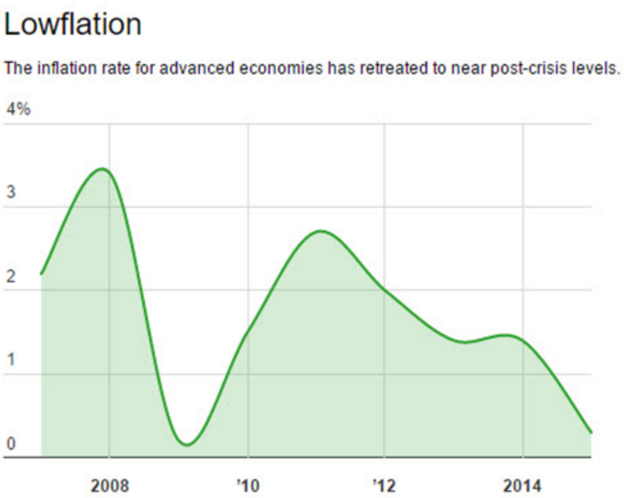
Despite some selected larger equity markets, notably those large cap indices in the US, recovering all or nearly all of their August declines I continue to see the cracks that occurred in the same light that I did last month and that we are still only at the 'end of the beginning' of what will be the next global cyclical bear market

Deflation

Almost five years ago I included a quote from the veteran news letter writer Richard Russell.

In the investment business, it pays to be suspicious of the obvious. If it's obvious, every dim-wit knows about it, and it seldom pays to follow what every dim-wit knows and is operating on.

Example -- Everybody know that inflation lies ahead. Again, be suspicious of what everybody knows. Richard Russell 7th February 2011



It is amazing how things have changed, as this chart (left) from a recent Wall Street Journal article makes very clear. Since early 2011 the inflation rate in advanced economies has done nothing but fall and is now approaching the lows recorded at the depths of the Global Financial Crisis.

That WSJ article was titled:

> Global Inflation Eased in September Despite Wave of Stimulus Measures
>
> Policy makers regard slide into deflation unlikely, but it would be highly damaging should it occur

Two months ago, in the September edition of Strategy Thoughts, I highlighted the futility of the Chinese government's attempts to prevent both an economic slowdown and a stock market retreat. I concluded those comments at that time by observing that it was highly unlikely that any intervention from those in charge 'the authorities' would actual bring about the desired reversal;

> It would be nice if somehow this 'magic wand' could be waved, however, that is not how bear markets end. They end with all 'hope' having been expunged amid general expectations that things are destined to only get worse, usually accompanied by learned economists dramatically cutting forward growth expectations

So far the 'magic wand' appears to have done the trick, albeit in a faltering fashion, however, I continue to believe that it is highly unlikely that the lows seen in China in late August early September were in fact the end of that particular bear market, again, that is not how bear markets end.

Similarly, the 'magic wand' of stimulus measures, referred to in the WSJ, are unlikely to work in reversing the seemingly inexorable downward spiral in inflation. To date that certainly seems to be the case and the risk is that this downward spiral does not stop at 'lowflation' but continues to slide into deflation which, as the WSJ pointed out, would be 'highly damaging'.

The latest World economic Outlook from the IMF is titled 'Adjusting to Lower Commodity Prices', which have undoubtedly been a key contributor to the weakness in both emerging economies growth and inflation globally. In the report the IMF states;

> These global factors—and country-specific developments—point to a **somewhat weaker recovery** in 2015 and 2016 than previously envisaged, and to **higher downside risks**. Growth in advanced economies is projected to increase modestly this year and next year. (emphasis added)

It then goes on to discuss the outlook for inflation;

> The renewed declines in commodity prices will again put **downward pressure on headline inflation** in advanced economies in the coming months and could delay the expected pickup in core inflation as the recovery progresses. While core inflation has remained more stable, it generally is still much below central bank objectives. The outlook is for **inflation to remain subdued**, notwithstanding declining unemployment and weaker medium-term growth potential.

Their forecasts for calendar 2015, which to be fair is almost already over, make disconcerting reading. In advanced Europe they forecast that inflation will be just 0.2%, down from an already alarmingly low 0.6% last year. In Japan they forecast a level of 0.7%, a dramatic fall from the 2.7% of last year, and in the US the forecast is for only 0.1% down from 1.6% the year before. The IMF is therefore forecasting a continuation of the decline in advanced economies inflation rates, shown in the chart on the previous page, right down to almost zero, with the US at 0.1% and Europe at 0.2%.

Interestingly, as that zero boundary between lowflation and outright deflation is approached the IMF look for a dramatic reversal. For 2016 their forecast is for both the US and Europe to experience a massive rebound from that approach to zero, they expect both regions to record 1.1% inflation for 2016. If this were to happen, then everyone, especially 'the authorities' that supposedly can 'engineer' these movements, could breathe a collective sigh of relief. Sadly I fear this may not be the actual outcome.

Economic forecasters generally have their greatest success in forecasting when trends continue, they are good extrapolators. Not surprisingly the longer a trend continues the more confident they tend to grow in their expectation for their extrapolation to continue to be right. Unfortunately this means that they tend to be very bad at forecasting important reversals and there currently seems to be an awful lot of hope pinned on the IMF's forecast for a reversal as zero is approached in inflation.

Not everyone is quite so confident that whatever is currently being done will be sufficient to bring about the forecast reversal. one of those doubters is the IMF's own chief economist;

> Deflation Risks May Warrant Radical New Central-Bank Thinking, the IMF's Chief Economist Says
>
> "I worry about deflation globally," new IMF Economic Counselor Maurice Obstfeld said in an interview ahead of an annual IMF research conference that focuses this year on unconventional monetary policies and exchange rate regimes. "It may be time to start thinking outside the box."

Perhaps the ultimate sign that everything is alright and that there is no need to worry about deflation was written recently in the Financial Times where even these threats of outright global deflation are being given a positive slant. In late October the FT ran a story highlighting how in fact, contrary to prior conventional wisdom, the dramatic slowdown in Chinese growth was a good thing for the world!

> **'Deflationary boom' in prospect as China slows**

It is obviously too early to claim that the world has fallen into a nasty deflationary spiral, however, it is a risk that all investors should be highly aware of. No one should take any comfort in the idea that somehow 'the authorities', whoever they may turn out to be, will do whatever is needed to prevent this outcome, nor should they hope that somehow everything will turn out fine and that somehow deflation will be good. Certainly there can be good deflation, and I have written about Gary Shilling's observations on this matter and recommended his book 'the Age of Deleveraging' many times. Unfortunately good deflation and bad deflation can occur simultaneously and this will be an uncomfortable environment for those seeking returns in higher risk assets.

Cause and Effect (Jeremy Beckwith's blog on Morningstar UK)

I recently read Matthew Ridley's new book 'The Evolution of the Universe'. In the past I have recommended Ridley's book 'The Rational Optimist' as providing a useful and different perspective on many issues but his latest book does an even better job of this. He looks at a vast array of subjects such as; morality, the mind, religion, money, the economy, leadership and the internet, and many more, from an evolutionary perspective. In doing so he repeatedly illustrates that our conventional take on the effect of top down decision making versus bottom up, grass roots, actions is often misplaced and as a result that in general our assumptions about what is cause and what is effect are also often totally wrong.

This is a point I have often made when referring to markets and the economy and so I was pleased, and also entertained when I read the following written by a former colleague and client in London, Jeremy Beckwith, for Morningstar in an article titled 'Is this the Beginning of a US Bear Market?';

> *Markets are commonly understood to be leading indicators of economic activity, despite the fact that most investment manager's reports to their investors focus on how actual economic developments have caused market movements.* ***Market prospects are not divined from economic developments; rather economic prospects are more likely to be divined from market developments.***
>
> *Ever since quantitative easing came to an end twelve months ago, the market expectation for the date of the first increase in the Federal Reserve base interest rate has been six months into the future. This has reflected the Fed's professed data-dependency, the market's*

perpetual optimism that the US economy has always been about to accelerate but also the steady stream of slightly disappointing economic news. Until August's market turmoil, the market, aided by strong hints from Janet Yellen, had priced in a first rate hike by now, but current expectations are once again for a hike in about six months' time.

The US high yield market peaked in May 2014. The most damage over the ensuing eighteen months has been in the energy sector, where much of the financing of the investment in the US shale oil fields was from the high yield market. However yields have also been rising across the rest of the high yield market for those 18 months.

This reflects economic growth disappointing expectations over that period, and the fact that in order to meet analysts' earnings per share expectations, companies have accelerated their share buybacks, and funded this through corporate debt issues. The high yield market has thus been signalling deteriorating creditworthiness amongst US companies, which is typically a leading indicator of an equity market top and economic downturn.

Through 2015 the US equity fund sector has lost the momentum that had sustained its long bull move since March 2009. The S&P 500 gained over 200% in this period, but has since trading sideways and in August it broke the uptrends from both the 2009 and 2011 lows. This fading price momentum was also accompanied by deteriorating breadth as fewer and fewer stocks made new highs as market leadership became concentrated in a few key technology and biotechnology names, and market volumes disappointed.

***These internal market signals, are very typical leading indicators of a developing market top**, and the August breakdown below 2,080 was a market statement that the bull market since 2009 was complete and a bear market, or at best a long sideways correction, had begun.*

In addition the daily market action of the last two years suggested a market that was valuation-driven as long as QE was still on the table, rather than a market led by stronger corporate performance. The market tended to rise on weak economic data, since it implied an easier monetary policy for longer, and tended to fall on strong economic data, implying a nearer, tighter monetary policy.(emphasis added)

I have reproduced much of what Jeremy wrote partly because it touched on the back to front nature in which the majority look at the economy and then use that to justify what they do in the market, and also because he referred to the underlying weakness that is currently being seen in markets as evidenced by market breadth.

This is a subject I have been writing about a lot, often under the guise of 'the generals' and 'the troops'. This refers to the observation that just as the generals only plant the flag on the summit of the hill long after the troops (who actually won the victory and secured the hill) have retreated, so too in markets by the time the only stocks making new highs are the largest capitalisation 'generals' and the smaller capitalisation 'troops' have long retreated it is highly likely that a peak is at hand.

In the US, as Jeremy describes, such behaviour has been very evident for some time and particularly apparent through the recent sell off and recovery. Small caps fell further through the August selloff, made further new lows, as did much of the rest of the world, in late September and have recovered far less of their decline than the almost total recovery experienced by the large cap indices

Last month I referred to the disappointments that European investors had endured over the prior six months and made reference to the troops versus general analogy. I concluded;

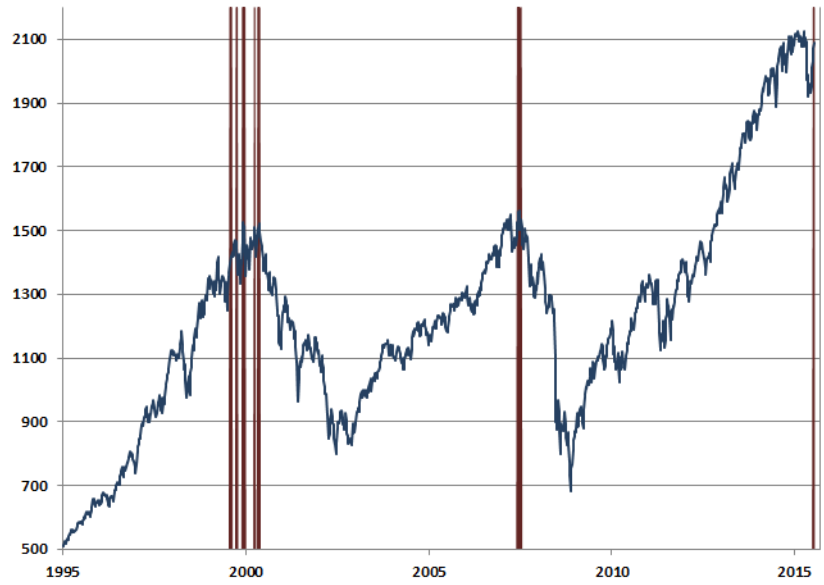
Those elevated expectations for Europe back in April / May have clearly been disappointed and the relative weakness of Europe, and the rest of the 'Troops' may be indicating that the 'Generals' of the US may soon be joining the widespread retreat of equity markets.

The chart below clearly illustrates the poor performance European investors have been experiencing for close to eighteen months when compared to the standout large cap US market. It is also clear that the post August recovery has been substantially muted in Europe.

The same observation can be made about the whole rest of the world. The chart below, that looks remarkably similar to the US Europe comparison above, shows the performance of the MSCI world index excluding the US compared to that of the US. The rest of the world has been underperforming the US for more than two years now, in a downtrend for a year and a half and dramatically underperformed the US's most recent rally.

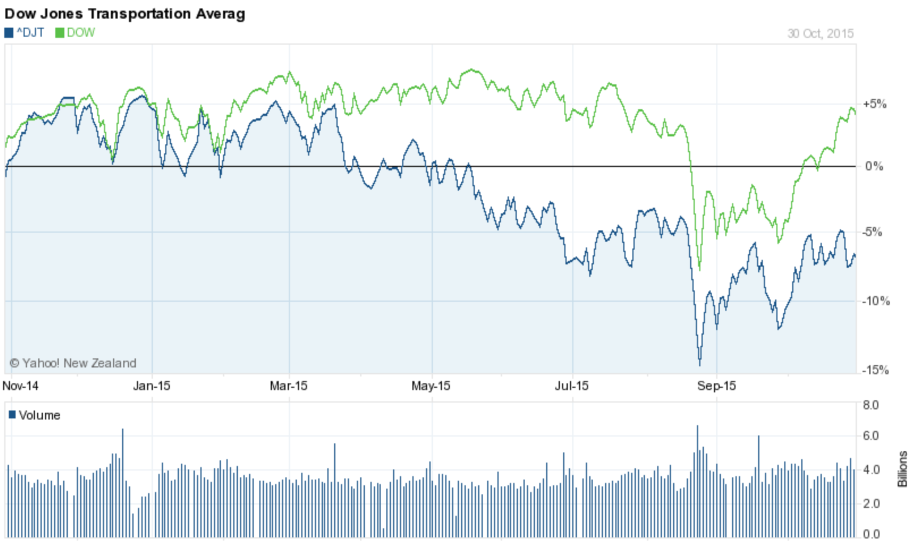
All of this has been great for purely US focussed investors, however, such returns as these investors have been enjoying should not be a source of comfort. Rather the growing divide between the outperforming General that is the US should be seen as a sign of real risk.

John Hussman in his weekly commentary on 2nd November 2015provided another illustration of why US investors should be feeling a little uncomfortable. The chart below shows the last twenty years of action in the S&P500 with the highlighted points being periods, like now, when similar deterioration had occurred within the US market.



1) S&P 500 declines below 200-day moving average following overvalued, overbought, overbullish syndrome during prior 26-week period.
2) S&P 500 recovers above 200-day moving average and within 3% of 5-year high.
3) Market internals remain unfavorable (based on market action across a broad range of securities, industries, sectors, and credit spreads on debt of varying creditworthiness) with fewer than 60% of S&P 500 components above their own 200-day averages

Dow Jones Transportation



Further evidence of the deterioration in the underpinnings of the US market can be found in a comparison between the performance of the Dow Jones Transportation Index and the Industrials Index.

Since late last year the Dow Jones Transportation Average has severely lagged the Dow Jones Industrial Average. The Transportation index peaked in November of last year seven months prior to the peak in the Industrials in May of this year. In that time, as can be seen in the chart above, the Transports fell 10% while the Industrials continued to rally.

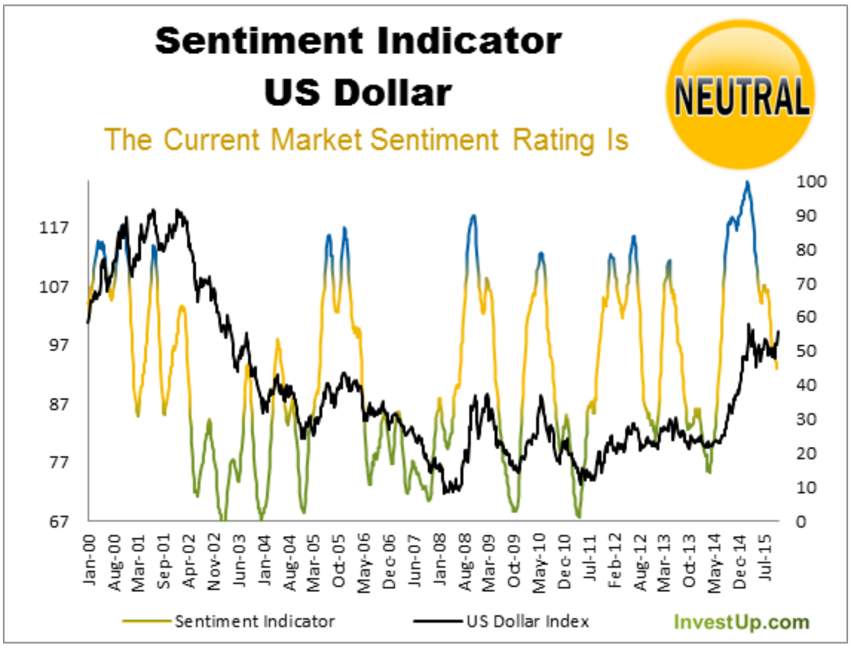
The last time a divergence between these two major indices of this magnitude was seen was in the build up to the NASDAQ's bubble peak in early 2000. Prior to that peak the Transportation stocks peaked in May of 1999, eight months ahead of the Industrials, in the intervening period the Transports fell 25% while the Industrials rose a further 5%.

Obviously neither this somewhat worrying comparison, nor those described earlier, imply that a replay of either the post tech bubble bear market or the GFC associated bear market is imminent, but it should alert investors to the fact that all is not quite as rosy as so many commentators and economists would have them believe. Now is a time for continued vigilance and caution, rather than chasing risk in search of hoped for returns or yield.

The US Dollar

In early February I discussed the action of the US dollar, and particularly the ETF UUP that I had personally employed to gain exposure to the US dollar. At the time I had just sold half my position in UUP largely on the back of what had then become an incredibly bullish sentiment backdrop to the currency in the wake of its remarkable rise. Back then 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.



At the time the sentiment indicator put together by Investup.com had reached an unprecedented 100% bullish as can be seen in the chart (left). Since then, as the US dollar has corrected and meandered sideways, this sentiment extreme has been at least partially unwound and the dollar has once again begun to rally.

I am sorry to say that I was not alert, nimble or bold enough to fully re-establish my position in the ETF UUP, however, I am pleased to say that I still have the balance that I did not sell and, particularly in NZ dollars, it is worth substantially more than the half I sold back in early February.

The chart below shows the last years price action of UUP in US dollars (green line) and the US / NZ dollar exchange rate (blue line). They are far from mirror images of each other, however, there is understandably a degree of inverse correlation.

As I wrote in February I still do not believe the US dollar bull market is over. Given the eight months or more of consolidation that has taken place in the US currency since then and the unwinding of the sentiment extreme that has accompanied this I anticipate further upside surprises in the US dollar. I would therefore not be surprised to see further disappointment in the Kiwi although I expect that the majority of any appreciation in NZ dollars of my UUP holding will now be due to outright dollar strength rather than a replay of the sharp decline in the Kiwi.

Conclusions

Over the last six months it seems an awful lot has happened in financial markets; China has instigated numerous initiatives to stave off economic slowdown and a fall in their domestic market, the devaluation of the Yuan sent world markets into turmoil, volatility rose across most asset classes, commodity markets continued their falls and the Federal Reserve has been in apparently on again off again mode regarding raising interest rates for the first time in almost ten years. Despite all this equity markets are more or less where they were in or around the build up to this recent increase in volatility. A quick review of some of the major equity markets of the world shows the following;

- In the US the Dow Jones Industrial Average is currently at the same level it was four months ago in July. It is also still at the same level it was in February of this year and November of last year.
- In Europe the broad Euro Stoxx 50 index, despite a vigorous rally over the last six weeks, is flat with where it was in both August and February of this year. Still in Europe the UK market has not fared so well. It has made no progress over the last four weeks, it is flat with where it was in August, but it is also still at the same value it was in January of this year and February of 2013.
- The Japanese market is flat since August and is also unchanged since March of this year.
- The Hong Kong market is, like so many others, unchanged since August, but is also flat since June of 2011 and November of 2009.
- Finally the Australian market is flat since August and also still at the same levels it traded at in August and March of 2013.

So despite all the volatility and turmoil that has been witnessed over the last few months equity markets have, on balance, made little progress. More worryingly is that so many have made little if any progress in a number of years now. It is beginning to look like the standout performer of the last few years, the US equity market, is becoming increasingly alone and more and more looks like the 'last General planting the flag'. It certainly highlights the fragility of what so many continue to view as a healthy bull market.

As deflationary pressures continue to mount, and the impotence of 'the authorities' to do anything about it become more obvious markets are likely to become even more fragile and prone to bouts of extreme volatility. Through such an environment the depth and liquidity of the US dollar will become increasingly prized and I continue to believe that preservation of capital will be the most prudent, and rewarding, investment strategy. As I wrote last month, eventually this will lead to a period of remarkable opportunity, albeit accompanied by remarkable discomfort, but we are not there currently. Now is not the time to chase yield or return, patience and discipline will be rewarded, firstly by avoiding exposure to increased volatility and downdraughts and secondly through preserving buying power for when true long term opportunities do eventually arrive.

Kevin Armstrong

10th November 2015

Another recommendation

As I have been finishing this month's Strategy Thoughts I have also been finishing another book that deserves a recommendation; 'Super Forecasting, the art and science of prediction', by Philip Tetlock and Dan Gardner. On the cover Nobel laureate Daniel Kahneman, whose 'Thinking Fast and Slow' I strongly recommended four years ago, writes simply; 'A manual for thinking clearly in an uncertain world. Read it.'

It seems that a number of individuals do possess the ability to forecast the outcomes of a vast array of events with a degree of success that is far from average or random (which is actually all that the majority of headline grabbing forecasters achieve). Among their keys to success are humility, they are very quick to change their mind and so their forecast as events unfold, and the discipline to recognise, and more importantly avoid, the many behavioural biases that so best us all. Not surprisingly these are also among the traits required to become a successful investors.

Usefully, for those who would like to improve their forecasting skills, the authors provide an appendix containing the 'Ten Commandments for Aspiring Superforecasters'. I won't list them all here but I highly recommend the book and for those interested more can be found out about the studies that resulted in the book at www.goodjudgment.com.