Strategy Thoughts

November 2017

What do tops feel like, and what are credit markets forecasting now that everyday it's RISK ON

Introduction

I concluded last month's Strategy Thoughts with the comment that 'the risk of something dysfunctional happening' had continued to increase. Since then nothing dysfunctional has happened, the 'benign' grind higher has continued, but with this so too has the risk. Narrowing credit spreads, rising economic and earnings forecasts, dip buying and yield chasing are all signs of elevated and rising expectations, all of which raises the possibility of disappointment and so an important market top in many assets. In this month's Strategy Thoughts I review the characteristics that are typically seen at market tops and conclude that many are already in place and raising the warning flags that most are only too happy and comfortable to ignore. Finally I examine the conundrum facing the majority of central bankers around the world, their impotence to break the deflationary spiral we have been in for years and actually drive up inflation.

What do tops feel like

Almost fifteen years ago, in December 2002, with the S&P500 still down more than 40% and the NASDAQ having been down more than 80% I wrote a piece that I wanted to title 'What do Bottoms Feel Like?'. Unfortunately my employer at the time didn't appreciate the title so it was changed to the somewhat bland 'Is now the time to buy international equities?' Whilst this may not have had as much immediate impact the conclusion was the same. With expectations so bleak after the worst bear market in decades the environment was similar to that seen at other great buying opportunities in history. Buying opportunities do not come along when everything is starting to recover and look healthy again and economists are raising growth forecasts, by the time this is seen the bottom will be long past. A similar approach served me well in early 2009, in fact I frequently referred to that 2002 article back then, when the financial world as we knew it was supposedly ending. Both those bottoms shared similar expectational characteristics and both witnessed dramatic, and almost immediate, reversals. Bottoms, it seems, frequently share this trait, an extremely negative and emotionally driven sell off that could be characterised by 'get me out while there is at least some value left' driven by, and justified by, an accompaniment of daily downgrades on the parts of economists and analysts. Unfortunately tops have rarely been as obvious, except with the benefit of hindsight. Tops are frequently rolling affairs, where the number of stocks making new highs narrows continually and so different sectors peak at different times. Most recently this was seen in 2005 through to 2007.

It is now conventional wisdom that the cause of the equity market and economic downturn associated with the Global Financial Crisis was the US housing bubble driven by increasingly loose lending practices. What is less well remembered is that the stocks of homebuilding companies, those that directly benefited from the boom, peaked long before the stock market top occurred. Homebuilders in the US enjoyed a rampant bull market through the first five years of the 2000s with individual companies such as Pulte Homes, D R Horton or Lennar rising 10 to 15 times in value through to the end of July 2005, more than two years before the final stock market peak. From those frenetic peaks most of the homebuilder collapsed, falling back to the levels they had languished at five years before their peaks.

Perhaps most instructive for investors wondering what might accompany an impending top, in addition to sectors rolling over at different times, is that it wasn't until early 2006, six months AFTER the peak, that the two largest ETFs for retail investors wanting to capture the housing boom (even though the bubble had already burst) were launched. A proliferation of offerings associated with whatever is thought to have been driving the bull market is almost always seen at major market peaks and frequently some of those IPOs are the biggest ever. Peaks are also frequently accompanied by enormous mergers that later only look to have been a good idea if the already inflated expectations had been exceeded. This was seen at the peak of the commodity boom with Glencore's ill-timed and enormous IPO, just after the commodity bubble had burst. It was also seen at the crescendo of the tech boom when the enormous, and also terribly ill-fated merger of AOL and Time Warner was announced.

Major peaks may be frustrating as they are rarely as concentrated and obvious, even with hindsight, as bottoms but they do share a number of characteristics, most of which are understandably the reverse of those witnessed at bottoms.

Peaks are always accompanied by extremely elevated expectations and ever increasing and optimistic forecasts from economists and analysts. This all results in ever larger, and ultimately risky, deals that may result in unprecedented mergers or massive IPOs. And frequently the number of vehicles for retail investors to access what by then is very much an aging boom proliferates.

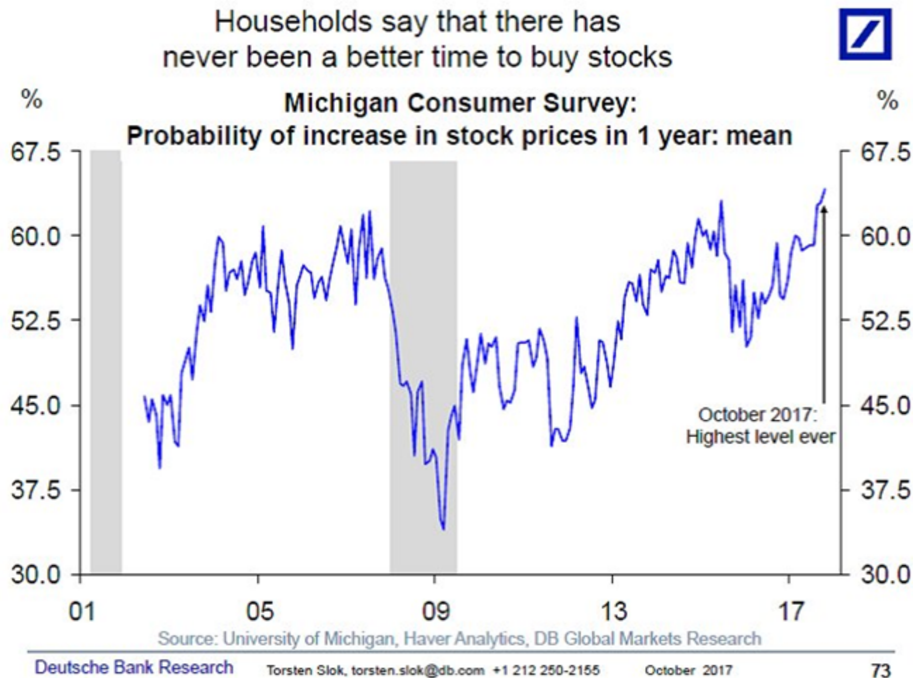
With all this in mind it is interesting to look at the current market situation.

Expectations

As I have documented for some time, expectations are elevated and are becoming more elevated daily. Morningstar recently published an article that focussed upon where expectations are on the part of retail investors in the US:

Retail investors see this as the 'best time ever' to jump into stocks. Time to worry?

The article highlighted that "both retail and institutional investors seem to be warming up to the market, showing more confidence that the multiyear rally has some more gas in the tank." And that fund flows into equities were accelerating. The article included research from Deutsche Bank that showed, based upon consumer sentiment surveys, retail investors in the US currently viewed now as the best time EVER to get into the market.



This incredible observation reminded me of a survey conducted in late 1999 by Paine Webber and Gallup. One of their findings then was that amongst investors who had been involved in the stock market for five years or less (a period that had witnessed virtually no setbacks) 'expected' annual returns from the stock market of 22%. Obviously, we now know that these extreme expectations were about to be severely disappointed. Unfortunately, the chart above does not go back to 1999 but the fact that the highs seen in 2007 have been surpassed should be a warning sign to all investors, not a green light or all clear.

The Morningstar article also highlighted;

- The extremely elevated position of the CNN fear and greed index.
- The high levels of bulls and retreating number of bears in the widely followed AAII survey.
- And a growing faith in the "Goldilocks" scenario rather than fear of stagnation.

The best time to be invested is NOT when the vast majority believe that it is. That position may have been uncomfortable for some time, and may continue to be uncomfortable, but the risks of the 'dysfunctional' outcome I discussed last month continues to increase.

Economic and earnings forecasts

The IMF in their October quarterly economic outlook wrote;

> The earlier projected increase in growth is strengthening. Notable pickups in investment, trade, and industrial production, coupled with stronger business and consumer confidence, are supporting the recovery. With early 2017 growth generally stronger than expected, upward revisions to projections are broad based.

And they upgraded their global growth forecasts for both 2017 and 2018.

At about the same time the OECD came out with a very similar finding;

> The OECD projects that the global economy will grow by 3.5 percent this year and 3.7 percent in 2018, with industrial production and trade picking up and further acceleration in the rebound of technology spending. The projections reflect modest improvements in the global economy since the previous Economic Outlook in June 2017.

Finally, as far as earnings estimates are concerned, and these are always a lagging indicator, forward forecasts for the final quarter of 2017 are now holding at a level of over 10% growth, something that has rarely been seen since the GFC. It is also noteworthy that analysts' estimates are holding up, whereas usually analyst estimates begin each quarter at a high level and then gradually get ratcheted down.

It's RISK ON, another perspective on elevated expectations?

On the 16th October Bloomberg ran the story;

Everything's Crazy and the Markets Aren't freaking Out

The article pointed out that despite the threat of nuclear war, Russian meddling or disruptive weather events nothing seems to distract US investors from pushing the market ever higher. The article even quoted the recent Noble Laureate Richard Thaler, a noted behavioural economist, who recently commented that he couldn't understand why stocks kept going higher.

The article concluded;

> So what's going on? After all, during most of the first 8½ years of the bull market, the mood was paradoxical. Although stocks rose, many investors scarred by the financial crisis acted as though they hated owning shares again, and every obstacle was framed as the next big meltdown (even as the underlying fundamentals remained strong). Now, everywhere you look—swelling stock valuations, hot sales of new cryptocurrencies, IPO shares with no voting rights—investors are embracing their speculative side. In the language of Wall Street, every day it's **"risk-on."** (emphasis added)

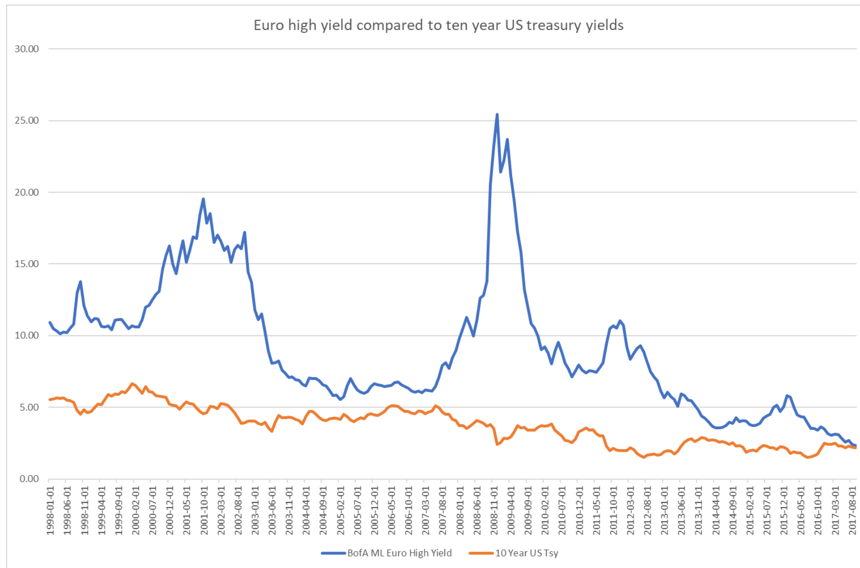
The credit market's perspective on expectations

The October 7th edition of The Economist, in an article titled 'The bubble without any fizz', referred to research by Harvard's Jeremy Stein, and two co-authors at the Fed, that highlighted 'that when the mood in credit markets is bullish (ie. Corporate bond spreads are unusually narrow and the share of junk bond issuance is high), the economy will soon suffer, with an abrupt tightening of credit and slower growth.'

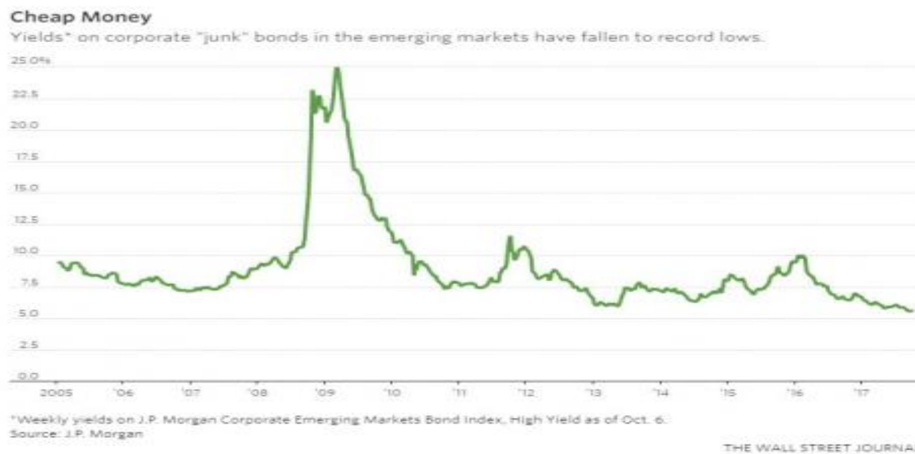
Stein's actual research paper, referenced by The Economist, included the following;

> In particular, in U.S. data running from 1929 to 2013, we find that when corporate bond credit spreads are narrow relative to their historical norms and when the share of high-yield (or "junk") bond issuance in total corporate bond issuance is elevated, this forecasts a **substantial** slowing of growth in real GDP, business investment, and employment over the subsequent few years. Thus buoyant credit-market sentiment today is associated with a **significant** weakening of real economic outcomes over a medium-term horizon. (emphasis added)

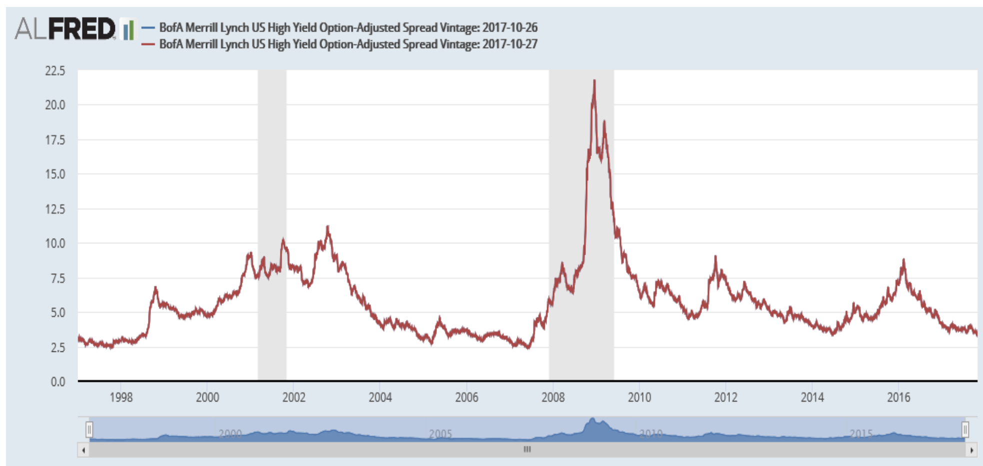
The chart below illustrates just how narrow high yield spreads in Europe have become.



The Wall Street Journal recently highlighted how the chase for yield and risk aversion had pushed yields on Emerging Market Junk bonds to record lows;

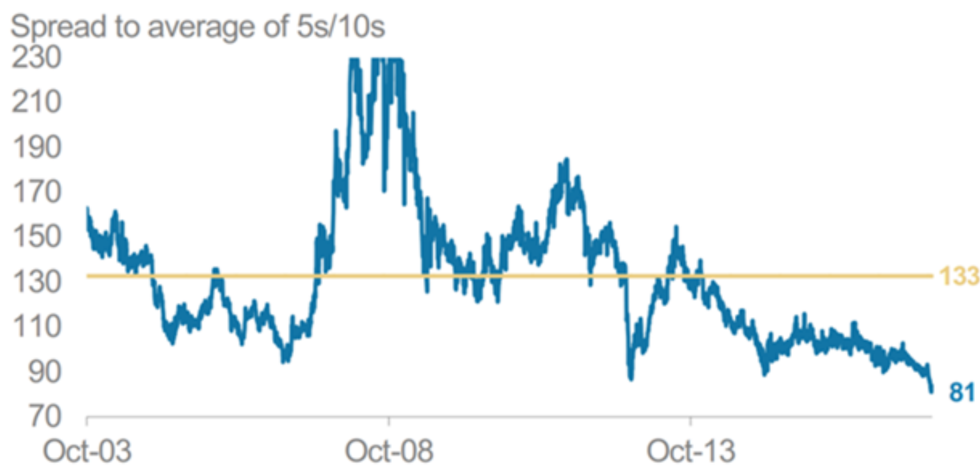


And the chart below shows that spreads between US high yield and treasuries have fallen to their lowest level since July 2007



Finally, spreads between mortgage backed securities, those vehicles that were so central to the Great Recession or GFC, and treasuries have also narrowed to record lows;

Exhibit 2: MBS spreads: Near tights



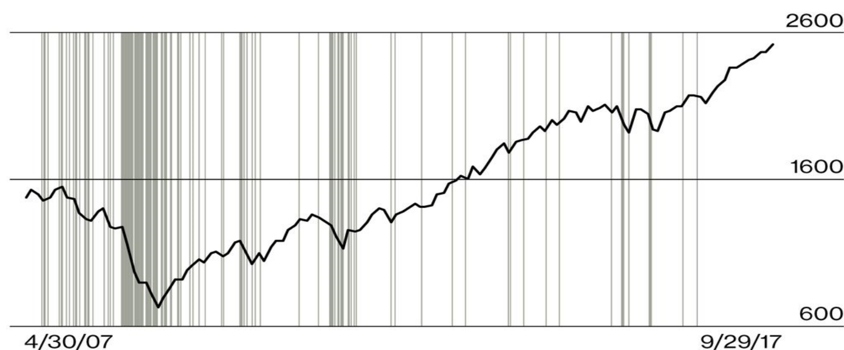
Source: Bloomberg, Morgan Stanley Research

None of this means that a top has already been seen, or is necessarily imminent, however, it is yet another characteristic seen around tops and should be a warning sign that expectations are high and that yield chasing is rampant, neither of which should be a source of any comfort to an investor.

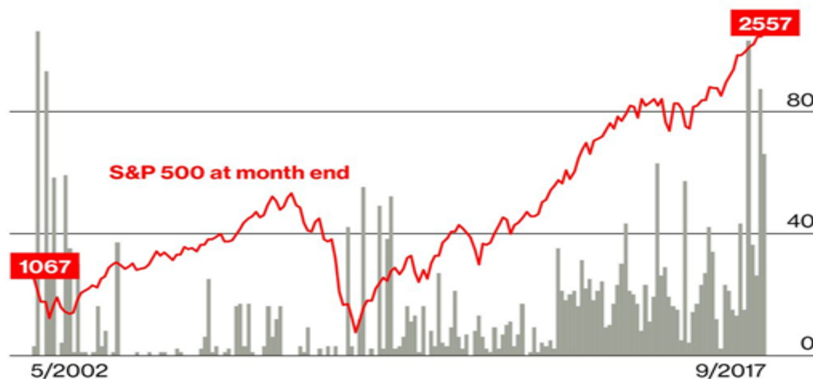
Buy the dip

Another characteristic found in the build up to, and aftermath of, important tops is a growing conviction that all dips, or minor sell offs, should be bought. This is the exact opposite of the behaviour seen around important bottoms where all rallies are seen as last chances to get out, and the start of what becomes the next bull market is always derided as nothing more than a 'dead cat' bounce.

The effect of this behaviour can be seen in two charts recently produced by Bloomberg. The first shows that the frequency of even minor set backs in the US equity market has diminished to the point of almost non existence. Even sell offs of less than 2% are seen as dips that must be bought.



This is another way of looking at the phenomenon I likened last month to a too regular heart beat that can lead to something 'dysfunctional' happening. But the reason for this behaviour in the market can be seen in the next chart that quantifies the frequency of reference to buying the dip in mainstream media. Early in a bull market it is virtually unheard of but the longer the bull market runs the louder and more frequently that 'buy the dip' can be heard.



A recent example of the clarion cry of 'buy the dip' was seen in emerging markets. After suffering their first set back (albeit only a fraction of one percent) of the year in September the markets rebounded in October. Bloomberg reported this behaviour with the following headlines;

Hear no Evil, See no Evil is the mantra for emerging stocks

Don't be fooled by a little slump. That's the message emerging-market stocks sent investors when they rebounded from the first monthly loss of the year.

Rising expectations, improving economic and earnings forecasts, increased confidence, narrowing spreads and yield chasing and dip buying behaviour may feel good and probably further boosts already elevated levels of expectations and confidence, however, these should all be seen as a warning sign, and the more they occur simultaneously the more clearly and loudly that warning should be heard.

Deflation

On the 11th October the Financial Times ran a major article in their 'Big Reads' section that highlighted just how misplaced the faith so many investors have in the abilities and prescience of central bankers actually is. The article, which is well worth reading, was titled;

Central bankers face a crisis of confidence as models fail

The new masters of the universe are struggling to understand what makes a modern economy tick and their actions could prove harmful

Over the years I have repeatedly maintained that economists in general, and central bankers in particular, invariably react to what has happened and then tend to extrapolate the recent past into the future. Just last month in Strategy Thoughts I included the following quote from the then chairman of the Federal Reserve Ben Bernanke;

> The global economy continues to be strong, supported by solid economic growth abroad. U.S. exports should expand further in coming quarters. Overall, the U.S. economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend.

This was his considered, and at the time widely followed, assessment in mid 2007, just ahead of the worst economic contraction and stock market collapse for seven decades. With the benefit of hindsight this view can be seen as having been nothing more than an extrapolation of the growth that had already been seen and demonstrated no apparent concern about the possibility of the earth shaking reversals that lay just ahead. What is most surprising is that despite the repeated failings of economists and central bankers to forecast important inflection points in the past the vast majority of investors continue to cling to the hope that somehow this same group of people will possibly provide some warnings if danger is approaching. And perhaps even prevent anything too bad from happening. This was the role of the 'Plunge protection team' that was put in place of the 1987 crash, yet since then world markets have suffered some of their largest plunges in history, from the Nikkei collapse to the Asian crisis, the Russian default and LTCM, through to the bursting of the tech bubble and most recently the Great Recession.

What should be most surprising is that only now, after three decades of 'plunges', are central bankers facing a 'crisis of confidence'. The FT article was primarily focussed upon the failure of falling unemployment and global economic growth to produce any meaningful uptick in inflation. It reported that their economic models were failing and that doubts existed as to whether they understood the effects of interest rates and other monetary policies on the economy. Some extracts from the article include;

- **The root of the current insecurity around monetary policy is that in advanced economies — from Japan to the US — inflation is not behaving in the way economic models predicted.**
- **The normal relationships in the labour market have broken down.**
- **"Our framework for understanding inflation dynamics could be mis-specified in some fundamental way," Janet Yellen**
- **Claudio Borio, chief economist of the Bank for International Settlements, which provides banking services to the world's central banks, says: "If one is completely honest, it is hard to avoid the question: how much do we really know about the inflation process?"**

- **If it was not bad enough that the link between the economic cycle and inflation has broken down, the second fundamental problem in central banking is that estimates of the neutral rate of interest — seen as the long-term rate of interest that balances people's desire to save and invest with their desire to borrow and spend — appear to have fallen persistently across the world.**
- **One question posed by Richard Barwell, a senior economist at BNP Paribas, is whether they should let on about how little they know. "It's rather like Daddy is driving the car down a hill, turning round to the family and saying, 'I'm not sure the brakes work, but trust me anyway'," he says.**

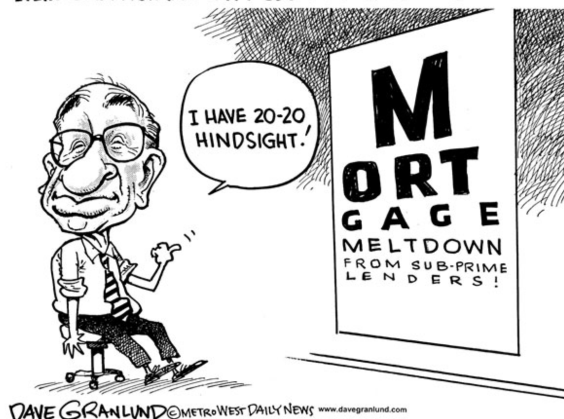
More than six years ago I included the following quote from Richard Russell

> 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.

It now seems clear that Russell was far more prescient than those 'dim wits' he referred too, and most central bankers.

In addition to listening to Russell, central bankers and investors would have done well to heed the warnings put out by A Gary Shilling in his magnificent tomb, 'The Age of Deleveraging', a book I strongly recommended back in 2011. Whilst all of his recommendations and warnings have not come about (perhaps yet), his general thesis has been far superior to the mainstream extrapolations that continue to dominate, albeit with increasing questions finally being asked!

Unfortunately, this is just another example of the majority of investors placing too much faith in things that feel like they should, but actually don't, drive markets. Markets are ultimately driven by the ebb and flow of social mood and the effects this has on aggregate expectations, and important reversals occur when expectations reach extremes.



Conclusions

Expectations are now at historic extremes on several of the measures discussed this month, the risk of disappointment and so something 'dysfunctional' happening is high. Investors would do well to take little comfort from the confident forecasts of economists and analysts and should see the 'crisis of confidence' amongst central bankers as yet another indication of markets not working in the mechanistic manner that so many would like. A top of some significance may already be in place in

some assets and may be imminent in many others, preservation of capital continues to be of the utmost importance.

Kevin Armstrong

1st November 2017

Disclaimer

The information presented in Kevin Armstrong's Strategy Thoughts is provided for informational purposes only and is not to be considered as an offer or a solicitation to buy or sell particular securities. Information should not be interpreted as investment or personal investment advice or as an endorsement of individual securities. Always consult a financial adviser before making any investment decisions. The research herein does not have regard to specific investment objectives, financial situation and the particular needs of any specific individual who may read Kevin Armstrong's Strategy Thoughts. The information is believed to be-but not guaranteed-to be accurate. Past performance is never a guarantee of future performance. Kevin Armstrong's Strategy Thoughts nor its author accepts no responsibility for any losses or damages resulting from decisions made from or because of information within this publication. Investing and trading securities is always risky so you should do your own research before buying or selling securities.