**Strategy Thoughts**

**January 2018**

## The Underestimation FLIP ahead of a MELT UP!

### Introduction

Last month I focussed upon the dangers of FOMO, fear of missing out, now it seems that there is a reason for FOMO if the general media is to be believed, markets are apparently on the verge of a Melt Up! This month I will look at what the rapid acceptance of a potential melt up may mean for expectations and also what it may mean for most investors. Not surprisingly I will highlight the danger of investing in the hope that one actually occurs. This melt up talk has also influenced the expectations of those 'experts' that routinely put out year ahead forecasts at this time of year for where the market will go. What is now occurring is a game of leap frog amongst them as each has to raise their forecasts as the markets rise and other's forecasts rise. As a result we may be witnessing the flip from underestimation to possibly over estimation historically seen ahead of reversals. Expectations, as evidenced by the melt up talk, on the part of the majority of investors and commentators, are undoubtedly stretched and this is also a trait frequently seen ahead of important market reversals.

### The FLIP

Forecast for what a market will do in the year ahead abound as one year ends and another begins, this has always been the case and probably always will be but there is no reason why the next twelve months should be any more clearly divined at one point in a year or another. Unfortunately, history has repeatedly shown that the accuracy of year end forecasts is poor, they have always tended to be extrapolations of what has already happened, they tend to underestimate until starting to overestimate at just the wrong time (both on the way up in bull markets and down in bear markets), and they generally always miss important inflection points. It seems that 2018's crop of forecasts will likely continue to capture these characteristics. On 22nd December Bloomberg reported;

**Wall Street's Rushing to Raise S&P 500 Forecasts for 2018**

> Two more Wall Street strategists bumped up their 2018 forecasts for the S&P 500 just days before the new year starts.
> Jonathan Golub of Credit Suisse Group AG now predicts that the benchmark index will end next year at 3,000, up from a previous target of 2,875. Wells Fargo & Co.'s Chris Harvey boosted his projection to 2,863 from 2,784.

On the same day CNBC reported similar news;

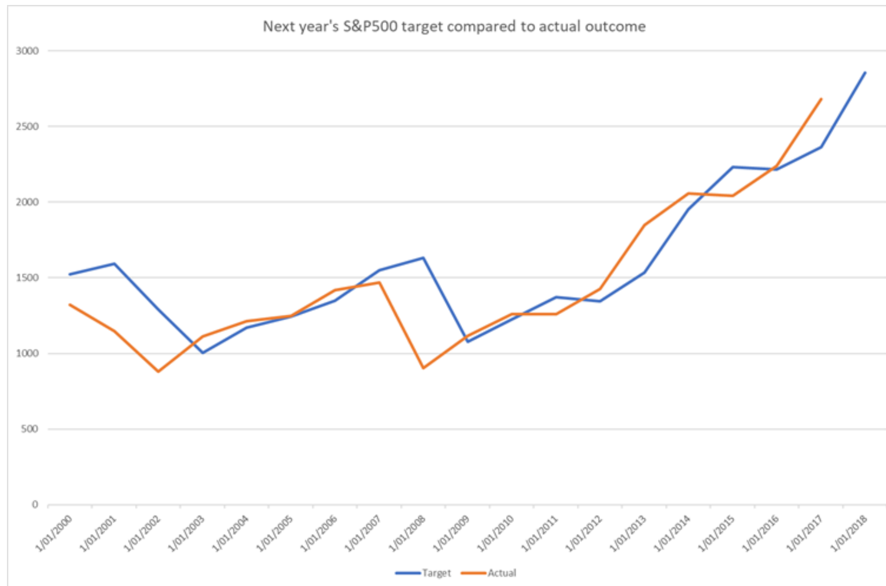
**The stock rally is unfolding so fast investment banks are already raising their 2018 forecasts**

That article concluded;

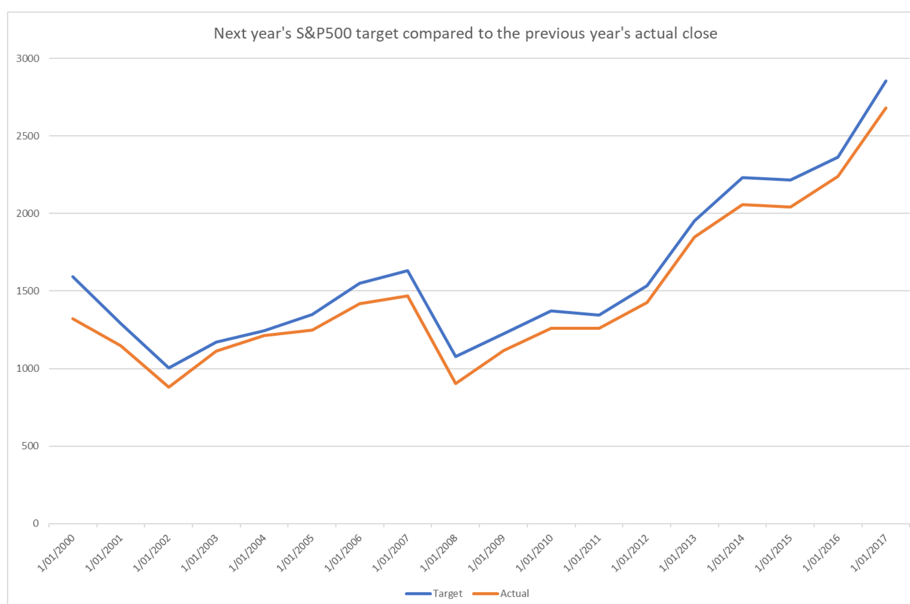
> The flood of optimism on equities comes even as the S&P notches daily records: The index closed at an all-time high Monday and fell just short of beating that record Thursday, up more than 20 percent this year. For its part, the Dow Jones Industrial Average has closed at a record high 70 times this year, the most record closes in a single calendar year. The index added 55 points Thursday.

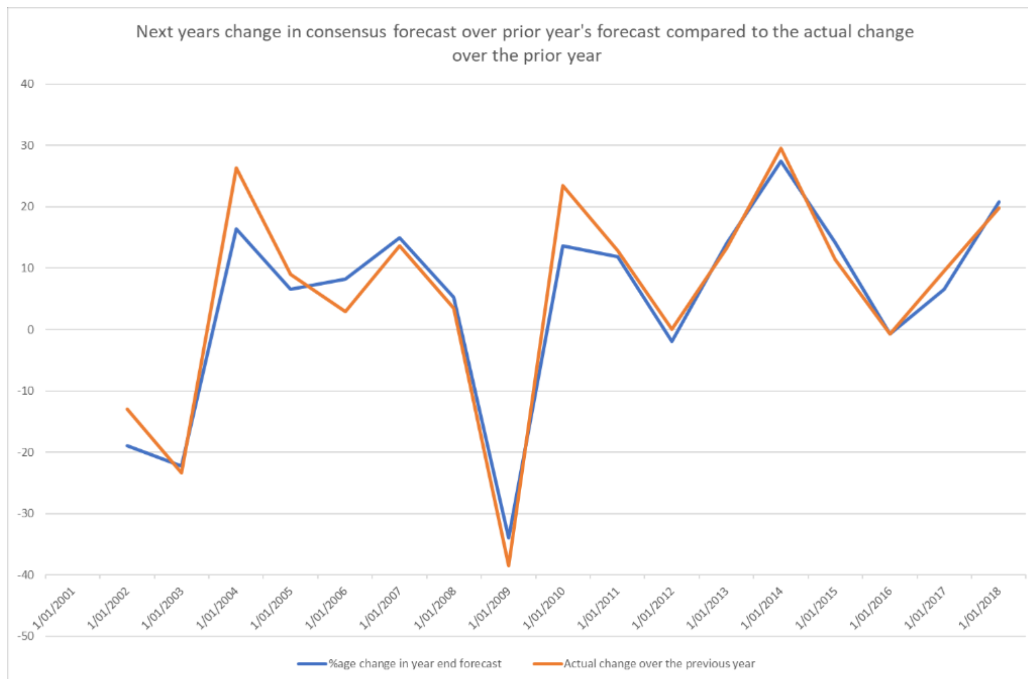
The question investors need to ask is what is leading what?

In late December the Bespoke Investment Group published a table of consensus year end targets for the S&P500 and compared them to the actual outcome. I have reproduced these targets and outcomes in the graph below. It is clear that one of these lines, the orange one, is leading the blue line. When the orange line slows down or reverses so too does the blue line, but with a lag of twelve months. The orange line is an excellent forecaster of the blue line but sadly this provides investors with no insight what so ever as the blue is the forecast and the orange is the actual. The prevalence of this tendency to extrapolate the previous year's results into the next year can be seen when the blue line, the 'forecast', is brought back twelve months.




When the target for the next year is compared to what actually happened the previous year the correlation clearly becomes more obvious. Unfortunately for investors this is not particularly helpful as all the important inflection points, when a bull market turns into a bear market, or vice versa, are missed.






No one should be surprised that the consensus forecast for next year is 20.8% higher than the consensus forecast twelve months earlier. That is almost exactly how much the market actually rose last year. Year after year, how much the market rose or fell over the previous year is an incredibly good forecaster of what the consensus view will be compared to the consensus view the year earlier as the chart above shows.

What has happened in the markets over the prior year is far and away the largest drivers of what forecasters believe will happen over the next year, and invariably, the better a market is doing, the better the forecasters think it will do, this can easily be illustrated by the forecasts ahead of the Global Financial Crisis.

As 2007 drew to a close there was much to be concerned about, not least of which was the deflating US housing market, but this did nothing to dampen the enthusiasm of Wall Street Strategists surveyed by Barron's under a banner headline;

**A Bullish Call**

The strategists' consensus expectation was for the bull market to continue as they forecast a continually rising market with targets as high as an 18% rise.

The article concluded;

> Yet if Wall Street's strategists are right about the market, the rich will get richer in 2008, along with most other equity investors. Chances are, the ride won't be smooth and the direction won't always be clear -- but by now we're used to that.

With the benefit of hindsight, we now know that the final sentence was spot on except for the fact the direction was clear, and it was down, not the hoped-for rise.

The first week of this New Year saw equity markets the world over rally prompting Bloomberg to describe the situation as;

## Equity Euphoria Grips the Entire World

That 'euphoria' was illustrated in the following chart depicting almost the entire world's equity markets as being overbought

Obviously, things can get more overbought, and markets can remain overbought for a long time, however, investors should realise that now is not the time to get more excited, rather one should become increasingly cautious.

Another side effect of this early year's strength is that the analyst estimates described earlier are beginning to look too modest, as Bloomberg highlighted with the following headline;

## US Equity Market Melt-Up Already Obliterating Analysts' 2018 Targets

This early rise will almost certainly spawn repeated revisions and upgrades in year end targets, and the leap frogging will continue, at least until the bull market ends. As the earlier example shows, forecasts are predominantly driven by what has happened and tend to be extrapolations and are therefore lagging indicators with no predictive insight. Nonetheless, they can be self-fulfilling for a while and can therefore result in what Jeremy Grantham has described as a potential Melt Up in his latest commentary.

**A Melt Up!**

Since the beginning of the year there has been increasing talk of, and a growing conviction around the possibility of, a stock market melt up;

A Financial Times headline read;

**New Year's Global Stock Market 'Melt Up' Silences Bears**

CNBC ran;

**Legendary investor Bill Miller: Market could be headed for a 'melt-up' of 30%**

Bloomberg reported;

**Blackrock's Rupert Harrison Sees a Market 'Melt Up'**

Some, but certainly not all, of the Melt Up talk has appeared as a result of comments by GMO's Jeremy Grantham in his latest market letter for clients. He began his latest commentary with;

> I recognize on one hand that this is one of the highest-priced markets in US history. On the other hand, as a historian of the great equity bubbles, I also recognize that we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market.

And he concluded with the following summary points;

- A melt-up or end-phase of a bubble within the next 6 months to 2 years is likely, i.e., over 50%.
- If there is a melt-up, then the odds of a subsequent bubble break or melt-down are very, very high, i.e., over 90%.
- If there is a market decline following a melt-up, it is quite likely to be a decline of some 50%.
- If such a decline takes place, I believe the market is very likely (over 2:1) to bounce back up way over the pre 1998 level of 15x, but likely a bit below the average trend of the last 20 years, as the trend slowly works its way back toward the old normal on my "Not with a Bang but a Whimper" flight path.4

His suggested strategy to deal with a melt up and its aftermath;

> if we have the accelerating rally that has typified previous blow-off phases, **you should be ready to reduce equity exposure, ideally by a lot if you can stand it, when either the psychological signs become extreme, or when, after further considerable gain, the market convincingly stumbles.** If you can't cope with this thought and can't develop and execute an exit strategy, then sit tight and ignore all this advice, except for an overweighting of Emerging. (emphasis added).

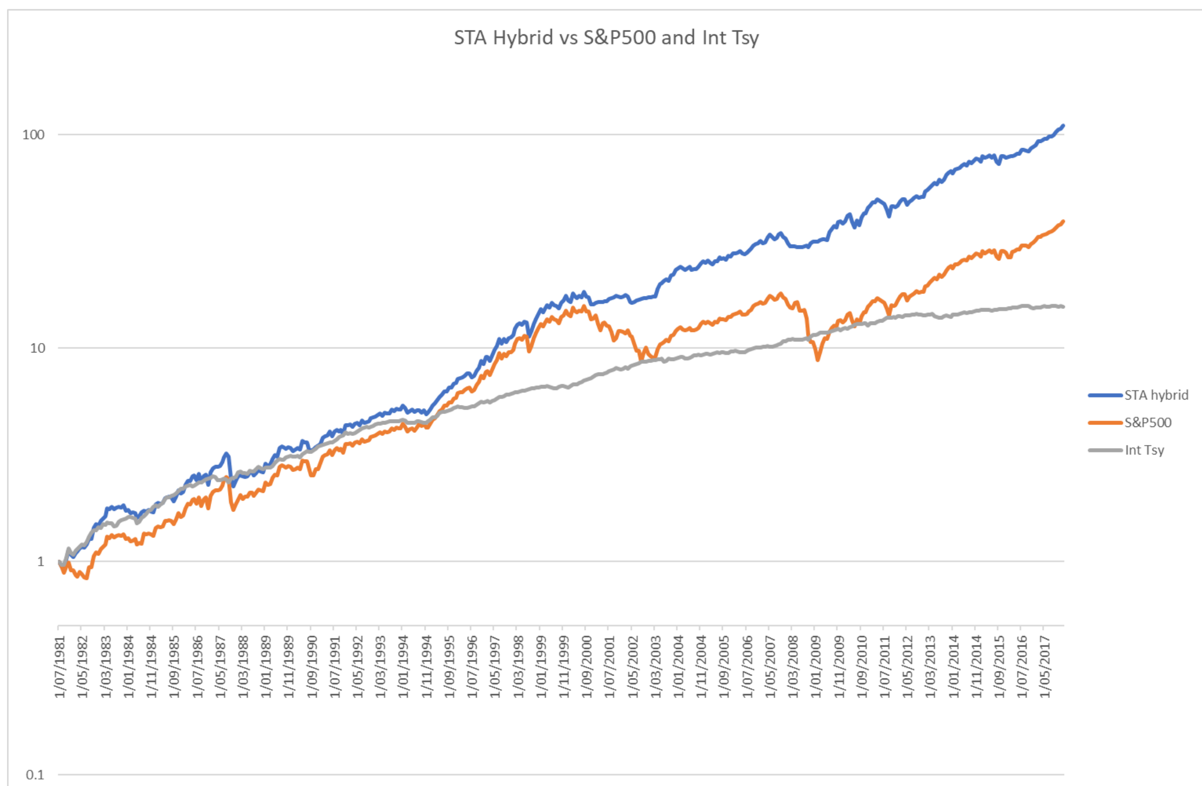
Obviously this current bull market that began in early 2009 has lasted substantially longer than I expected, and a melt up is entirely possible. However, it is also possible that what has already been seen may one day be looked back upon as having been the melt up and that this point of recognition we are currently witnessing marked the beginning of its imminent demise. Whether further 'melt up' eventuates or not it is important that investors also recognise the downside of a Granthamesq melt up. If his estimations are correct then the market may rise to an incredible crescendo, 50% above current levels, before collapsing by 50% (an outcome he believes to be 90% probable). This would leave the market 25% below its current level a few years from now.

The chances of an investor benefiting by investing in the last stages of a blow off are very remote as anyone jumping into the latest dot.com offerings in late 1999 can testify. The problem is that everyone involved wants the party to continue and so are only too happy to believe that any sell off is just a 'healthy correction' and another buying opportunity. Unfortunately, the last 'healthy correction' always deteriorates into a miserable bear market. Playing this game can be very dangerous and I continue to consider the downside risks in equities far outweigh any last stage blow off potential.

This is where the STA approach, which in all honesty has been far more successful during the latter half of this bull market than my own judgements have been, comes in.

**Avoiding the aftermath of a Melt Up – The STA approach**

It has been some months since I last commented on the performance of the STA portfolio, over that period I have continued to refine and simplify this approach. In summary, the key features of the STA approach, as I outlined in 'Investing-The Expectations Game', are that it should be simple, with decisions only being taken once a month and that those decisions must be solely based on price action. The new STA approach is driven by three simple questions; is the market above its 13 month moving average, is the 6 month moving average above the 13 month moving average and is the market up over the prior six months. If any one of these conditions is met then an investor is fully invested in the market, to be out of the market and invested in intermediate treasury bonds then all three conditions must not be met. As a result, over the more than thirty five years shown below (the entire price history of the low cost Vanguard Funds used) an investor would have been invested in the equity fund 83% of the time and in the treasury fund the remaining 17% of the time.



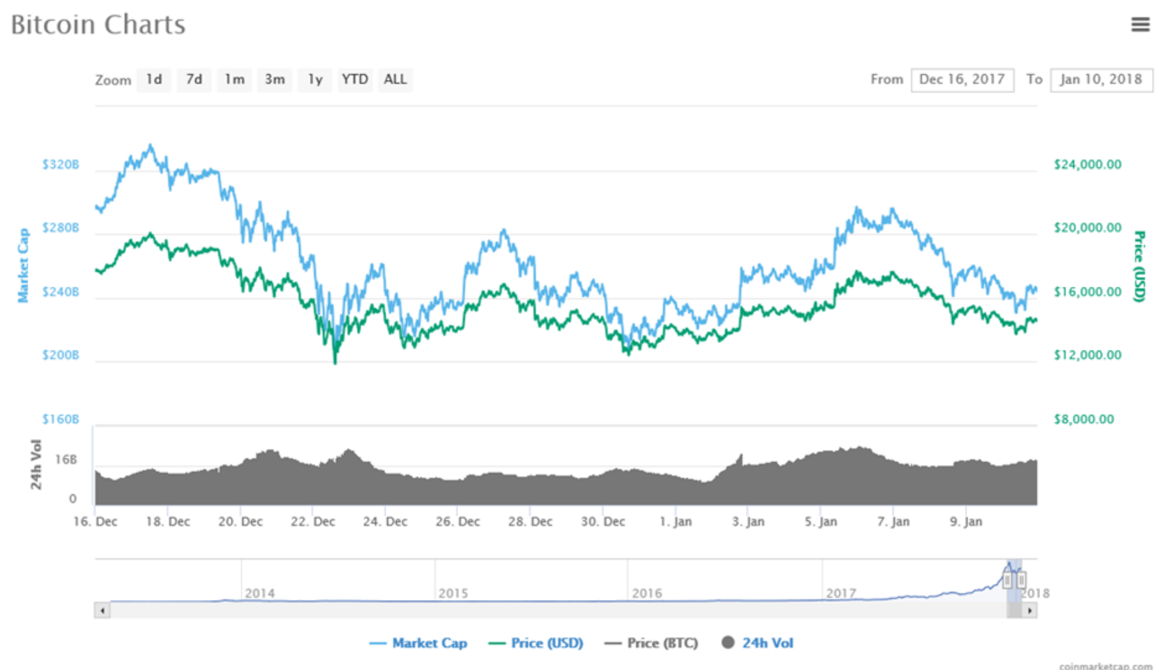

The reason for discussing the STA approach in light of Jeremy Grantham's comments is that it would deliver, and has delivered, an investment solution that many find hard to execute. During a rising market, and even during a melt up, it keeps the investor largely fully invested. This can be seen throughout the great bull market of the eighties and nineties where the STA hybrid very closely mirrored the market's movements. Importantly, once that bull market ended and the market began what would become the miserable tech wreck of the early 2000s the STA hybrid stepped aside. The Hybrid did suffer a fall of 13% from September 2000 to November of the same year, however, over the next 21 months the hybrid was invested in the treasury fund over 90% of the time. Over the same period the S&P500 fund suffered a decline in total return of 45%. A similar pattern can be seen during the Global Financial Crisis. In October of 2007 both the STA hybrid and the S&P500 hit historic highs, however from that point the S&P 500 suffered a total return collapse of more than 50% through to its very depressed low point in early 2009. Over that same time period the STA hybrid, as can be seen on the chart above never fell by more than 14%, and, most importantly, as with the prior bear market, was back at new highs long before the underlying market. Not because it outperformed in the subsequent bull market, it didn't, in fact it actually lagged for a while, but because it didn't suffer anything like the loss that the market endured. The result is that the long term compound annual growth rate for the STA hybrid has been almost 14% compared to less than 11% for the market and with substantially less volatility.

As Jeremy Grantham points out, executing such a strategy of selling into a market that has already 'convincingly stumbled' is difficult, particularly as the majority of 'experts' will by then be describing whatever has already been suffered as a 'healthy correction' and a buying opportunity. For the majority of investors it is only by having a simple and disciplined strategy in place well before market volatility turns ugly that such damaging bear markets can be avoided. It is also only by having a disciplined approach in place that the strong psychological urge to sell out of everything when the pain becomes too great, invariably close to the bottom, can be avoided.

A disciplined investor will always outperform the vast majority of investors who simply follow the news and get increasingly excited as markets rise and depressed when they fall, and there are many different disciplines an investor can follow. The STA approach is only one such discipline, importantly it is not a silver bullet that will capture all of the gains and none of the losses, such an approach does not and cannot exist. The STA will underperform the underlying market at times, especially during the early stages of new bull markets, but it will keep investors invested during bull markets, even a market melt up, and most importantly it will avoid the worst of the worst bear markets.

**Bitcoin FOMO, an early follow up**

Last month I discussed Bitcoin for the first time and referred to pole dancers and meat workers becoming apparent experts in the trading of crypto currencies. This behaviour, driven by the phenomenal price appreciation already seen, suggested to me that Bitcoin was well on the way to being a bubble that was about to burst and certainly not anything I would want to invest in. That edition came out on the 18th December New Zealand time, late on the 17th US time. It is interesting to see what has happened since.




Over the next twenty-four hours, amid even greater hype, Bitcoin rose to $20,000 and it s market capitalisation exceeded $320 billion (by comparison at that point if Bitcoin were a corporation it would have been the tenth largest in the US). Since then price action will no doubt have disappointed the rampant expectations of so many as Christmas approached, by the 22nd December the price had fallen to $12,000, a 40% crash. If this had been a market, or even a stock whose market capitalisation had fallen by $130 billon the headlines would have been dire. This wasn't the case for Bitcoin. On Christmas Eve Bloomberg ran the following story;

**Wall Street Strategist Sees Bitcoin's Friday Price Plunge as 'Healthy'**

Beware the 'healthy correction'. Every bear market in history has begun as nothing more than a so called healthy correction.

**Conclusions**

Last month's comments focussed upon FOMO, fear of missing out, and this has obviously continued in equity markets where enthusiasm and expectations are rising daily. This has resulted in FOMO morphing into, and being justified by, an expected Melt Up. This may transpire, however, investing in the hope of a continued melt up is speculation in the extreme and all those doing so would do well to note what the 'melt up' spokesman Grantham expects as the aftermath, a 50% bear market. A few very nimble and lucky traders may be able to extract some further value out of this extended market before the melt up reverts to a melt down but history shows that majority do not. Caution and preservation of capital, so one in is a position to take advantage of such a bear market, continue to be the most appropriate strategy for those not currently invested. For those that have enjoyed this bull market, a disciplined approach for reducing exposure, such as the STA will likely prove invaluable in the months and years ahead.

Kevin Armstrong

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