Strategy Thoughts

March 2018

The Slide down the 'Slope of Hope' has begun

January was the end, not the beginning, of the Melt Up!

Introduction

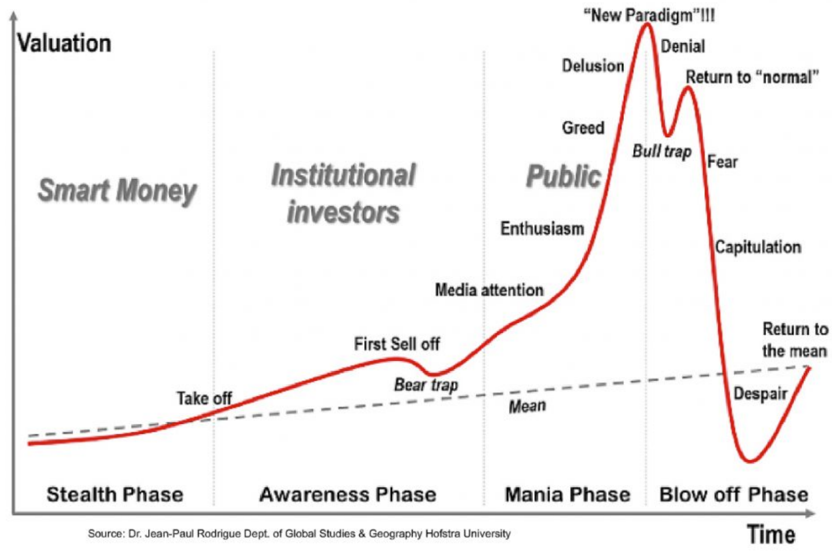
Last month I concluded with;

> From here there will eventually be a rally that will reinforce in the majority's minds that they were right not to panic and that the anticipated melt up is back on track, but the first rally in a bear market eventually dashes that hope and fails to deliver a new high. As markets start delivering lower highs and lower lows, instead of the ever higher highs that investors had become accustomed to, the slide down the 'slope of hope' begins.

Over the last month the vast majority of markets around the world have followed a path remarkably similar to the 'script' I outlined last month. As a result investors generally feel that 'things are getting back to normal', that a correction has passed and expectations are once again rising. Now is not the time for renewed, or even new, enthusiasm. Selling rallies will prove a far more successful long term strategy than buying dips now that the wall of worry has morphed into the slope of hope.

The Wall of Worry, or Slope of Hope?

We are now about five weeks into what may well turn out to be the next bear market with stocks globally having peaked on 4th February 2018, yet, perhaps not surprisingly, the overwhelming message from the financial media is; don't panic, things are getting back to normal and the current bull market, despite its record breaking length and magnitude, is far from over. This 'hope' is always seen in the early stages of a bear market, particularly after a 'melt up' parabolic rise, as the schematic left illustrates.

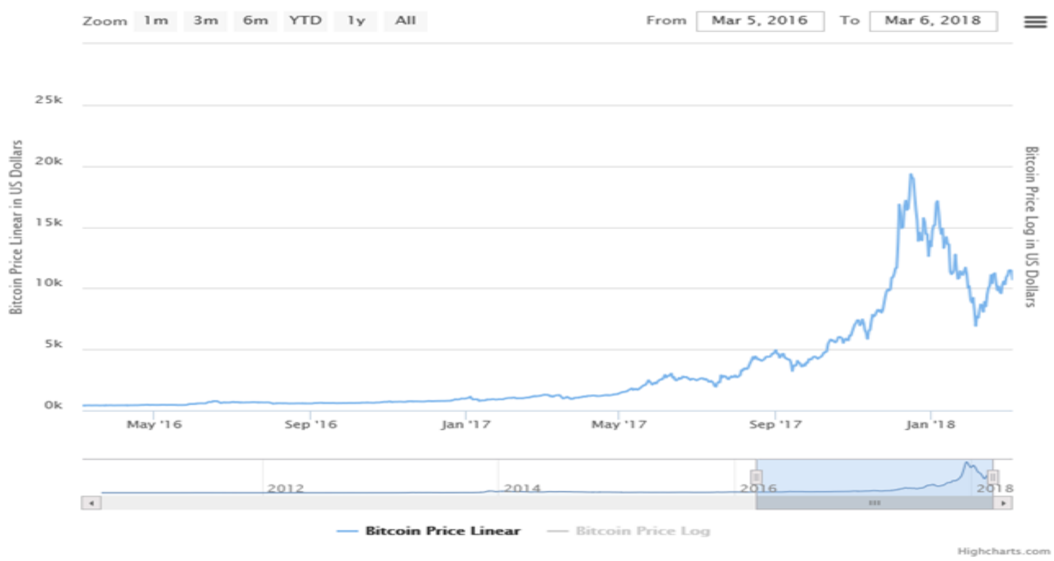


A more detailed depiction of a typical bear market would show that far from there being just one 'return to normal' rally there tends to be many as the slide down the slope of hope progresses. But just as corrections get weaker and weaker in a bull market, as fear subsides and expectations and hope rise, the reverse happens in a bear market; the rallies get weaker, successive lows get lower and hope gets gradually eaten away. So far, in many stock markets, and Bitcoin, we have seen two such rallies, but hope, as I will illustrate this month, remains high.

Where are we now?

The charts above and to the left show a selection of the world's stock markets over the last year; the Indian Sensex, the Eurostoxx 50, the Nikkei, the UK's FTSE, and the Dow Jones Industrial Average.

Most experienced their recent bull market highs as the 'melt up' talk was dominating stock market commentary in late January, although the Eurostoxx did peak a couple of months earlier. In all cases the brief 'melt down' in February is obvious and this has been followed by, in most cases a couple of rally attempts. Interestingly a remarkably similar chart pattern to the schematic earlier has also been displayed by Bitcoin.



Bitcoin's current rally may be one of its largest since it's spectacular peak last December but it is along way from displaying the characteristics of Despair shown in the schematic.

Interestingly, given that many markets are in either their first or second stages of 'returning to normal' even the marked increase in volatility that has been endured is being used by many commentators as merely yet another element in the stock market's 'return to normal'. The UK's Spectator on 8th March ran the story;

The return of volatility to stock markets is something to be celebrated, not feared

The article pointed out that;

> "the return of stock market volatility, is a welcome step towards economic normalisation"

And concluded with the comforting advice;

> "Any resulting volatility, however, should be welcomed; for patient investors, it will provide market entry points that have been conspicuously absent of late."

Similar messages of comfort and hope have been seen throughout the more volatile times that have been experienced over the last couple of months. As a result of all the calming 'hope', that always dominates in the early stages of a bear market, investors generally are eager to 'buy the current dip'.

This should not be surprising given that it is human expectations that drive markets to extremes and markets were certainly at an expectational extreme with all the 'melt up' hype in January and early February. Lessons can and should be learned from the most recent, but opposite, expectational extreme that was experienced back in March and April of 2009. So many characteristics of the current market environment and commentary are beautiful opposites of the extremes seen at the end of the first quarter of 2009, and expectations are similarly displaying the mirror image of the attitudes that prevailed nine years ago as the last great bear market ended and this most recent bull market began. Then the majority certainly did not want to buy any dip, the previous damaging decline had conditioned them against that, all everyone wanted to do was 'sell the rally'.

At the end of April 2009, in the May 2009 edition of Strategy Thoughts, seven weeks into the bull market, I wrote;

It really did feel like all hope was finally lost as March began and many measures of investor sentiment were severely depressed. That marked deterioration in the psychological backdrop of global equity markets was one of the elements that prompted us to reverse our cautious position of the last few years and adopt a markedly more positive attitude to equities generally.

In the early weeks of the current rally doubt appeared to be the dominant attitude as the following collection of headlines put together by Investec research illustrates;

Rally, Yes; Bottom, No
Forbes.com – 3/10/09
No Way You're Getting Me Back in This Market
Yahoo! Finance – 4/8/09
Is this a sustainable bull market?
The March run likely will lead to weakness
MarketWatch – 4/1/09
Warning: The bear isn't hibernating yet
CNNMoney.com – 4/1/09
Goldilocks rally meets the bears
March was good, but a downturn is inevitable
MarketWatch – 4/1/09
Don't Buy the Chirpy Forecasts
The history of banking crises indicates this one may be far from over.
Newsweek – 3/30/09
Bear Rallies Turn Market Into a Circus
Wall Street Journal – 3/23/09
Enjoy the Sucker's Rally, Says Merrill's Rosenburg
Yahoo! Finance – 3/19/09
Roubini Says Rally is a "Dead Cat Bounce"
The Business Insider – 3/16/09
Is This A Real Rally Or Dead Cat Bounce?
Investors Business Daily – 3/16/09

One month earlier I had written;

> Unfortunately, as I have written many times in the past, investing is far more of an art than a science; no indicator is ever anything more than just an indicator and all they ever do is highlight how probabilities, not certainties, have changed. With the bottom of the 'slope of hope' possibly having been seen, sentiment remaining depressed in spite of the rally already seen and RSI's globally being historically depressed it is at least reasonable to conclude that the best cyclical opportunity in equities for a number of years may now be at hand. The question investors now face though is should they be concerned about the continued, and much publicised, deterioration in the global economy.

I went on to ponder how this new bull market, that virtually no one believed possible, might end;

> Without intending to be disrespectful to the IMF, it is likely that any new cyclical bull market will end amid similar beliefs to those witnessed at the end of the last cyclical bull market two years ago. With equity markets substantially higher and the fear of risk once again having, at least partially, evaporated it is probable that forecasts for economic growth will be being revised higher and a general belief that the 'Great Depression II' has passed and been survived. Credit will undoubtedly be given to the various central bank and treasury officials globally who will appear to have engineered the recovery and all the long term concerns and fears that are so near the surface currently will be forgotten. A 'wall of worry' will have been climbed and so another slide down the 'slope of hope' will be about to begin.

> All of this is getting somewhat into the realm of fantasy, clearly it is far from certain that a new cyclical bull market has begun, but if it has it will be useful to keep some of these perspectives in the back of one's mind as the bull market runs its course, however far it goes and long it runs.

Some of those perspectives are certainly of great value currently, particularly given the near universality of the idea that all is fine as no recession is imminent and that these current dips should be bought. An almost exactly 180 degree difference in the view dominating nine years ago. This can clearly be seen by comparing the selection of headlines below to those that dominated the media nine years ago.

> **Buy the Dip Isn't Dead. In Fact, It's Just Getting Stronger** Bloomberg 21 Feb 2018
> **Strategist: Buy the dip for the next 12 months** CNBC 2 March 2018
> Institutional Investors Buy The Dip Seeking Alpha Feb. 28, 2018
> Media mentions of 'buy the dip' have never been higher. So... buy the dip Feb 8, 2018
> **The 10 percent correction won't turn into a full-blown bear market: Strategist Katie Stockton** CNBC 9 Feb 2018
> **10 Reasons Why This Market Correction Is An Overshoot** Forbes 9 Feb 2018
> **History suggests strong economy can ward off bear market** Reuters 13 Feb
> **After Correction Pain, More Market Gain?** Barron's 10 Feb 2018
> **Stock market's rout is not impacting the US economic outlook: Cleveland Fed's Mester** CNBC 13 Feb 2018
> **Buy-the-Dip Believers Rejoice After White House Tries to Ease Trade Tension** Bloomberg 8 March 2018

But still the media, and most of the investing public, continue to take comfort in the outpourings of economic commentators. This despite such an approach, as I discussed at length last month, having been useless in pinpointing and benefiting from any important reversal in markets. Economic forecasts have been very good at identifying established trends and extrapolating those trends forward, both during good times and bad times. They have rarely, if ever, identified inflection points, and if they have the stock market had usually already anticipated that turn many months, or even years, earlier.

One of the more considered observations on the recent market turmoil appeared in a March 4th article in the Wall Street Journal by Mark Hulbert. It was titled;

> **Why the Strong Economy Is a Poor Predictor for the Stock Market** The stock market usually tops out well before the economy slips into a recession

And concluded with the following;

> None of this discussion should be taken to mean that the stock market doesn't care about the economy, or that the economy is immune from the wealth effects of a bear market in stocks. But it is surprisingly difficult to translate these undeniable truths into actionable investment advice.

Whilst I agree with much of what Mark Hulbert wrote I don't necessarily totally agree with his final sentence. I do agree that economic forecasts do not translate into actionable investment advice, and this is particularly the case at market extremes, but this observation does give a disciplined investor something very useful to hang onto. Don't take comfort from economic forecasts, no matter how seemingly sensible they may be, particularly when they are part of a very broad and strong economic consensus. As the legendary economist and investor John Maynard Keynes famously observed;

> Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again.

Currently economists have not even identified that a 'tempestuous season' may be upon us. A reversal of Keynes' observation for the current environment may be that; 'Economists set themselves too easy, too useless a task if when all is calm and smooth they can only tell us that when the calm has passed a tempestuous season will be upon us!'

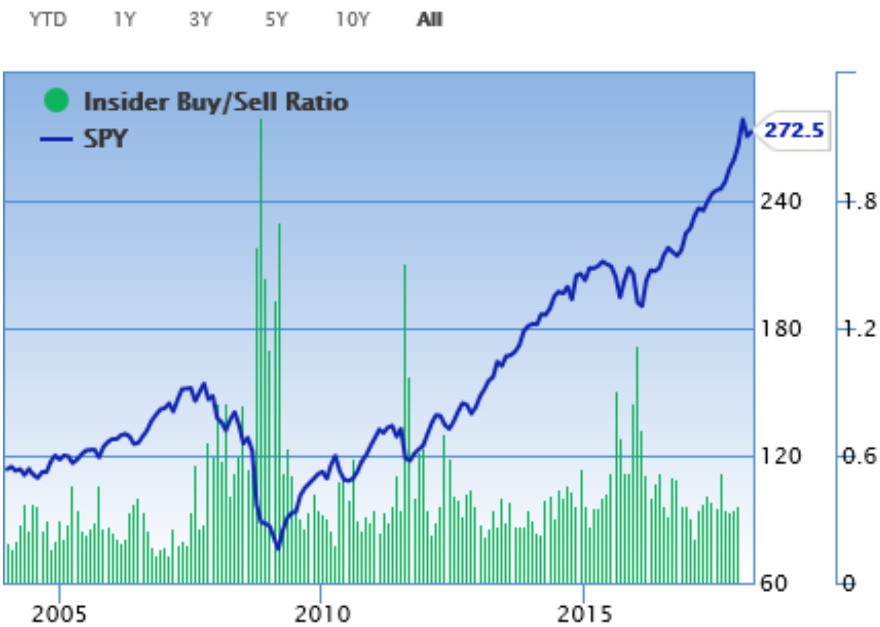
Reasons to stay cautious

Aside from the overwhelming lack of fear currently being displayed by investors, along side their extremely hopeful expectations, whether these are based upon hope for successful trade negotiations or even peace talks with North Korea, there are currently other reasons investors should be cautious

On February 27th CNBC reported;

> **Executives aren't buying their company's shares after market correction**
>
> Insiders are clearly in a cautious mood as stock prices have quickly recovered ground in what many felt was a healthy and needed correction.

The article highlighted that even though corporations were buying back their own stock on the recent pull back, corporate executives, so called 'insiders', were not. This isn't a particularly healthy sign as the chart below shows.



Through 2007 to 2009 bear market insiders became very aggressive buyers as the bottom approached. The same was true, only to a lesser extent, in 2011 and 2016 corrections. So far there is no sign that insiders are viewing the recent sell off as a 'healthy correction' that they should be taking advantage of. The CNBC article concluded with the following;

> "The main reason to worry that stocks are not yet done correcting is that, even after the pullback, the stock market is far from cheap," he wrote. "The days of indiscriminate gains, and the complacency that environment bred, is a thing of the past."

Whilst I don't share the commentators concern regarding valuation, as it is an incredibly blunt tool from a market timing perspective, I do agree that the 'indiscriminate gains' and 'complacency' will prove to be things of the past as the current slide down the slope of hope progresses.

Recession?

Finally, this month I thought it worth sharing some observations I included in Strategy Thoughts just as the previous bear market was beginning. Then, as now, the consensus view was that there was very little for investors to be too concerned about from a stock market perspective as there was no recession on the horizon (It is amazing just how neatly history repeats itself and how little we humans learn). Ten and a half years ago, in the October 2007 edition of Strategy Thoughts I included the following;

> **Food for Thought**
> **A US Recession?**
>
> Given all my comments on the credit crunch and the US real eastate slump I have included some extracts from this morning's Wall Street Journal. Columnist David Wessel wrote an excellent and considered piece titled "Three Ingredient Recipe for Recession;
>
> "*There are three rules to keep in mind when reading a recession prediction.*
>
> • ***Rule No. 1:*** *Forecasters rarely call the turn in the economy accurately. Even the wisest business-cycle veterans have a hard time. "There are forecasts of thunderstorms and everyone is saying, 'Well, the thunder has occurred and the lightning has occurred and it's raining.' But nobody has stuck his hand out the window," then-Fed Chairman Alan Greenspan told Fed colleagues on Oct. 2, 1990, transcripts reveal. "And at the moment," he said, "it isn't raining. ...The economy has not yet slipped into a recession." Much later, arbiters at the private National Bureau of Economic Research determined a recession had begun that July.*
>
> • ***Rule No. 2:*** *Once forecasters start shaving their growth forecasts, they tend to keep shaving them. At the end of August, economists surveyed by Macroeconomic Advisers, a St. Louis forecaster, predicted the U.S. would grow at a 2.7% annual rate in the fourth quarter; last week, they were betting on 1.6% growth.*
>
> • ***Rule No. 3:*** *There are always good reasons to argue, "This time it'll be different." But "this time" is usually different in specifics, not in the overall outcome.*

Currently, as I discussed at length last month, there is a considerable degree of comfort being taken in the fact that there is apparently no recession on the horizon. But what is happening to growth forecasts?

The February 28th edition of the Wall Street Journal reported;

> **Year-End Growth Revised Down, First Quarter Looks Set to Slow From There**
>
> GDP expanded 2.5% in the fourth quarter, and the early part of 2018 is forecast to be even lower

Two weeks earlier Marketwatch reported;

> Wall Street firms cut their forecasts for U.S. economic growth in the first quarter of 2018 after a disappointing decline in retail sales in January. Morgan Stanley chopped its estimate for gross domestic product to 2.9% from 3.3%. Barclays and IHS trimmed their GDP estimates to 2.3% from 2.5%. And Bank of America Merrill Lynch lowered its target to 2% from 2.3%. Sales at U.S. retailers fell 0.2% in January, the biggest drop in almost a year.

Don't be surprised if economic forecasts continue to 'fine-tuned' but in a downward direction (rule 2) and don't expect a majority of economic forecasters to actually recognise an imminent recession in any way that will be useful for an investor (rule 1), and continue to be wary of any comments that suggest that in some way the current market cycle will 'be different this time'.

Conclusions

It has been remarkable to see how well markets have followed the path I outlined last month, from here I anticipate that there will be a continuation of the volatile rallies and setbacks that have been seen over the last month as the slide down the slope of hope progresses and that each successive sell off will hit lower lows and the rallies lower highs. This is the nature of the early stages of bear markets. It is also the case that each of the rallies will be fully and almost immediately understood and seized upon by hopeful investors wanting to buy any dip. This was seen as the most recent rally kicked off when CNBC reported;

> Dow closes 336 points higher as trade-war worries ease

Unfortunately, the most rewarding market moves are never readily and broadly understood or accepted by the vast majority. The next bear market will not be over until the vast majority fully accept that things are only going to get worse and that what has up until then been suffered is only the beginning. Then all hope will have been expunged, the slope will have been slide down and new wall of worry can begin to be climbed.

Kevin Armstrong

13th March 2018