Strategy Thoughts

April 2018

The Slide Continues!

Plus

Technology and the Power of 6

Introduction

Last month I concluded;

> 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 a new wall of worry can begin to be climbed.

To date all the bounces that markets have delivered, whether they have come off so called technical levels such as the 200 day moving average or apparently resulted from supposedly improving fundamentals, have been warmly greeted and welcomed. They have been seen as a 'return to normal' rather than the 'dead cat bounce' that they are always dismissed as when real buying opportunities are at hand. It is clear that HOPE continues to be alive and well and that the slide down the 'slope of hope' will continue.

They're still buying the dips and Hope on the Slope, is alive and well!

The day after the Dow Jones Industrial Average fell to its worst closing low of the year, lower than anything seen in February's sell off, the pundits were still queuing up for TV spots on CNBC etc. to proclaim the 'health' of this down draught and the need to 'buy the dip'.

> Technical analyst Katie Stockton: The stock market retest of February correction is 'actually a positive' CNBC
>
> An occasional correction is not a bad thing: NYT's Jim Stewart CNBC
>
> JPMorgan Sees Market Overcoming Stock Rout Bloomberg 25th March

One strategist on CNBC's Fast Money commented;

> "The entire market is fine,"
> "Corrections are only natural, normal and healthy until you actually get one,"
> "You get one of these selloffs and it feels like we're going to break down and tank,"
> "During those periods, I want to remind everyone, we're going to have 20 percent earnings growth this year. That's one hell of a multiple compression."
> "In the last three cycles, those are the three sectors that outperformed both cycles when you're flattening the curve to this current degree."
> **"You want to buy dips,"** (emphasis added)
> "Markets are not based on time. They're based on Fed policy."

So everything should be fine, because Fed policy is becoming less aggressive and earnings are set to rise. It would be nice if there were a neat cause and effect relationship between earnings and the stock market, or even earnings estimates and the stock market. There isn't, and there isn't such a relationship between Fed policy and interest rates and the market. If there were we would all know where the market was headed, but it would never move, we'd all be on the same side. Markets move as a result of surprises and disappointments. As long as hope remains the dominant emotion the risk of disappointment is far higher than the possibility of a surprise.

The markets have apparently been selling off for a multitude of reasons ranging from the fear of trade wars through to the troubles in the tech sector, particularly Facebook. However, even though these fears are getting a lot of air time virtually all the commentary highlights the reasons not to panic and why there should be hope.

On trade the following calming comments were included in a Reuters article titled;

Little sign of trade war panic in European equities

- "investors think Trump's tariff moves are a negotiating tactic to secure better terms with the European Union, China and NAFTA partners "as opposed to a particular desire to ratchet up on actual tariffs per se"."
- Goldman Sachs said we are "probably approaching peak trade risk in the near-term", while Citi analysts reckon the recent growth in world trade will overcome the impact of tariffs.
- "For now, our base case is for moderate increases in global protectionism and for these to mostly remain targeted at specific sectors," they wrote.
- Shares in European industries in the firing line of a potential trade war took a hit on March 2 after Trump proposed the steel and aluminum tariffs, and steelmakers have continued to weaken.

And then in the immediate wake of the third largest points gain ever in the Dow Jones Industrial Average, albeit after the worst week in two years, hope that a trade war would be averted was obvious;

Stocks surge as trade-war fears ease; it's their best day in more than two years LA Times 26th March

It seems to be a similar story with Facebook, where hope that everything will work out ok in the end is clearly dominating fear of further down draughts;

Facebook- buy the dip!

Facebook suffered its first hiccup of the year in mid January when the stock fell 4%. This minor decline was greeted as a great buying opportunity.

Wall Street analysts say buy Facebook dip because newsfeed change lowers regulation risk CNBC 16th Jan

Since then the turmoil in markets, and particularly in Facebook has only increased.

By the 20th March the stock had fallen more than 15% from its all time high recorded in early February but still its stock price was seen as 'extremely compelling'!

> Wall Street analysts sticking by Facebook, say buy the dip for the 'extremely compelling' valuation CNBC 20th March

On March 26th The Motley Fool wrote an article that appeared on Yahoo Finance titled;

Can Facebook Stock Bounce Back After Last Week's 14% Drop?

The conclusion was a resounding YES.

> Wall Street, for the most part, sided with Facebook. Most analysts think the sell-off presents a buying opportunity.
>
> Sam Kemp at Piper thinks the saber-rattling will pass. He recognizes that the dot-com behemoth could've done a better job of securing user data, but he thinks the long-term relevance of the scandal will be minimal. He is sticking to his overweight rating and $210 price target.
>
> Ken Sena at Wells Fargo thinks CEO Mark Zuckerberg's response, criticized by some as coming too late, was reasonable. He believes the mandate to ensure user privacy is genuine and sees it as a constructive first step for Facebook. He's also sticking to his bullish outperform market call on the stock.

The rationlsation of why one should not worry were beautifully summed up in a Bloomberg article on 27th March;

> "It's important to remain cool," said Walter "Bucky" Hellwig, Birmingham, Alabama-based senior vice president at BB&T Wealth Management, who helps oversee about $17 billion. "I keep the checklist of things that went wrong during the financial crisis, and I look at it from time to time to see where we stand. We're nowhere close."

Naturally this seems sensible, measured and logical, however, one has to think back to just when "Bucky's" checklist would have been ticked back during the financial crisis. It would not have been in the early stages of what ultimately became known as the financial crisis. It would only have been fully checked off once markets were already down something like 30 – 40%, certainly not during the first ten and a bit percent sell off. During that stage of what became the crisis, despite growing evidence of the magnitude of write offs being taken by major banks in early 2008, misplaced hope was the dominant theme in mainstream commentary, an example of which I highlighted in early 2008.

> The hope continued amid further write downs into January when Anatole Kaletsky wrote in the FT;
>
> **"Goodbye to all that; the worst is over for the global credit crunch"**

Unfortunately, we now know just how misplaced that hope was as the financial crisis and accompanying bear market had in fact only just begun.

The Ultimate Hope! Earnings

This time around the supposed catalysts for the stock market peak and correction to date are obviously different but so far the 'hope' is just as strong as was seen in early 2008, and it is not just hope that

Facebook can get through this set back. In fact the biggest hope, and therefore the one with the greatest potential for disappointment, is earnings. The vast majority of bullish commentary early in the year, and so far through this correction, has been based upon the strength of both the US and global economy and, particularly in the US, the expected strength in corporate earnings, especially after the windfall of tax reform. This hope has been reflected in numerous media headlines, including;

> **Wall Street investors hope for unusually strong results** 2nd April 2018
>
> **NEW YORK:** Nervous stock investors are hoping an unusually US strong earnings season can restore some of the optimism that characterised equity markets last year.
>
> **Earnings season could stop the 'bleeding' on stock markets: Nuveen strategist** 31st March 2018
>
> **Earnings hold key to positive market outlook 31st March**

At the end of March Factset commented on the current outlook for earnings;

Record-High Increase in S&P 500 EPS Estimates for Q1 2018 and CY 2018 During Q1

Their report went on to point out;

> In fact, the first quarter of 2018 marked the largest increase in the bottom-up EPS estimate during a quarter since FactSet began tracking the quarterly bottom-up EPS estimate in Q2 2002. The previous record for the largest increase in the bottom-up EPS estimate was 4.8%, which occurred in Q2 2004.

Such optimism, the ease with which sell offs continue to be seen as an opportunity rather than a harbinger of worse times ahead, and the dominance of hope should all be seen as cautionary flags, not a signal that everything is in fact getting back to the so called 'normal' of 2017.

Finally, in early April, after the Chinese responded to The US's trade tariffs and prompted another short lived sell off, the headlines once again focussed on 'hope'.

> **Barclays boss Staley sticks to hope of averting trade wars** Bank chief says jousting' between US and China should 'remain a side issue'

And on the same day Bloomberg ran;

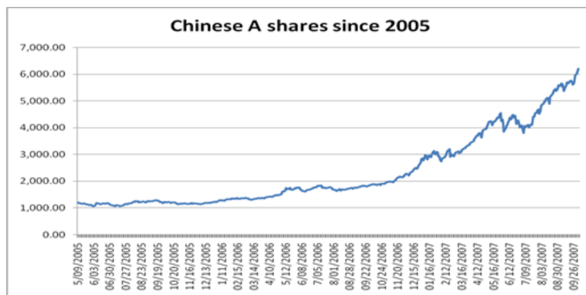
> **Wall Street Analysts See Room for Less Trade-War Worry**

When a real long term buying opportunity does arrive such headlines will be nowhere to be found, hope will have been replaced by outright gloom regarding the economy and possibly even disinterest in the stock market. We are clearly along way from anything like that yet!

Technology and the Power of 6

Moving away from the emotional backdrop to the market currently I was recently prompted to revisit something I wrote over ten years ago, in October of 2007, by the parabolic rise in the NASDAQ and the accompanying mania for so called FANG stocks, Facebook, Amazon, Netflix and Google (Alphabet). That article from 2007 was titled "The power of SIX, or, How Big Can Bubbles get? The primary aim of that article was to highlight just how manic things had become in the Chinese stock market. I wrote;

> Now that the US housing bubble has burst the "bubble seekers" of the world's attention has shifted to China.



> As the chart above shows Chinese A shares have been on an incredible run over the last two and a half years and are now up six fold from their low point. The ride up has been relatively smooth and the major February 'hiccup', when the market fell 9% in one day triggering a fall of 416 points in the US and the worst falls of the year in most other markets, is virtually invisible as the market has more than doubled since then.
>
> Whether or not this phenomenal rise is a bubble or not is obviously highly debatable, however, the anecdotal evidence around the number of retail investment accounts being opened and the types of individuals opening those accounts does sound a little like the late twenties in the US when bell hops and shoe shine boys were giving stock tips. Naturally there are plenty of commentators who will counter those sorts of observations with the actual numbers coming out of China for both economic and corporate earnings growth. Only time will tell whether or not this is a bubble about to burst or only the beginning of something really big.
>
> There may still be some doubters about the Chinese market but there doesn't appear to be any room for doubt about China in the corporate world, as Vitaliy Katsenelson wrote in one of his columns last month;
>
> *"Currently companies emphasise their China strategy on their conference calls, in a similar fashion as companies were emphasising their internet strategies in the late 90's."*
>
> Attempting to identify a bubble, or its peak, has obviously been a very dangerous investment strategy, however, some insights as to how much further the A shares juggernaut could roll may be gleaned from studying previous bubbles.

The article went on to review a number of previous historic investment bubbles including The South Sea Bubble, The New Zealand market ahead of the 1987 crash, gold up to 1981, the Dow from 1921 to 1929, the Nikkei up until 1989 and the Hang Seng index up to its peak in 1994. All of these bubbles shared characteristics of a parabolic rise accompanied by greater and greater conviction on the part of investors as to why the acceleration upwards should continue and all preceded severe bear markets of

50% or more. They also shared an almost uncannily similar degree of appreciation. All of them rose, from their previous bear market lows, by almost exactly 500%, a six fold increase in price. A couple of examples are the Dow in the 1920s which rose from 64 to 386 (384 would have been an exact six fold rise) and the Nikkei's rise from 6,849 in 1982 to 39,000 seven years later, just a few percent short of an exact six fold rise.

Remarkably, the timing of that article in 2007 could hardly have been better as the Chinese market peaked out on October 16th 2007 at 6,429, almost exactly six times its bear market low of 1,050, and then endured a bear market lasting little more than a year but falling more than 70% in value.

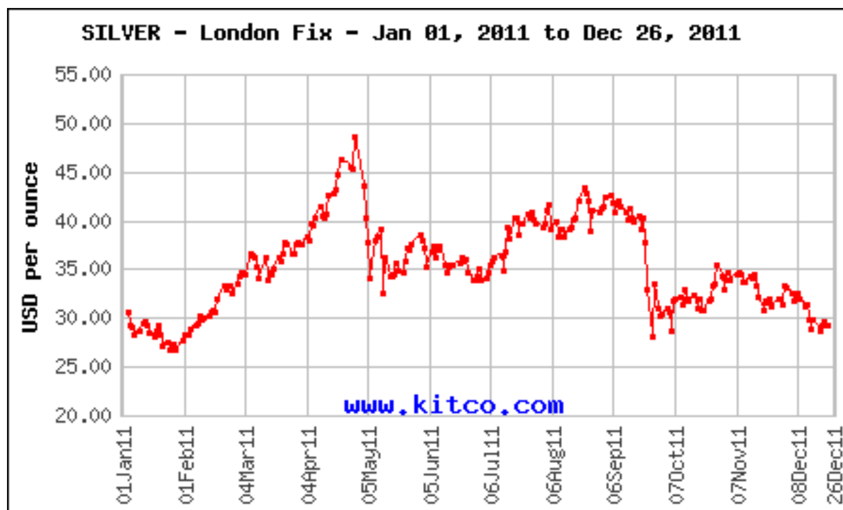
In that article I pointed out;

> *"it is hard to find an example of a market that has enjoyed an increase of more than six times without suffering a major bear market, and for those that have, the ultimate high has usually occurred in a brief blow off within weeks of a six fold increase having been recorded. With this in mind it is easy to conclude that investing after a six fold increase has already been recorded in anything is probably not the most prudent investment strategy."*

Subsequently I revisited the 'power of six' to pinpoint the manic top in the silver market. In May 2011 I wrote;

> At its intraday low, in late 2008, having more than halved over the preceding nine months, silver traded at $8.46. A six fold multiple of this low point would target silver getting to $50.76, last week at its intraday high silver traded just fractionally below $50

A chart for silver throughout 2011 reveals what happened next;



Ultimately, having risen six fold in value over two and half years, silver fell by approximately 70% over the next five years.

Obviously there is nothing magic about six when it comes to the stock market, however, it is intriguing how often such an enormous, and accelerating, appreciation has marked an imminent reversal. Particularly when the market or stocks or asset class that has risen so much has become widely appreciated and followed. Currently, apart from the Bitcoin bubble, which I have discussed a number of times over the last few months, the most widely followed stocks, and those that now have

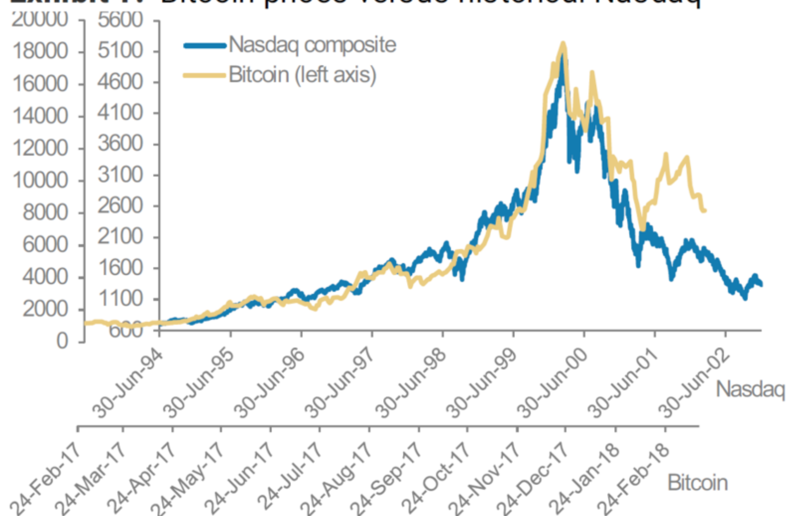
the most influence on indices, are the leading technology, or FANG stocks. This influence has clearly been seen in the rapid appreciation in the NASDAQ composite index.

The closing low for this index on March 10th 2009 was 1,268.64, from there it has risen in a virtually uninterrupted and accelerating fashion until the most recent market turmoil. An exact six fold appreciation would have targeted 7,611.84. On March 14th the index hit an intraday high of 7,637 before reversing and closing at 7,511.

None of this means that the NASDAQ and associated FANG stocks are all going to collapse by 70% or more, however, it is probably sensible, particularly given the rampant hope I have already described to reiterate my comments from ten years ago, "*investing after a six fold increase has already been recorded in anything is probably not the most prudent investment strategy.*"

Finally, on the subject of bubbles bursting, I thought it worthwhile including the following chart produced by Morgan Stanley and reported on by Bloomberg on 20th March;

Bitcoin Bust Reminds Morgan Stanley of Nasdaq Crash, But Faster



Source: Bloomberg, Morgan Stanley Research

I have written enough over the last few months on Bitcoin for readers to know that at $20,000 I considered it a bubble about to burst, this was when I reported on pole dancers and meat workers becoming ‘experts’ on the crypto currency. Since then it is obvious that the bubble has well and truly been popped and the crypto currency, without any apparent media coverage, has now broken down below its lows of February and is ‘catching up’ with the NASDAQ blue line in the Morgan Stanley chart.

Conclusions

Very little has changed over the last month, hope, in many forms, continues to be the dominant emotion in the markets and yet many of the major averages are continuing to record lower lows and lower highs. The slide down the ‘slope of hope’ is continuing.

Preservation of capital should continue to be investors primary aim, not buying the dip or averaging down.

Kevin Armstrong

5th April 2018

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.