Strategy Thoughts

May 2018

Where are expectations now?

Introduction

Over the last six weeks most equity markets have rallied, and the volatility that characterised February and much of March has subsided. Despite this rally most markets are only back to where they were in early February and some, like the Eurostoxx50 and the Chinese market are still where they were almost three years ago. Given this back drop it is clear that the much anticipated 'Melt Up' that was so widely forecast in January has failed to materialise. This should not be a surprise. Widely anticipated moves are invariably simple extrapolations of trends already in place, and, by definition, if expectations are strongly one sided and therefore a move is widely anticipated the scope for further surprise is limited. This has not only been seen recently in the failure of the melt up to materialise but also in the failure of strong earnings in the US to meaningfully propel markets higher. It is the level of expectations, and the magnitude of subsequent surprises and disappointments that moves markets. In this month's edition of Strategy Thoughts, I look at the extreme nature of expectations in the oil market, review where expectations are now in equities and also look at where longer term interest rates may still be heading and whether a second housing bubble in the US may have burst.

Oil expectations

In the January 2016 edition of Strategy Thoughts I attempted to highlight the futility of believing that simply analysing supply and demand would somehow indicate where a market would move next and I used the price of oil to illustrate that futility;

> In his marvellous 2010 book 'Economyths' David Orrell wrote of the futility in believing that somehow there was this direct relationship between the price of an asset and the prevailing supply and demand situation for that asset.
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> > In fact the idea that supply or demand can be expressed in terms of neat lines at all is a fiction. As econophysicist Joe McCarthy observed, there is no empirical evidence for the existence of such curves. Despite that, 'intersecting neo-classical supply-demand curves remain the foundation of every standard economics textbook'. Like unicorns, the plot of supply and demand is a mythological beast that is often drawn, but never actually seen.
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> > This helps explain why large economic models, which are based on the same laws, fail to make accurate predictions (traditionally the test of reductionist theories).
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> He then goes on to review the forecasts, over the previous quarter of a century, of the Energy Information Administration, (part of the US Department of Energy). There forecasts are based upon computations using their World Oil Refining, Logistics and Demand model.
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> > In the 180s, the predictions called for prices to increase, probably because the models incorporated memory of the 1970s oil shock. Prices instead fell and remained low for the next couple of decades. The forecasts eventually learned that prices were not going to return to previous levels, and flattened out; but as soon as they did prices spiked up to $147 per barrel. Then plummeted to $33. Then doubled again.

> This oil price spike played a large part in exacerbating the credit crunch, but went completely unpredicted by the experts. The reason is that it had absolutely nothing to do with supply or demand. According to the EIA, world oil supply actually *rose,* and demand *dropped,* in the six months preceding the spike.

Oil is obviously closer to the opposite price extreme now than it was when it hit $147 in 2008, and it is easy to believe that the price can only keep falling given the apparent oversupply that exists, however, it is important to remember that supply and demand does not set prices, what does is expectations on the part of market participants, and what causes prices to change are surprises and disappointments. It seems right now that given the extremely bleak expectations in the oil market that if there is to be a surprise or disappointment it is more likely to be a surprise. There still may be massive oversupply, but if that oversupply is less than the majority fear then it will qualify as a positive surprise and the price will rise.

At the time, as I noted in the final paragraph, oil was at the opposite price extreme to that witnessed at the commodity's historic price highs seen in 2008 and forecasts were almost universally targeting still lower prices due to massive oversupply. All this set up the potential for a massive positive surprise, and what a surprise it has been!

In the early months of 2016 WTI oil briefly traded below $30, down a massive 80% over the prior eight years and more than 70% over just the prior eighteen months. At the time expectations were indeed bleak as reflected by the BBC in mid January

Just how low can oil prices go and who is hardest hit? BBC News 18th January 2016

> Many analysts have slashed their 2016 oil price forecasts, with Morgan Stanley analysts saying that "oil in the $20s is possible", if China devalues its currency further.
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> Economists at the Royal Bank of Scotland say that oil could fall to $16, while Standard Chartered predicts that prices could hit just $10 a barrel.

With hindsight it is obvious that 'slashing' forecasts was merely an extrapolation of the decline that had already been suffered, even though it may have been dressed up in a seemingly sensible assessment of supply and demand factors. It was also, far more importantly, an indication of just how bleak expectations were for the price of oil at that time. This raises the very important question of, where are we now, given that the price of oil, rather than cratering, has rocketed higher by close to 200%. Not surprisingly it is beginning to appear that we are once again at an opposite extreme, analysts are seemingly leapfrogging over each other to come up with higher and higher forecasts.

Reuters recently reported;

> There is a risk that oil prices could hit $100 per barrel next year for the first time since 2014, according to new research from Bank of America Merrill Lynch. It's primarily an old-fashioned case of more demand, less supply.

Daily FX ran the headline;

> **Crude Oil Price Forecast: Oil Leads As OPEC Boosts Demand Forecast**

Investing.com reported;

> **This Oil Rally Could Have Much Further To Go**

And one of the same banks that 'slashed' their forecasts two and a half years ago:

> Morgan Stanley Says a Shipping Revolution Has Oil Headed for $90 Bloomberg 17th May 2018

I now feel fairly comfortable writing something similar, but the exact opposite, of what I wrote in January 2016. If there is to be a surprise, or a disappointment, for oil investors going forward it looks far more likely to be a disappointment. Irrespective of how the widely followed supply and demand numbers may change.

Stock market expectations

Last month I highlighted that, particularly in the US, there was great 'hope' that earnings would beat expectations and so reignite the bull market, that had failed to 'melt up' earlier this year when it slipped into a correction. I wrote;

> 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.

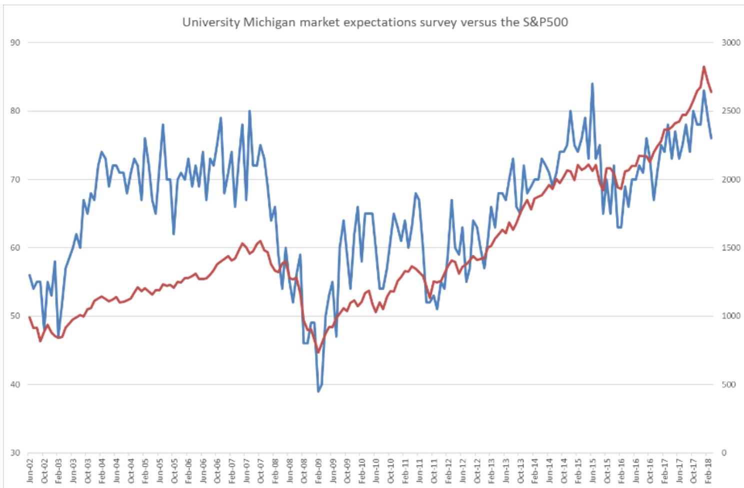
Since then earnings have been delivered that did indeed surpass estimates but the market has failed to surge. This should be something of a warning sign. When good news fails to produce a move upwards it is likely that expectations were already far more stretched and that seems to be what is happening now. But this is not dampening the bulls 'hopes'. In fact, some are claiming that the fact that the market failed to rally on the good news about earnings is itself good news! Forbes late last month wrote;

Worried About Flat Stock Market? Don't Be

The article concluded with the following bottom line;

> Forget the worrisome view that 80% of companies are beating expectations, but the market remains unmoved. There is actually fulsome analysis and evaluation going on, regardless of the amount of "surprise" in earnings reports. Moreover, while the hope is fading that good earnings reports will reignite the 2017 bull market, the stock market is holding its own – an important accomplishment at its near-correction level. Therefore, it appears that a good time to invest in stocks is approaching.

Perhaps the author is right, but I fear that he is grasping for any hope as the slide down the slope of hope continues. Expectations generally continue to be stretched on the upside. The chart below shows the percentage of respondents in the University of Michigan survey that expect the stock market to have a 50% or better chance of being up over the next twelve months compared to the S&P500. This survey has only given a value of 80% or higher on two previous occasions, July 2007, just three months ahead of the worst stock market rout in seventy years, and June 2015, just as the worst setback of the bull market to date began. Most recently, in November of last year, two months prior to the stock market's peak, this measure once again surpassed 80%



I have made the point many times in the past, that the best buying opportunities are never comfortable and never accompanied by a general feeling of optimism and elevated expectations. John Hussman in a recent essay summed this point up beautifully;

> The key point is that strong investment opportunities are almost always born out of discomfort. Likewise, market collapses are almost always born out of confidence and euphoria. John Hussman

Expectations currently remain far closer to confidence and euphoria, rather than the discomfort felt at what eventually turns out to have been a great buying opportunity.

The inflation conundrum

By now it is obvious that longer term interest rates, as measured by the US 10 year treasury yield, are rising, this eventuality was far from obvious two years ago and was certainly the opposite of what the majority were forecasting back then. In August of 2016 I wrote the following about forecasters possibly lagging behind interest rate moves, (rather than leading them) as what may have been the long term secular low in ten year treasury yields occurred;

> A similar behaviour was apparent in bond yields back in 2012. As I commented back then I only became concerned as to the possibility of a low in yields having been seen once the majority of forecasters gave up forecasting a reversal in yields and created the overwhelming chorus of lower for longer. As with the analyst estimates above, this was just at the wrong time.
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> It is possible a similar surprise may be setting up in the yield on ten year US Treasuries.
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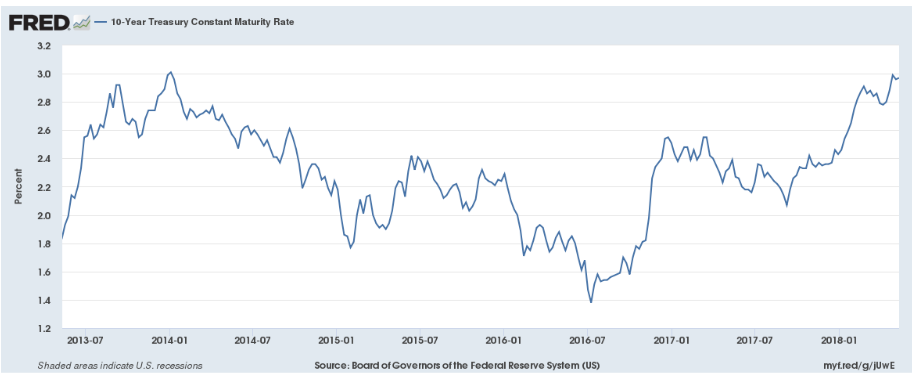
> The chart above from Bloomberg shows the average forecast for where ten year yields will be at the end of the year and the actual level of ten year yields. Sadly it only goes back to the beginning of this year but a similar behaviour to that of the analyst forecasts can be seen. The steepest cuts in forecasts are only made after the actual yield has already fallen but importantly those cuts never show confidence in the decline continuing. That is until now. Finally, with yields having hit those new lows in July described earlier and confidence in the outlook for treasuries having risen sharply, the median forecast has seen its largest cut year to date. Unfortunately those cuts have been made just as actual yields have risen and the two lines have crossed for the first time. Another potential whipsawing of forecasters may well be in the making.

Updating where yields have gone since then shows that indeed a massive whipsawing did occur.



The enormous slashing of expectations was indeed taking place just as yields were embarking on a huge reversal that has seen ten year treasury yields more than double. Remarkably it seems that analysts and economists are continuing their historic trend of following a market's move rather than forecasting where it may be heading. As recently as late April, with yields already setting multi year highs over 3% Bloomberg reported one strategist forecasting a year end 'target' of 3.2% and went on to report;

> The consensus across Wall Street agrees: rates are rising, but perhaps not in a hurry. J P Morgan Chase and Co estimates the 10 year yield will end 2018 at 3.15%, the same as the median forecast of 56 analysts surveyed by Bloomberg.

Since then ten year yields have hit a high of 3.12% and the consensus continues to be that while rates may rise the rise wont be that dramatic or indeed anything to materially worry about. Indeed, one widely followed bond guru was quoted as stating that the bond bear market had gone into 'hibernation'. This may well be the case, however, the important characteristic of the bond market currently is that there continues to be far more scope for yields to surprise (or perhaps disappoint) on the upside rather trading benignly around current levels.

That complacency, and the chasing for yield behaviour it encourages, can also be seen in the historically still low spreads between high yield bonds and treasuries.

Further evidence of such complacency could be seen in a recent Bloomberg article titled;

It's Not 2007, and Junk Bonds Can Still Be Dancing

Spreads are tight, but credit markets are functioning as they should

The article, rather than comforting investors, should alert investors as to the risk of disappointment. Just as the then Citigroups CEO, Charles Price, comments about continuing to dance as long as the music was playing in mid 2007's can now be seen as a major indication of both hubris and complacency, a similar degree of hubris and complacency can be seen in debt markets now. Unfortunately neither of these characteristics are found in the early stages of a healthy market move.

Are homebuilders telling us something?

Rising interest rates have also had their effect on US Homebuilders, but only very recently. As late as the end of last year expectations towards this sector were as elevated as they had been for years, as the following Bloomberg article from late December 2017 highlighted;

U.S. Homebuilder Sentiment Hits Highest Level in 18 Years

Since then the fortunes of the homebuilders' stocks have floundered, falling 20% from their highs in late January, as can be seen in the following chart of the SPDR Homebuilders ETF.

This was after they had risen six fold over the prior nine years. It is remarkable how often important peaks occur after an asset has risen six fold in price as I discussed last month. The high point reached by US homebuilders was remarkably similar to that seen twelve years earlier, at least in the ETF shown above.

A longer term history can be seen in the price histories of some of the underlying homebuilding stocks; Lennar, Pulte Homes and DR Horton

None of this means that it is 2006/7 again, but it is worth noting that back then, as US housing's bubble burst, oil prices were rocketing higher, interest rates were rising (the ten year treasury yield had risen more than 50% over the prior three years), virtually nobody saw the housing bubble bursting as a harbinger of anything like what would eventually turn into the Great Recession, and expectations for the stock market were high and rising.

It is clear now, with the benefit of hindsight, that the bursting of the US housing bubble was the 'canary in the coal mine'.

Conclusions

Last month I concluded with the following;

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

Nothing that has happened since I wrote that to make me alter my view. Equity markets may have rallied higher, but generally still remain below their all time highs. It continues to be a concern that the shocking set back, and accompanying surge in volatility, seen in February has now been virtually forgotten and for the majority of investors things now seem to be 'back to normal'. Unfortunately, steadily rising markets, that satisfy and please the vast majority, rarely endure. The probability of expectations being disappointed in the oil and interest rate markets, a bursting US housing bubble and renewed complacency in equity markets should all be a source of increased concern, rather than the comfort so obvious currently, for investors.

Kevin Armstrong

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