Strategy Thoughts

August 2018

Don't Fear a CRASH! Fear a Bear Market

Introduction

Having been overseas for much of the last month and a half it has been fascinating to return and see the growing fear of a stock market CRASH. Much of this fear has been fuelled by widely reported comments from the French Stock market regulator in their annual report. Ambrose Evans Pritchard of the UK's Daily Telegraph reported their concerns in an opinion piece with following opening sentence;

> France's market watchdog is bracing for a surge in global bond yields and a Wall Street crash as soon as this year, fearing that contagion will spread to Europe and snuff out the fragile recovery.

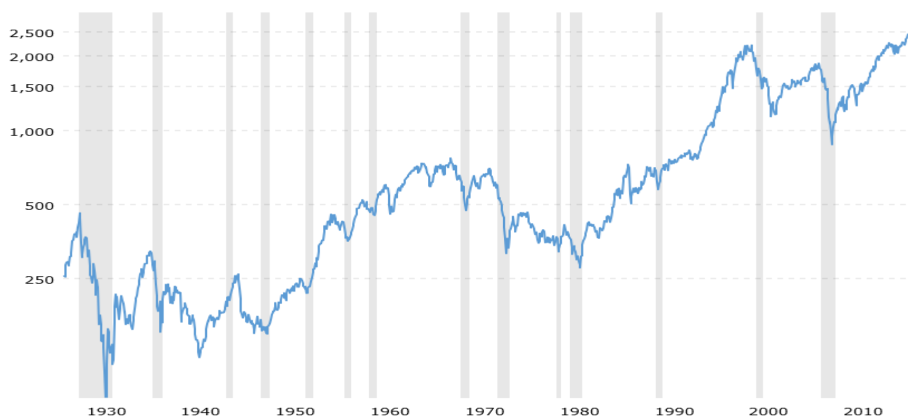
These increased fears of a crash reminded me of something I wrote almost two decades ago, when crash fears were similarly high. At the time, as I am now, I was far more concerned about a bear market and went to some lengths to point out the difference. In this edition of Strategy Thoughts, I will once again review those differences, particularly as they relate to investors rather than speculators, and once again highlight the very real danger of a bear market. I will review how changing expectations set up major turning points in markets using China's recent experience as an example and highlight a couple of features that make a bear market a far larger threat to most investors than a crash. Finally, I recommend a couple of books I read in my travels.

Expectations

Investors' expectations are shaped by the recent past, as a result they tend to reflect an extrapolation of that past. Ironically, and totally counterintuitively, the longer a trend has been in place the more confirmed consensus expectations become that the trend will continue. Expected future returns from a market are always highest after a lengthy bull market, and lowest after a protracted bear market. Whilst such expectations may be understandable it is obvious that they are totally wrong. Statements from financial advisors and others that the long term annual rate of return from the stock market has been about 10%, or 7% after inflation is taken into account, may be superficially correct, however, it is far from the case that all investors receive anything like such a return, primarily, and most importantly, because when an investor buys has a huge effect upon subsequent returns.

The chart on page 2 shows the long term real price history of the S&P500, and whilst the chart does indeed trend from the bottom left hand corner to the top right hand corner it has been anything but a steady rise. Investors who got into the market in the early 1940s, the early 1980s, or in March 2009 have seen a far superior return than the long term average. Unfortunately, at all those turning points expectations for future returns were dire and few were encouraged to own the market for its long term return. On the other hand, expectations in the late 1920s, mid 1960s and in 1999 were very bright, obviously shaped by the preceding bull markets, yet the returns for all those clamouring to get into the market around those peaks was only ultimately positive if they diligently held on and waited a decade or more. Even if they did exercise such discipline and fortitude it is still the case that their long term returns will always be less than the hoped for average return until markets once again reach a similarly extreme peak.

Long term inflation adjusted S&P 500



Of course, the other reason that most investors fail to get anything like the long term rate of return is that they fail to hold on through those miserable bear markets and eventually give up and bail out when collective expectations are at their bleakest and ironically the next bull market is about to begin.

China

That collective expectations tend to peak and trough at important turning points for markets can be clearly demonstrated with the Chinese stock market over the last year or so.

At the beginning of this year hopes and expectations amongst investors were high for the Chinese stock market. Over the prior two years, since its previous bear market low, the market, as measured by the Shanghai Composite index, had risen in a fairly steady fashion by 30%. With that backdrop headlines such as these appeared throughout the financial media;

> **The Shanghai composite is riding bullish investor sentiment** CNBC 21 January 2018
>
> **Chinese investors bullish on stock market: survey** Xinhuanet.com 21 January 2018
>
> **China's stock market is on a 'once in a lifetime' kind of rally** CNBC 25 January 2018
>
> **China Stocks Take Flight As Indicator Suggests Economic Expansion** investors.com 2 January 2018

Earlier in the month the South China Morning Post highlighted that the market had delivered its longest streak of gains in 25 years.

Such headlines should have alerted investors to the possibility of a reversal, particularly, as Bloomberg reported on the 24th January 2018, that foreigners were pouring money into China through 2017 at an astonishing rate, increasing their holdings by 81%. A dramatic increase in interest in any market by foreigners does not usually end well, but Bloomberg were more relaxed back then as 'experts' were extrapolating a continuation in this growth. Sadly, those optimistic expectations and extrapolations have been dashed as the Chinese market has now given up all the gains it had clawed back since the 2016 low and has, at its recent low, fallen by 25% since the January high.

Shanghai Composite Index

Not surprisingly if one were to look back at the attitudes to the Chinese market in early 2016, before the bull run that peaked earlier this year, they were far from optimistic. Understandably attitudes then were shaped by the extremely volatile, more than 40%, bear market that had been experienced over the prior seven months. Back then 2016 was expected to be accompanied by continued volatility and little upside. Those expectations shifted as the market began its two year long, and relatively unvolatile, rise to its recent peak.

Incredibly, but perhaps we shouldn't be too surprised given the whipsawing that the Chinese market has delivered over the last few years, expectations that were so ebullient six or seven months ago have once again shifted.

> **China stock market, the worst in the world, peaked in January and could remain weak until US trade spat ends** CNBC July 5, 2018
>
> **Do Not Buy The China Stock Market Until Next Spring** Forbes July 16, 2018

Whether expectations have now reached a bearish extreme on China, and so a new bull market can begin, it is probably too early to tell. However, with such gloomy headlines, borne out of a six month plunge, it does appear some upside surprise is possible and the Chinese market may no longer be 'the worst in the world'.

What the last few years in the Chinese market should illustrate is that extremely optimistic outlooks, based upon apparently sound 'fundamentals', but coming **after** a dramatic rise, should be greeted with a high degree of scepticism rather than comfortably embraced. The reverse is obviously also true.

Invariably the so called positive fundamentals that are embraced at peaks are the reason why a market has already risen, not a reason to extrapolate even further rises. With elevated expectations the possibility of any further positive surprise, that could propel the market even higher, get slimmer and slimmer and so disappointment, and market reversals, follow.

A Crash?

Currently expectations are an interesting mixture of the bull market continuing and the possibility of a sharp correction or crash. A google search for 'bull market' over the last month illustrates the bull market continuing theme. A few examples include;

> **Citigroup says the global bull market isn't nearing an end: 'So keep buying the dips'**
>
> **In A Secular Bull Market, Surprises Often Occur On The Upside**
>
> **U.S. Bull Market Could Last Two More Years, Schwab Says**

There also continues to be a widely held view that prospective returns from equities will continue to outstrip those of virtually any other asset class, so 'there is no alternative!' and equities should continue to be bought.

At the same time, given that the current bull market has been running for more than nine years, the fear of a sudden crash, as noted in the introduction, has grown. A collection of recent headlines highlights this fear.

> **This Favorite Warren Buffett Metric Tells Us a Stock Market Crash Could Be Coming** Yahoo finance 27 July 2018
>
> **The signs of a potential market crash are now appearing, asset manager warns** CNBC 11 June 2018
>
> **Stock market CRASH: Analyst warns of major CORRECTION in US stock market** Express newspapers 27 June 2018
>
> **A Stock Market Crash With Chinese Characteristics** WSJ 9 July

Interestingly the majority of these articles focus upon the risk of a dramatic but short lived correction, like that seen in 1987. However, for most relatively long term investors a crash should not be their primary concern. Whilst it would be understandably uncomfortable history shows that it is not crashes that determine investors long term returns, it is longer term bull and bear markets. To illustrate this almost nineteen years ago, when similar crash fears were growing given the length of the preceding bull market, I wrote an article titled;

Don't' fear a crash in the US, worry about a bear market

In that article I wrote;

> For investors as opposed to speculators, crashes don't matter. This may sound ridiculous but it is true. Crashes usually only correct the previous few months or at most one years movement, this can wipe a speculator out, but for an investor it is of little consequence, painful but no where near terminal. If however the crash precedes a major bear market well then everyone is affected. A popular misconception is that the crash of '29 did huge damage, whereas in fact half of the crash's fall was recovered over the following months, it was when this recovery faltered that the damage started to be done with the market falling persistently for a number of years.

At the time the US, and many other world markets, were at record levels having enjoyed a spectacular bull market over the prior eight years, and some over the preceding seventeen years.

Whilst there is no text book definition of what a crash is Wikipedia sums it up well with;

> A **stock market crash** is a sudden dramatic decline of stock prices across a significant cross-section of a stock market, resulting in a significant loss of paper wealth. Crashes are driven by panic as much as by underlying economic factors. They often follow speculative stock market bubbles.

The important terms in that definition are 'panic' and 'paper wealth'. As I noted in the piece I wrote nearly two decades ago crashes really only hurt speculators, as in most cases all or a large part of the decline are recovered over subsequent months and sometimes weeks.

A review of the long term S&P chart on page 2 illustrates this well. The famous crash of 1929 is almost invisible on the far left hand side of the chart. It was a sudden and abrupt period of panic selling but with hindsight it is obvious that it formed only a tiny part of the devastating bear market that persisted until 1932. Similarly the 1987 crash is now just a blip in an otherwise steady bull market that ran from 1982 through to at least 1990 and arguably until 2000. On the other hand, the persistent and very damaging bear markets, that typically lasted several years, are very obvious, and it is those bear markets that kill long term returns.

2008 misconception, or mis remembering

Most casual observers recall that the last so called stock market crash was suffered in 2008, however, that particular crash, and there was a period that had many crash like characteristics in 2008, was only a part, and a small part at that, of what was a devastating cyclical bear market. In fact there was more than one crash through September and October of 2008. In the wake of the Lehman Brothers bankruptcy the Dow suffered its largest one day fall ever and some referred to this as a crash, but then in the second week of October those miserable records were broken with an even more devastating crash like panic that resulted in even more massive paper losses.

On October 11th 2008 The Financial Times ran the headline;

Market crash shakes the world

And pointed out that the week before had been the US stock market's worst week ever. By any definition the prior week had been something of a crash, but it was only a part of a much larger bear market. Before that week long plunge the US market had already slumped by 25% from its all time high one year earlier. Even after that devastating crash week, which saw the S&P500 fall to 909, its lowest point in five and a half years, it still had another 243 points, or 27%, to fall over the next five months before the bear market would finally end.

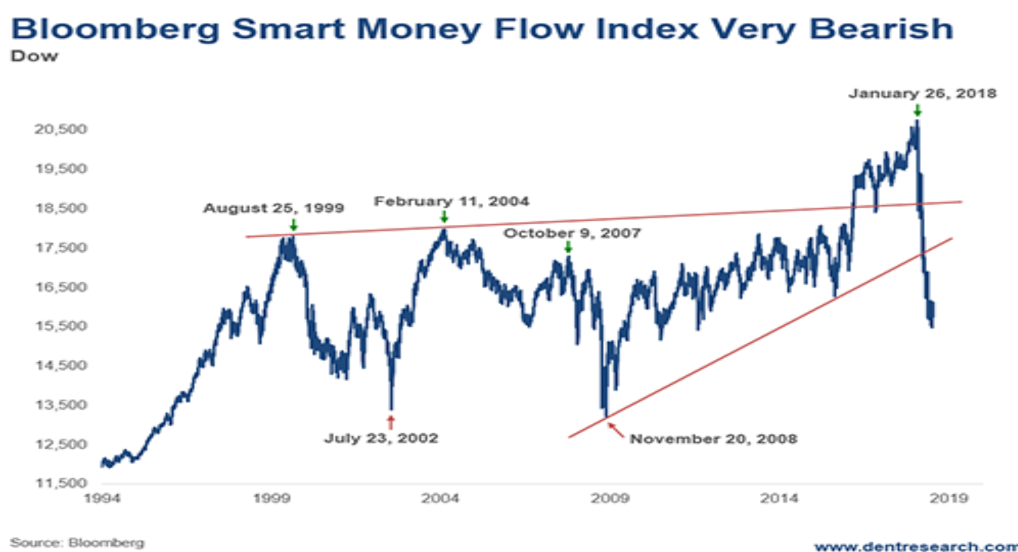
In the three weeks after that so called crash the S&P 500 did rally close to 12%, so to a certain extent it did follow previous crash characteristics, but the most important point once again is that the period of the 2008 crash was not what killed investment returns, it was the massive cyclical bear market that ran from October 2007 through to March 2009.

Something else to worry about!

In early July Bloomberg ran the following story;

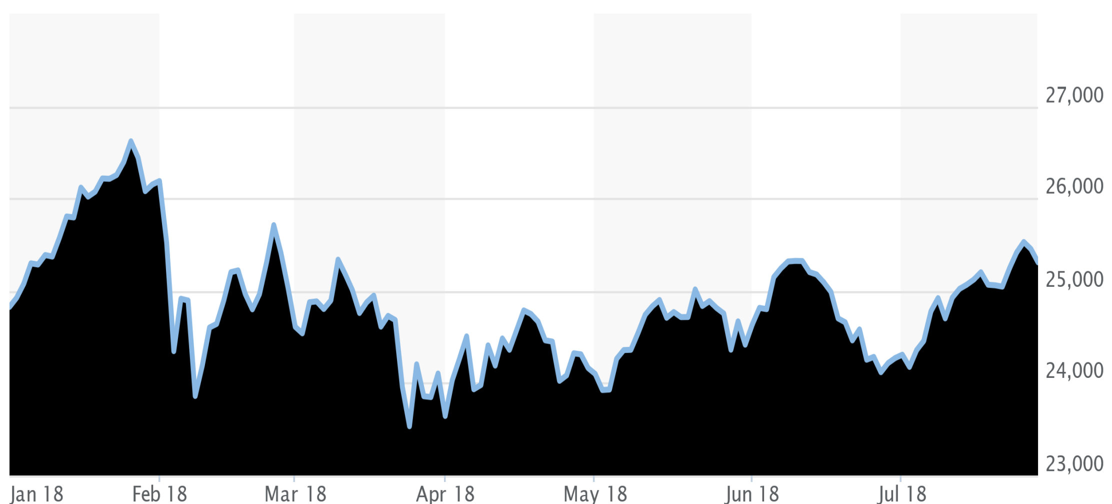
> **Smart-Money Club Has Kicked Out the Optimists** A sign of a struggling bull market leads market commentary.

The article focussed upon the so called Smart Money Flow Index. This is an index that compares the action of the Dow Jones Industrial Average's first half hour of trading, when the supposed 'dumb' and emotional trades are placed, to the last hour, when the supposed 'smart' and more considered trades are placed. Since the 1990's, as the chart reproduced by Harry Dent below highlights, the indicator has provided a valuable early warning sign of impending market shifts.



The indicator peaked well ahead of the major bear markets of the early and later 2000s and most recently has been plunging since the January high in the market. The chart below shows the actual price movement of the Dow Jones Industrial Average so far this year.

Dow Jones Industrial Average year to date



The peak in late January, when the smart money flow index peaked is obvious, however, it is also very clear that despite the Dow managing to meander sideways for the last five months this action

should not be seen as a sign of underlying health. Sustainable rallies tend not to be accompanied by a collapsing smart money flow index.

Recommendations

While travelling over the last month I read a number of books, two of which I consider worthy of a strong recommendation. The first is 'Bad Blood. Secrets and lies in a Silicon Valley Start Up'. The book is an expansion of the exhaustive investigative journalism of John Carreyrou into what at one time was the largest private equity start up, larger even than Uber, in Silicon Valley, the supposed revolutionary blood testing company Theranos. Carreyrou's revelations first appeared, after lengthy legal wrangling, in The Wall Street Journal in mid 2015 and so began the unravelling of what had become the Theranos legend.

GQ ended its review of the book with;

> In the past two years, we've watched public opinion flip on Uber and Facebook, and the nerdy opulence of startups has become a frequent punchline, be it through the lampoon of HBO's *Silicon Valley* or memes of thick Mark Zuckerberg. In the same vein, *Bad Blood* is a satisfying read for anyone who wants a book full of salacious startupenfreude. (Who doesn't like reading about a good old-fashioned scam?) But more vitally, the resonant moments of the book make not just Theranos out to be a fraud, but the promise of the tech industry itself. Overpromising everything to dazzle investors, abusing employees as the norm for "startup culture," skirting laws and morality in the name of innovation—these are all features of Silicon Valley, not a bug.

It is well worth reading, however, if you'd rather wait, there is a film being made and apparently Jennifer Lawrence will be playing the lead role of Theranos' founder Elizabeth Holmes.

The other book I wanted to recommend is certainly not as easy to read, nor is it as entertaining, but in the long run it will probably be more valuable, particularly to investors. I have long admired Ray Dalio, the founder of Bridgewater Associates, the largest hedge fund manager in the world. His track record has been phenomenal and it is clear his approach both to investing, and building a business, has been different to the vast majority. In 'Principles' Dalio puts down on paper much of his own biography through which he outlines and expands upon the principles he has learnt and adapted and brought to bear inside an incredibly successful investment organisation. It provides many fascinating and often uncomfortable insights. The New Yorks Times included the following in their review;

> At first glance, his principles may not be easy to stomach, especially for those of us accustomed to sugarcoated critiques. One of his principles, for example, is "Evaluate accurately, not kindly." Another is "Recognize that tough love is both the hardest and the most important type of love to give (because it is so rarely welcomed)."
> But underneath what may seem like a clinical, emotionless approach is something different and far more poignant: Mr. Dalio is preaching for individuals to have a sense of humility and introspection, an ability to open themselves to appreciate pointed criticism and use it to improve.

There will not be a film version of this book! However, I do look forward to his follow up work which is set to reveal more of his principles specifically regarding investing.

Conclusions

There continues to be a lot that investors should be concerned about, and, with selected markets challenging, and in some cases making, new all time highs, after close to a decade of bull market action, those concerns should be growing. But seemingly ever expanding levels of debt, stretched valuations and the prospect of trade wars (among the many things an investor could choose to be concerned about) are all being shrugged off. When investors choose not to worry is when the proverbial 'wall of worry' has been climbed, not when there is nothing to worry about. Ironically, the one concern that does appear to have captured investors attention is the risk of a crash, yet, as I have described at some length, it is not crashes that ultimately hurt investors, it is bear markets, and very few are currently focusing upon the very real risk of the next global cyclical bear market.

The last edition of Strategy Thoughts concluded with the following;

> 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.

With markets having seen little nett change while I have been overseas all those comments from two months ago remain valid, and for those markets that have further advanced, such as the NASDAQ, expectations should be growing more muted and concerned. However, as so often happens, the more a market rises the more elevated expectations become. This may be understandable but it is rarely helpful. Talk of a possible crash will likely continue whether the markets rise or fall from here, however, it is not a crash that most investors should fear. The real damage is done by a devastating bear market, one that will see expectations totally reverse and eventually present a once in a generational buying opportunity.

Kevin Armstrong

1st August 2018

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