**Strategy Thoughts**

**September 2018**

**Beware the call for yet another ‘Melt Up’, and**

**Do Dead Cats tell us anything?**

## Introduction

Over the last few days the US stock market as measured by the S&P500 has recorded further new highs in what is now the longest bull market in history. This positive action has renewed calls, last heard at the beginning of this year, for a ‘melt up’ in the markets. Those previous ‘melt up’ calls were a clear sign that expectations were rampant but they rapidly fizzled out when markets the world over plunged from late January and into February. These latest calls for a ‘melt up’ maybe even more of a warning than those eight months ago. Back then most markets had been rising in unison whereas now many of the major markets of the world have failed to deliver a rally that could even be considered a ‘dead cat bounce’. In this month’s edition of Strategy Thoughts, I review these calls for a ‘melt up’, compare them with those last heard earlier this year, examine where expectations are now through the lens of consumer confidence and highlight the danger presented by the relative weakness seen in many of the major markets of the world.

## Another Melt Up!

On 29th August, with US markets hitting further record highs, Bloomberg ran the following story;

> **Melt-Up on the Mind as U.S. Stock Advance Hits Euphoria**

This was one day after stocknews.com ran the headline;

> **Melt-Up Alert Remains**

And CNBC wrote ;

> The market doesn't always make it so easy as to play the same late-year **melt-up** script two straight years, but one can't ignore the chance that something similar could unfold.

The last time a ‘Melt Up’ was supposedly in the offing was just a few months ago at the beginning of this year. In the January 2018 edition of Strategy Thoughts I included the following;

> **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'**

I concluded that article with;

> 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.

Since then it is obvious that the much hyped and hoped for melt up did not materialise, in fact, as the chart below clearly shows, what followed was almost the exact opposite of a melt up;

Over much of the last seven months the Dow Jones Industrial Average has meandered sideways in frustrating manner before finally surging higher over the last month. Remarkably, that move, that also saw the S&P500 and NASDAQ break out to new all time highs, has been sufficient to reignite the belief in a melt. The last outbreak of 'melt up' fever came after a two year uninterrupted rise of close to 60%, this latest version has come after less than two months and less than a 10% advance! The speed and enthusiasm to adopt such an extremely bullish stance by so many should be a cause for concern, not comfort and hope.

**Consumer confidence and expectations**

On 29th August Reuters reported;

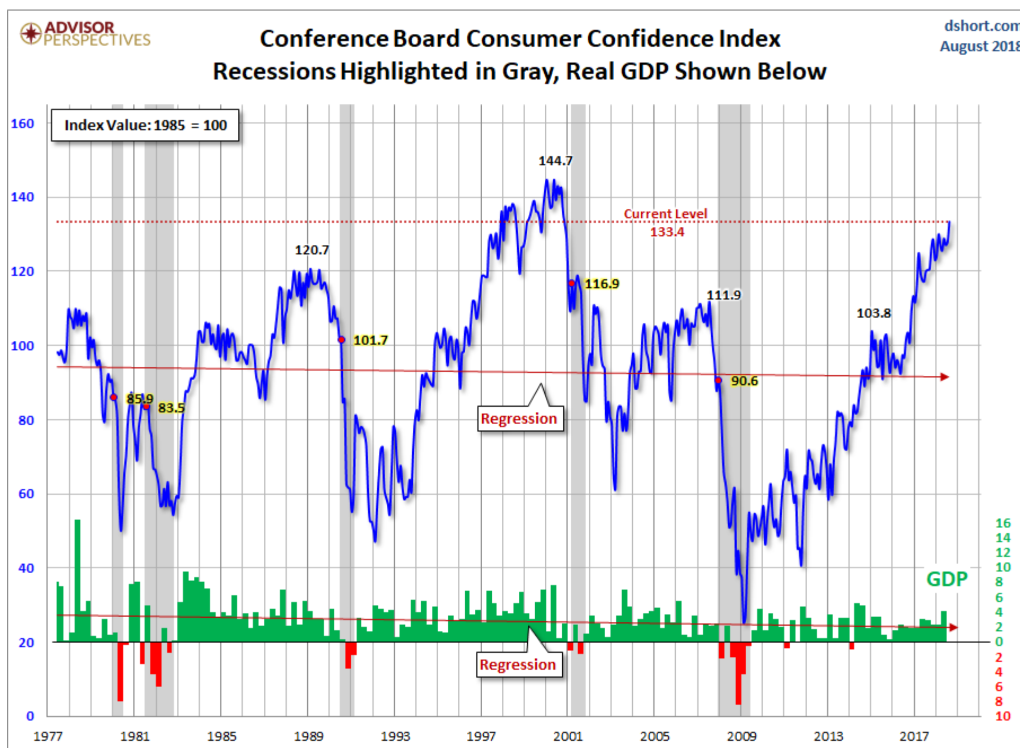
### U.S. consumer confidence races to near 18-year high

The article began;

> U.S. consumer confidence surged to near an 18-year high in August, as households remained upbeat on the labor market, pointing to strong consumer spending that should help to sustain the economy for the remainder of the year.

It is undoubtedly the case that such headlines and reports further fuel the hope and expectation amongst investors looking for a ‘melt up’. Unfortunately, history has repeatedly shown that peaks in consumer confidence do not lead to further economic gains, they reflect what the economy has already delivered, and almost always the stock market will have already reflected this. One only has to think back to the prior peak in consumer confidence that this latest survey was being compared to, back in October 2000. This was only weeks after the S&P500 challenged its all time high and the economy, despite the NASDAQ having already rolled over in the early stages of an 80% collapse, was apparently in great shape. A recession was not actually going to begin until March of 2001 (although this would not actually be officially declared by the NBER until November of 2001, by which time the recession would actually have ended, although November 2001 would not be officially declared the end date until July 2003!)

What followed on from this previous peak in consumer confidence was the worst collapse in the S&P500 since the 1970s as the index fell by almost exactly 50% through to its low in October 2002.




The fact that consumer confidence is high does not mean that the stock market has to reverse immediately, however, even a cursory glance at the long term history of this indicator easily highlights that the very best long term buying opportunities, such as in March 2009, early 2003, 1991 and 1982, do not come when confidence is high. They are always accompanied by troughs in confidence and accompanying low expectations. Conversely, peaks in confidence have always preceded bear markets and then recessions.

**Dead Cat Bounces**

The phrase ‘Dead Cat Bounce’ is heard often in discussions about the stock market and it refers to a recovery in prices after a significant decline that turns out to be nothing more than a brief interruption in the down trend. It seems to originate from the idea that even a dead cat would bounce a little if it was dropped from a sufficiently high height. There have been many throughout history and we are witnessing a number now.

**1929**

After the great crash of 1929 there followed what is probably the most famous dead cat bounce ever. After plummeting about 40% in value through late 1929, a plunge that obviously included the two crash days of October 28th and 29th when the market fell a combined close to 25%, the market recovered about half of this decline through the early months of 1930. Not surprisingly this was accompanied by waves of optimistic expectation, particularly regarding the outlook for the economy as reflected in the following quotes;

> *March 8 1930. "President Hoover predicted today that the worst effect of the crash upon unemployment will have been passed during the next sixty days." Washington Dispatch.*
>
> *May 21, 1930. "Business is gradually but unmistakably coming out of the depression." Dr Julius Klein, assistant secretary of commerce.*
>
> *June 28 1930. "The worst is over without a doubt, and it has been a disciplinary and in some ways constructive experience. People have learned once again that only work produces wealth." James J Davis, secretary of agriculture.*

Sadly, the bounce was nothing more than that of a dead cat offering a brief interruption in what would become a close to 90% fall in prices.

More recently an even longer, but just as frustrating, dead cat bounce has been witnessed in the emerging markets.

**Emerging Markets**

Back in early 2008 the emerging markets had fallen almost 30% from their bull market peak of late 2007, as can be seen in the long term chart below. The index fell more or less to its uptrend line and then began a terrific bounce, surging over the next few months to a level close, but still below where it had peaked six months earlier. It turned out to be nothing more than a dead cat bounce, but it was accompanied by ever hopeful expectations. These were typified by the IMF who, in their April 2008 economic outlook forecast a 'mild' recession in the US (a little out there!) but went on to say;

> 'By contrast, growth in emerging and developing countries is expected to ease modestly but remain robust in both 2008 and 2009'.

This was supposedly as a result of the global decoupling that was so widely discussed at the time. Sadly, we now know that there was no decoupling and both developing and emerging countries' economies suffered very badly and the emerging markets stock markets haemorrhaged 70% or more.

Over a far shorter time scale it can also be argued that the recovery after the initial fall in emerging markets earlier this year, when they recovered 70% of their late January / February plunge by March was again nothing more than a dead cat bounce. Since then they have steadily fallen to new bear market lows down 22% from their January peaks.

It has not only been in the emerging markets that the proverbial dead cat bounce has been seen.

**Developed Markets**

Despite the much ballyhooed new highs recorded by a number of indices in the US the post January sell off bounce has been far less impressive throughout much of the rest of the developed world. This relative weakness can be seen in the broad MSCI index of developed markets.

As can be seen in the chart above, despite recent strength, much of which would be attributable to the US markets, this index remains comfortably below the January (pre-hoped for melt up!) highs.

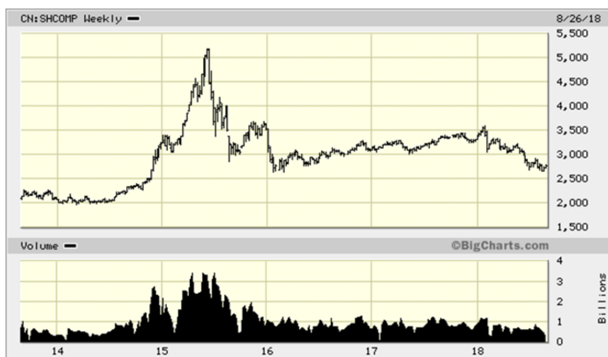
Outside of America many of the major markets of the world have delivered very weak bounces, possibly so weak that they don't even deserve to be considered a bounce worthy of a dead cat, bounces

**China**

The Shanghai Composite Index plunged, along with the rest of the world, from late January of this year, however, as I highlighted last month, the post sell off rally has been most disappointing. After the initial sell off the market quickly recovered about half of its fall before then rolling over and

falling even further than it fell in that first decline. That bounce could at best be described as that of a dead cat.

Interestingly, a similar dead cat bounce, only over a far longer period, can be seen in China since 2015.




The entire rally through 2016 and 2017 can now be seen as having been nothing more than a dead cat bounce. Last month I described the Chinese market as perhaps being more positioned for a positive surprise given how far expectations had fallen, that is still the case. However, that positive surprise maybe only that, as I concluded last month, the Chinese market may stop being ‘the worst in the world’.

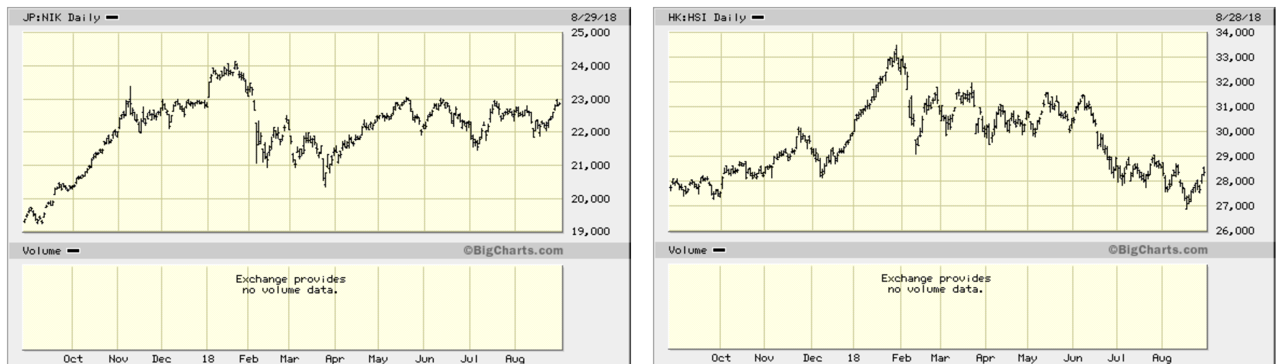
**Europe**

The Eurostoxx 50, shown below, worryingly displays not just one dead cat bounce since the early 2018 sell off, but a sequence of such bounces.

This should not be seen as a sign of underlying health in global markets.

**Japan and Hong Kong**

The Nikkei 225 index, like China and Europe, displays many of the characteristics of nothing more than a dead cat bounce.




The Hang Seng index, perhaps not surprisingly, looks like a cross between the Chinese and Japanese markets since late January and the brief dead cat bounce has clearly given way to renewed weakness.

The best time to be invested in stocks, anywhere in the world, is firstly when expectations and confidence are low, and secondly, when markets are rising together. It is not when only a handful of markets are rising while many struggle to deliver more than a dead cat bounce, nor when expectations are elevated.

**Something else to worry about! Copper**

The long term charts below show that falls in the price of copper have been indicative in the past of economic slowdowns, it has also presaged many of history's major bear markets. This is why Copper has often been referred to as Dr Copper, the only metal with a PhD.

'https://www.macrotrends.net/1476/copper-prices-historical-chart-data'>Copper Prices - 45 Year Historical Chart

A shorter term chart highlights just how severe the recent copper plunge has been;

Most of the rise in copper that was driven by the euphoria the emerged after Trump's election victory has been wiped out in recent weeks. Obviously copper has fallen in the past without a recession occurring, however, the current weakness should still be a source of at least some concern, particularly when it is occurring at the same time as the the difference between long and short term interest rates has narrowed as much as it has in a decade. This concern was highlighted in a recent paper from the San Francisco Federal Reserve;

> "In light of the evidence on its predictive power for recessions, the recent evolution of the yield curve suggests that recession risk might be rising,"

Recession risks may be rising, however, don't expect any evidence of a recession to be obvious to everyone until well after the stock market has started to fall. Just as in 2000, when consumer confidence was last at current levels, there was no evidence of a recession for at least six months and it wasn't an officially declared recession for more than a year by which time most of the damage in stock markets had already been suffered.

**Conclusions**

Aside from new highs in a few stock markets around the world, notably the US, little has changed over the last few months. However, those new highs in the US have spawned a worrying resurgence in expectations, as highlighted in both consumer confidence numbers and renewed calls for a 'melt up'. The last time a 'melt up' was being discussed was earlier this year, just ahead of a severe plunge that marked the beginning of bear markets in some countries, and the last time consumers' expectations were this high was, rather inauspiciously, just ahead of the 'tech wreck' associated bear market and recession.

Kevin Armstrong

30th August 2018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