Strategy Thoughts

October 2018

This is NOT the 'Melted Up!

And the divergences grow

Introduction

At the beginning of the year there was much talk in the financial media of the potential for a stock market 'melt up'. This was after the US market had already risen 25% over the prior seven months and more than 70% over the previous two years. What followed was not a melt up. In fact, it was the reverse, but now, nine month later, the US market as measured by the Dow Jones Industrial Average has recovered just enough to be very marginally above where it was when the melt up was supposed to have started. What has been seen has not been a melt up and what should be of most concern to most investors is that the headline strength in some of the major US indices has not been replicated in the majority of stocks, as fewer and fewer have been following the market to new highs. It is also the case that the strength in the US market has not been seen throughout the rest of the world and these divergences should certainly trump any comfort that investors may be taking from headlines about new highs.

Not a melt up

In mid January I discussed the then broadly proclaimed expectation for 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 discussion with the following comment;

> 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.**

Within days of that edition of Strategy Thoughts being released the US market stopped surging and abruptly reversed in its most dramatic sell off in several years. Since then the market has apparently

shaken off those early year jitters and recently managed to record a very modest new recovery high, barely 1% higher than the high recorded in late January. Not only has the hoped for 'melt up' not materialised, this year's recovery rally has almost certainly been a disappointment to the vast majority of investors as it has been an ever narrowing rally with fewer and fewer stocks contributing to the rise to new highs.

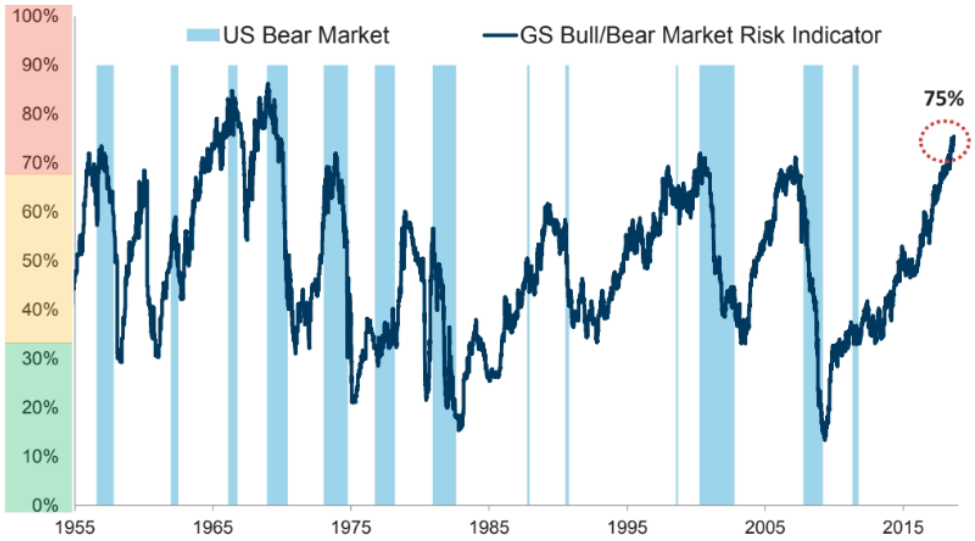
This can be clearly seen in the chart below which draws some rather disconcerting comparisons to previous bull market peaks.

The chart highlights those occasions in the last twenty five years when the Dow has recorded a new high while fewer than half the stocks in the New York Stock exchange were above their 200 day moving averages. All were at, or immediately preceding important bull market peaks.

What is remarkable about this narrow advance that will have rewarded so few is that still hope and expectations are at extreme levels.

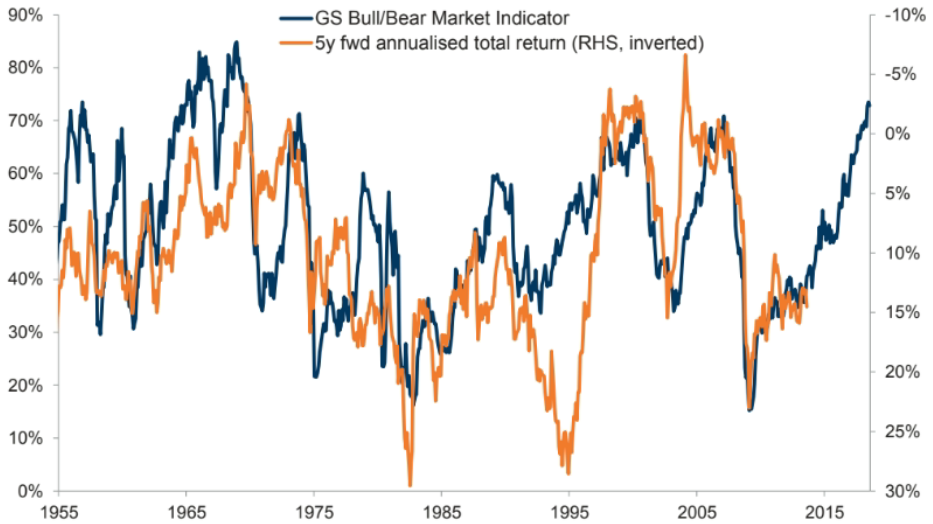
Where are expectations now, and a new indicator

Goldman Sachs recently published a paper highlighting that the risk of a new bear market was very high. The indicator considers five factors: growth momentum (measured by the average percentile for U.S. ISM indexes), the slope of the yield curve, core inflation, unemployment and stock valuations as measured by the Shiller price-earnings multiple. To be fair the indicator was also highlighted as signalling danger back in March when it crossed 70%, and obviously no bear market has manifested itself yet. However, the real value of longer term models such as this is that they give investors a reality check of what longer term returns can be expected going forward and Goldman Sachs couch their research report with this caveat, that they are not forecasting a crash or major bear market, but that lower returns should be expected as highlighted in the second chart



Source: Shiller, Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Exhibit 44: A high reading on our Bull/Bear Indicator typically implies a bear market or a period of low returns over the following 5 years
S&P 500

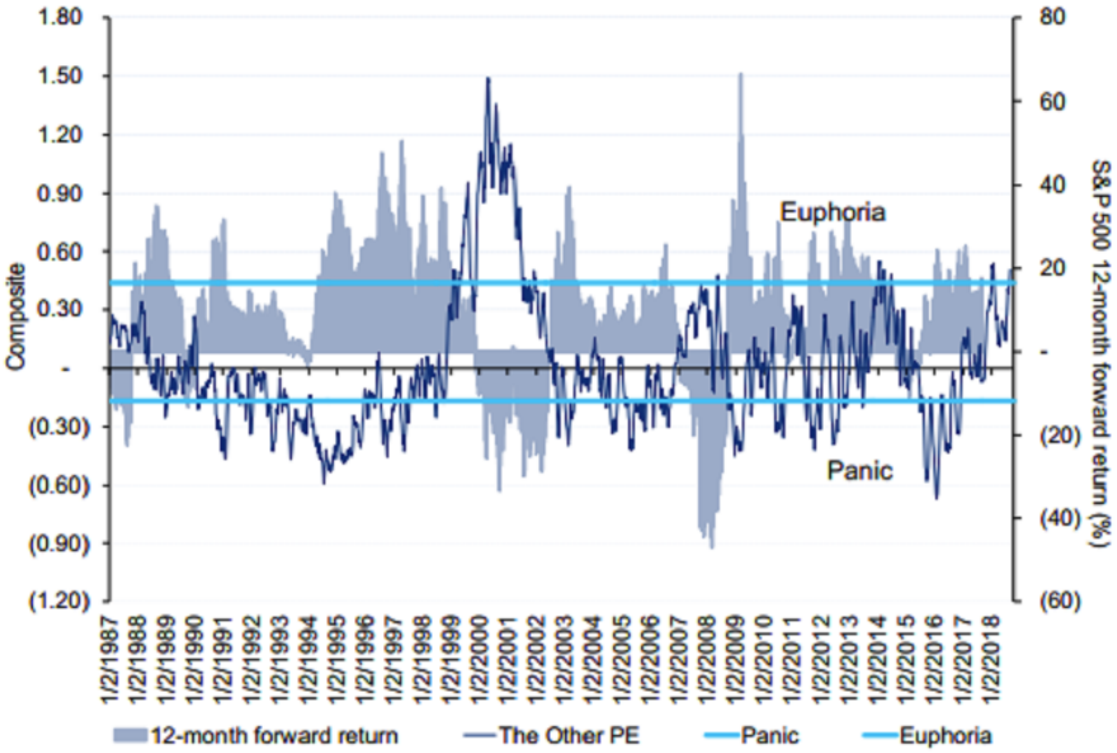


Source: Shiller, Haver Analytics, Datastream, Goldman Sachs Global Investment Research

This chart also indicated low expected returns ahead of the GFC, it forecast only 0% annualised returns for five years. This is pretty much what investors actually got, but they had to hold on through a 55% market collapse to actually get even a flat return. Low five year annualised returns rarely come as a result of a market moving sideways for five years and unfortunately the majority do not even get the low returns shown as they tend to panic out at the point of most extreme pain.

Citi Group's Panic Euphoria model also highlights that expectations are at extreme levels that have in the past preceded poor to miserable returns.

Figure 1. The Panic/Euphoria Model



Source: Haver Analytics, Pinnacle Data, and Citi Research – US Equity Strategy

Finally on the subject of expectations and what the average investor is thinking, I was amused by an observation by Harry Dent recently. He described what may be a new indicator, the sales of his own books. Harry has been an outspoken bear with his most recent book 'Zero Hour, turn the greatest political and financial upheaval in modern history to your advantage' perhaps being his most dire, but sales have obviously slowed somewhat.

Unfortunately, we all tend to succumb to confirmation bias and so read what resonates with our already established views. It is therefore no surprise that at major peaks in markets the best seller lists are full of titles proclaiming even more good times to come, and at major troughs the lists are full of dire forecasts of depression ahead. Poor sales for Harry should not be taken as a sign that his outlook is wrong, rather that it is not what anyone believes, expects or wants to hear. Ironically the best time to write a book on the coming next depression is when things have already been miserable for an extended period and the reverse is also true. Being right doesn't sell books, saying what people want to hear does, and the same is true for investment products as I will comment upon later.

A Global Narrowing

It is not only within the US market that fewer and fewer stocks have been contributing to recent strength, it has been a global phenomenon. Fewer and fewer markets around the world have been reflecting anything like the US market's strength. This can be seen in the following two charts. The first one shows just how the US market, as measured by the S&P500, has diverged from the world market excluding the US since the late January, early February sell off.

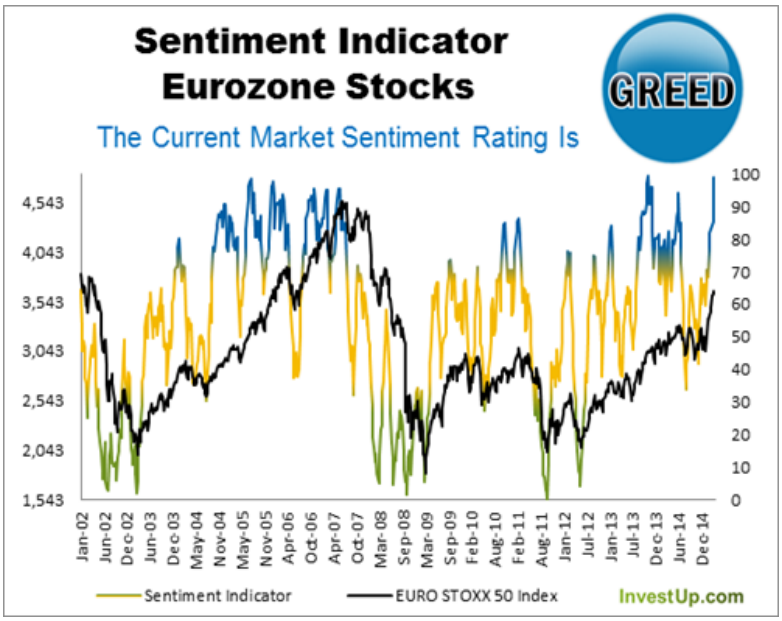
The second chart looks at the same comparison, only over a much longer time scale.

A similar, albeit much larger, divergence can be seen between the two indices going back to 2011. Such divergences are clearly not a sign of a healthy global equity market, despite, and also because of, the broad based optimistic expectations so apparent. And they should be a particular warning sign to those invested in the currently dramatically outperforming US market.

Over a smaller time scale a similar period of extremely elevated expectations after an extended period of outperformance was seen in Europe in the first half of 2015. In the April 2015 edition of Strategy Thoughts I highlighted these extreme expectations. Back then I wrote

> **Europe**
>
> Currently the greatest scope for disappointment appears to be in Europe as the chart to the right shows. Investup's sentiment indicator for the Eurozone market as a whole shows that

expectations have become about as elevated as they ever do. All this despite numerous signs of deflation in the region.



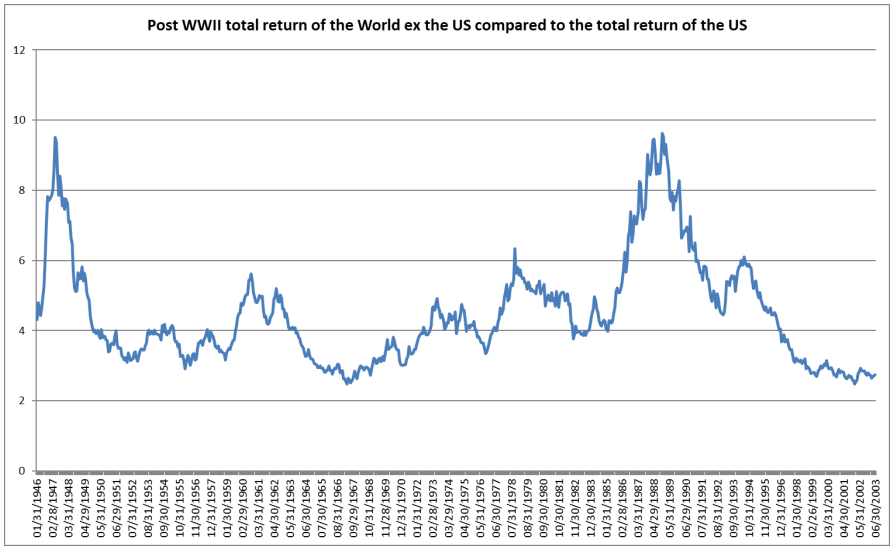
Undoubtedly a substantial driver of these elevated expectations in Europe has been the rapidly rising levels of optimism in France and Germany, both of which have seen surges in bullishness accompanying markets that have risen steeply over the last few weeks.

What followed would certainly qualify as being a major disappointment to those rampant European bulls.

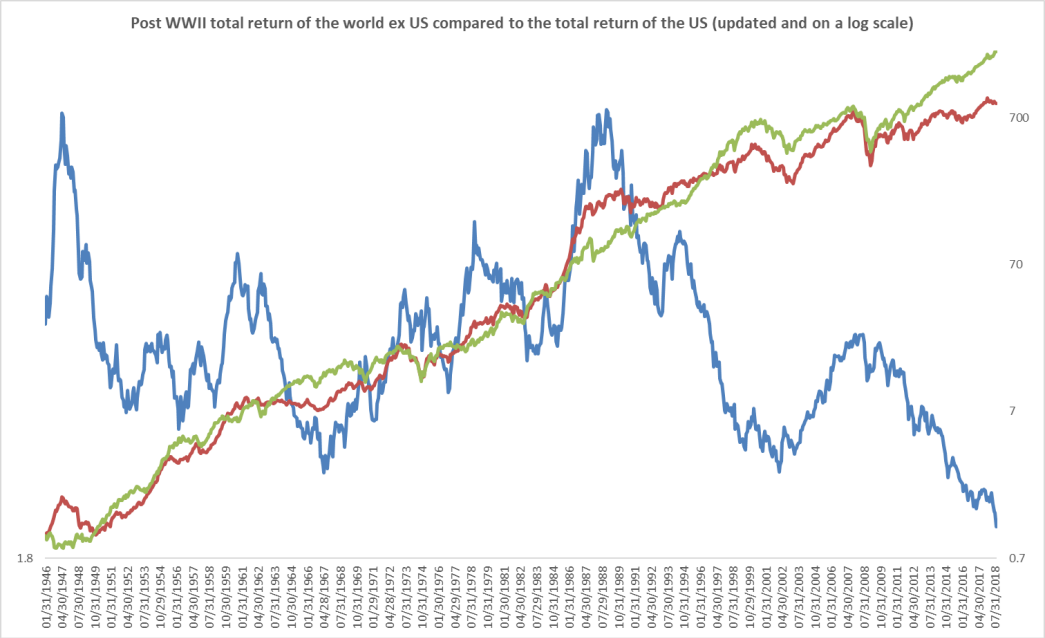
As can be seen in the chart above all that relative outperformance, and dramatic absolute performance with the EuroStoxx50 index having risen 25% in the early months of 2015, was unwound over the subsequent eleven months as a 30% bear market hit Europe.

When one market or region becomes the sole standard bearer for a supposed global bull market it is not a sign of underlying health, and should be seen as something of a warning about the prospects for that particular market. Fifteen years ago, I highlighted a similar extreme in the US market.

US versus the World



Using the chart above I highlighted how extreme the relative returns from the US had been throughout the nineties and early 2000s compared to the returns of the rest of the world. All of the prior underperformance through the prior quarter century had been unwound. This should have cautioned investors from being over exposed to the US market simply because it was the largest in the world as a result of it having already delivered the best long term performance. I likened relying upon historic relative performance to determine portfolio weightings as being akin to driving and only looking in the rear view mirror. It proved a timely warning as what followed was a period of six years during which the US markedly underperformed the rest of the world. This can be seen in the updated chart below.



What is also very clear is that since the GFC the US has once again been outperforming. The result of this can be seen in the comparison between the two long term total return lines for the US and the world excluding the US, the green and the blue lines, they are now as far apart as they have ever been.

A reversion to the long term mean should be expected. This does not bode well for the US market and probably not for much of the rest of the world, although they may fall less and so relatively speaking outperform.

FANG

Undoubtedly one of the reasons that the US market has performed so well has been the performance of technology stocks and a handful of those in particular, the so called FANG stocks; Facebook, Apple, Netflix and Google (Alphabet). These stocks have delivered remarkable returns, however, whenever any group becomes this dominant it should be a warning sign. Such dominance was seen in the mid 2000s by financial companies, ahead of the GFC, Tech Media and Telecoms ahead of the Tech wreck and energy stock back in the early 80s ahead of the energy bust. Typically, when one group begins to dominate investment banks scramble to cash in on the prevailing trend, usually just in time to get the last suckers in before the bust. This may be being seen now in FANG stocks. The following recently appeared in the Wall Street Journal. As well as highlighting the level of the current craze for these stocks it also highlighted that the issuers, not the underlying investors, usually fare the best.

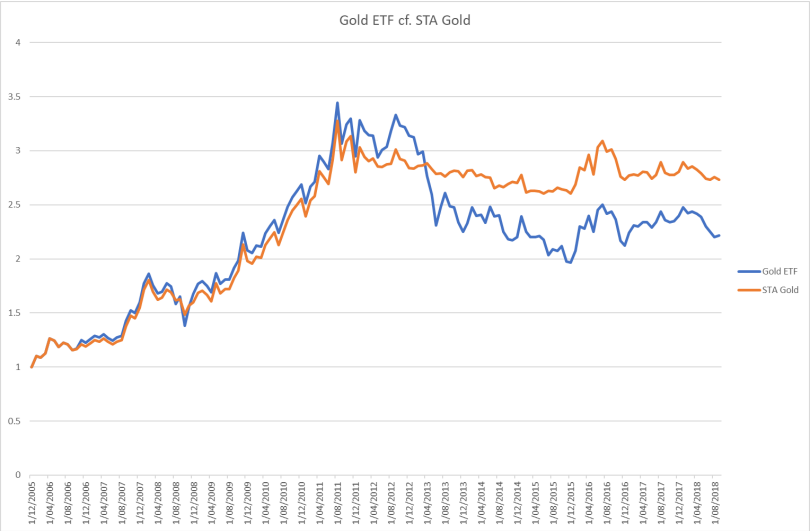
> **New Way to Play FANG Stocks Falls Short for Some Investors** 'Auto-callable' notes tied to tech stocks are gaining in popularity but aren't always delivering large payouts
>
> The notes are often sold to mom-and-pop investors seeking higher-yielding alternatives to government debt, which is reliably safe. Offering documents say that buyers can earn fixed payouts of as much as 25% of the purchase price annually without taking on the risk of outright common-share ownership.
>
> Yet many of these FANG-linked notes fail to produce returns anywhere near that stated range, according to an analysis of securities filings by The Wall Street Journal. Many times, the upfront fees banks collected were higher than the total returns earned by investors.

Gold

Whilst expectations in many equity markets are currently elevated the same can no longer be said for gold. In January, with gold trading at $1350, it's highest price in more than a year, daily sentiment readings were over 90% bullish, however, since then both the price and sentiment expectations have markedly changed. By mid August, with gold having fallen almost $200 in price, those same sentiment readings had collapsed to less than 10% bulls.

From such depressed expectations it would not be a surprise to see something of a reversal in gold, however, it would probably make sense to wait until the price rises slightly to confirm that a new bull move in gold has begun. An approach similar to that followed by the STA model. The chart below

shows the STA model's results in gold since 2005. Through most of the bull market, up to the 2011 peak the STA model closely followed the price of gold, since then the two have diverged markedly as the STA model has been predominantly invested in intermediate term treasuries.



Now, however, if gold were to rally just 3% from here the STA model would once again be investing in the metal.

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. Preservation of capital continues to be the most appropriate investment strategy.

Kevin Armstrong

Recommendation

Several years ago I strongly recommended David Orrell's book **Economyths**. I recently finished Orrell's latest book **Quantum Economics** and whilst it is not as light hearted as Economyths it is still well worth the effort if one doesn't want to be swept along by the pseudo-science of economics. A review of the book can be found at Goodreads; www.goodreads.com/review/show/2445980009

4th October 2018