Strategy Thoughts

December 2018

The Bear Market has begun

And the IMF do it again!

Introduction

Through November and early December equity market volatility increased and on balance markets have trended lower recording lower lows and lower highs. At the recent lows the MSCI all country world index was down more than 20% from its early year high and the S&P500 had fallen 14% from its high recorded in September. Amidst this deteriorating backdrop the consensus still seems to be that whilst this 'correction' was probably overdue it should be seen as a 'healthy correction' and, perhaps even more worryingly, that growth forecasts continue to be healthy therefore there is no reason for alarm.

In this edition of Strategy Thoughts, I examine one of the sources of this misplaced economic comfort, the IMF, revisit the global narrowing between the performance of the US market and that of the rest of the world that was discussed in the October edition and also follow up on the dismal performance of the previously dominant, and highly sought after, FANG stocks.

The IMF and economic growth forecasts

In the face of the massive increase in intraday volatility in equity markets throughout the world, and the resumption of a bear market that began either in September or January depending upon where one looks, there was a remarkable level of complacency among market commentators. Many took the seemingly sensible attitude that nothing had changed in the economy and took comfort in the fact that the IMF were continuing to forecast global growth for 2019 at the same level of the prior two years. Others, like Fox News, still took comfort in the economic outlook, but, perhaps not surprisingly, laid all the credit at the feet of president Trump;

Despite stock market drop, economic outlook is bright thanks to Trump

And the president himself, also not surprisingly, seems super optimistic about the US economy;

"I think we are a rocket ship going up."

Positive economic prospects do seem a logical reason for expecting a positive stock market outcome, unfortunately, as I have written many times in the past, the causality of this relationship is often confused. The reason the stock market has ever done what it does is as a result of whatever economic and other expectations may have been, any positive or negative outcome will already have been priced into the stock market. Markets move because of surprises or disappointments, not on expectations being fulfilled. I have illustrated this previously by examining the IMF's forecasts at each of the major turning points in markets over the last two decades.

Around the peak of the dotcom / TMT boom in 1999 / 2000 the IMF raised their forecast for global growth to 4.25% and cautioned that if there was to be a surprise it would be on the upside. It wasn't and the NASDAQ collapsed by 80%. Two years later, as that bear market was ending, the IMF were no longer looking for positive surprise, in fact they talked about various economic measures having

‘stagnated’ and forward looking indicators having ‘generally weakened’. From that miserable backdrop a great stock market and economic boom began and by mid 2007 the IMF was regularly upgrading their outlook, ultimately publishing their most aggressive global growth forecast ever, 5.2%, just ahead of the onset of the worst bear market and economic contraction since the 1930s. At the last important turning point, in March of 2009, as the most recent, and longest ever, bull market was just beginning, the organisation forecast their bleakest outlook ever, a remarkable reversal in the space of just eighteen months, but then it is amazing what an historic bull, or bear, market will do to expectations.

Now investors are being encouraged to ‘not panic’, to take comfort in what is supposedly still a wonderful economy, and to treat this current setback as nothing more than a buying opportunity and a ‘healthy correction’.

Tech Stocks Going Through ‘Healthy Correctio,’ RBC Capital’s Mahaney Says Bloomberg 13 December

Blockchain Research Institute’s Alex Tapscott: Bitcoin’s Price was Artificial, Healthy Correction Happening By Bitcoin Exchange Guide News Team - November 28, 2018

Markets at 'Healthy Correction' Inside a Bigger Bull Market, Lloyd Says Bloomberg Oct.11

Further illustrating the preponderance of the assurance that what is being seen is somehow ‘healthy’ was illustrated by the following question posted on Bogleheads.org;

> Over the past couple of weeks, listening to TV finance broadcasts while on the treadmill at the gym, several analysts have said that the market is "due for a correction" and that a market correction is "healthy".
> I'd appreciate if someone would explain why market corrections are "healthy".
> Thank you.

All bear markets begin with a decline that is initially described by the vast majority as being ‘healthy’ and a general acceptance that there is nothing to be concerned about due to the economic outlook being fine.

Given the continued failure of economic forecasters to predict an economic slowdown, and therefore a reason to be cautious on the stock market, it is remarkable that the vast majority of investors continue to look to the same forecasters, cycle after cycle, to somehow save them from the next bear market. It just illustrates how very strong our behavioural bias against uncertainty is. Amidst uncertainty we will anchor onto anything that somehow justifies whatever we want to justify, irrespective of that ‘things’ track record.

This edition of Strategy Thoughts was not intended to be just another missive knocking the efforts of the IMF, although it is important that investors are aware of their many shortcomings when forecasting global growth and that using theirs, or anyone else’s, economic forecasts to justify an investment is probably an ultimately flawed strategy. Ironically the organisation itself published a working paper this month that illustrates the exact point that I have been trying to get across for years. The paper was published on December 7th and titled;

Overfitting in Judgment-based Economic Forecasts: The Case of IMF Growth Projections

The summary of the paper reads as follows;

> I regress real GDP growth rates on the IMF's growth forecasts and find that IMF forecasts behave similarly to those generated by overfitted models, placing too much weight on observable predictors and underestimating the forces of mean reversion. I identify several such variables that explain forecasts well but are not predictors of actual growth. I show that, at long horizons, IMF forecasts are little better than a forecasting rule that uses no information other than the historical global sample average growth rate (i.e., a constant). Given the large noise component in forecasts, particularly at longer horizons, the paper calls into question the usefulness of judgment-based medium and long-run forecasts for policy analysis, including for debt sustainability assessments, and points to statistical methods to improve forecast accuracy by taking into account the risk of overfitting.

The paper illustrates at some length that most forecasts are nothing more than extrapolations, which explains why the most important turning points, which are in fact the most important moments for an investor, are never anticipated.

Don't expect the IMF, or virtually any other economic forecaster, to tell you that things don't look good and that a more cautious investment approach should be adopted, at least not at meaningfully useful time. By the time such commentary is being heard it is likely that most of the damage has already been done and that a positive surprise is far more likely than further, more severe, disappointment. We a currently a long way away from such a moment.

Finally, on the subject of economic forecasts, the working paper mentioned above reminds me of the famous Keynes quote;

> "Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."

A Global Narrowing Updated

In the October edition of Strategy Thoughts I highlighted the danger of the enormous divergence in performance that had been seen between the US equity markets and those of the rest of the world. It included the following chart.

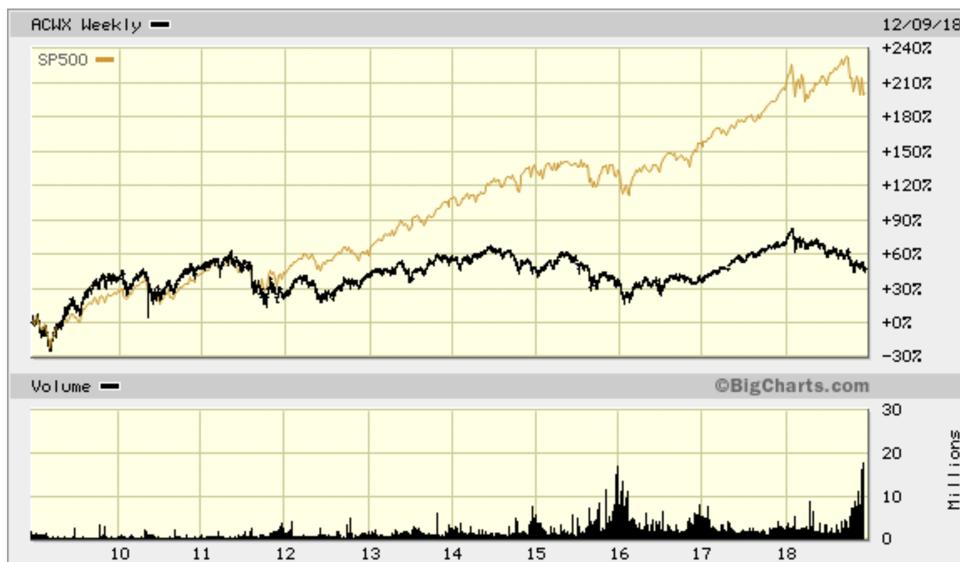
The chart clearly showed how much the US had outperformed the world through the end of September.

I concluded that commentary with the following;

> 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.

Since then a reversion to the mean has probably begun, although it is likely only in its early stages. An updated chart is shown below.

The gap that had built up over the last ten months may appear to have narrowed slightly, however, it is almost exactly the same as it was at both indices September highs. Of greater concern is the magnitude of the gap over the longer term. Substantial 'mean reversion' continues to be likely, and whilst this does not bode well for the US market, it probably only bodes slightly less well for the rest of the world.



FANG, a major reversal!

In the October issue I highlighted the probably danger being presented by the dominance of the so called FANG stocks, and illustrated that their time in the sun may be limited now that investment banks were coming up with ever more convoluted instruments for retail investors to get involved in the sector. I wrote;

> 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

This was written in early October. The following charts largely speak for themselves;

Facebook was recently down almost 45% from its high in July and 25% from its late September high.

Apple has fallen 30% in little more than the last two months.

Netflix was recently down more than 40% from its July high and 33% from its early October peak.

Alphabet, or Google, has fallen 20% since July and 17% since its early October peak.

Needless to say, those retail investors discussed in the Wall Street Journal article are probably getting something substantially different than the enhanced yield they were expecting. Three of the four FANGs included in the auto callable notes discussed peaked in June or July, it should not be too surprising that the issue date of these notes was 20th June.

Gold, an update

In October I wrote

> 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.

I concluded that segment by pointing out that if gold were to rise by about 3% the STA would be looking to get back into gold. Since then gold has risen, but in a very faltering fashion and some further, albeit modest, strength would be required to trigger a buy signal in gold at the end of this month in the STA model.

Oil

I last wrote about the huge swings in expectations around the widely followed price of oil in late May. At the time I was attempting to highlight the futility in believing that somehow the price of oil, or anything in fact, was mechanistically related to supply and demand. At the time the price of oil was soaring and forecasts abounded for ever higher prices. A not dissimilar behaviour to that described in the IMF working paper discussed earlier, a simple extrapolation of recent trends. This was a neat reversal of the expectations seen a little over two years earlier when analysts were 'slashing' forecasts for the price of oil, some to as low as $10 per barrel. In the May edition of Strategy Thoughts I wrote;

> 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

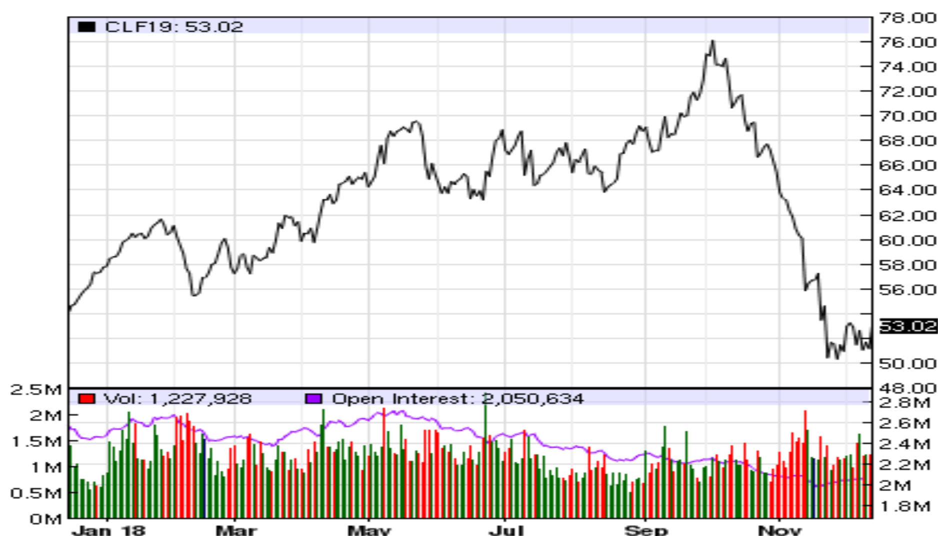
appear that we are once again at an opposite extreme, analysts are seemingly leapfrogging over each other to come up with higher and higher forecasts.

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 concluded that discussion with an assessment of the possible outlook for oil prices, not based upon any understanding of the global supply / demand picture but based upon an appreciation of the extreme expectations that were by then so obvious.

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.



The chart above shows the last twelve months price action for WTI futures on the NYMEX. Oil did briefly peak towards the end of May at close to $70 before finally, in September and early October, rocketing to one final, and very fleeting, new high at $76. Perhaps not surprisingly in late September expectations for where the price of oil was heading were continuing to rise, all based upon seemingly sensible and informed assessments of supply and demand. J P Morgan raised their forecast to $85 in six months with a spike to $90 likely and the EIA in early September raised their forecast for 2019 by 4.7% to $67.36 and then one month later, after the price had risen even further, raised their 2019 forecast once more by 3.3% to $69.36.

Obviously, those extreme expectations were delivered a massive disappointment in October and November as the price of WTI collapsed by $26 or 35%. Now expectations are understandably less extreme, or at least more subdued. Some sort of bounce should be expected, however, it will be most

interesting to observe how rapidly the bullish fervour, so obvious a little over two months ago, returns should a short term rally begin.

Conclusions

The last couple of months have witnessed a marked increase in volatility in many markets with lower lows and lower highs indicating downtrends across the globe. It is fascinating to think back to where expectations were at the beginning of this year, 2019 was going to be the year of the 'melt up'. The 'melt up' clearly didn't happen and it is likely that 2019 will go down in the history books as the year when the longest US bull market in history finally came to an end. Intriguingly, despite what for many must have been an incredibly frustrating year expectations remain constructive and positive with the probability of a recession apparently still historically low, as was summed up by Moody's Analytics at the end of November.

> The odds that the U.S. will be in recession in the next six months are low. Recessions normally occur when imbalances develop in the economy, and no glaring potential macroeconomic imbalances are forming. The economy's balance sheet is in good shape, and the tighter labor market isn't putting significant upward pressure on wages or inflation. Also, the tightening in financial market conditions recently is likely more therapeutic than problematic for growth. The economy is still being supported by fiscal stimulus, making it difficult to derail it. The probability that the U.S. economy will fall into recession in six months rose, from 11% in September to 15% in October. The historical average of our probability of recession is 22%.

Unfortunately, this supposedly benign backdrop leaves the probability of a disappointment in 2019 far greater than that of a positive surprise. Preservation of capital has been a low risk and modestly rewarding strategy in 2018 and will likely be even more so in 2020.

Kevin Armstrong

14th December 2018

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