Strategy Thoughts

January 2019

It's like Deja Vu all over again!

Introduction

The New Year has brought some relief to the gloom, that was growing in late December as markets the world over plunged, and with that relief has come a slew of prognostications that the worst has been seen and that the bull market will continue in 2019. Unfortunately, many of those same 'experts' were those calling for the never to materialise 'melt up' twelve months ago. These optimistic forecasts, and expectations for a renewal of the bull market remind me greatly of the mood that accompanied the close of 2007 and the start of 2008, hence this month's title from the great Yogi Berra. In this month's edition of Strategy Thoughts I review those similarities, explore just how unrewarding this so called 'great bull market' has been for many global investors, touch on the misguided comfort many bulls are currently taking in valuation measures and revisit both gold and oil.

What Bull Market?

In the last few editions of Strategy Thoughts I have included a chart showing the performance of the US market compared to that of the rest of the world excluding the US market. The reason was to highlight just how dramatically the US had outperformed the rest of the world since the GFC bear market. So much of the financial media focusses upon the US market, and to some extent I am guilty of this too, however, for many investors around the world the US market will make up only a small percentage of their 'balanced' portfolio. The result of this is that many investors will not have experienced anything like the bull market they may have been reading about, and a more cautious approach over the last five or more years could actually have been more rewarding. The chart below shows the world excluding the US' price performance since the lows of the GFC. The first couple of years could rightly be described as having been a bull market, however, since then it has been nothing of the sort. This index is currently below where it was in 2017, 2015, 2014 and 2011.

A similar pattern can be seen in many other major markets of the world. The UK FTSE100 is at the same level as it was more than five years ago in 2013, and the French market is at the same level it saw in 1999, 2001, 2005, 2008, 2015 and 2016. The Japanese index is flat since 2017, 2015 and 2000, the Hong Kong index was higher in 2017, 2015 and 2007, and a very similar experience has been endured by both Korean and Australian investors.

There have been exceptions other than the US, including New Zealand and India, however, the overall global weakness for much of the last decade should be a warning sign to those markets that have delivered rather than any sort of comfort. Despite the many glowing (US centric) headlines describing what has been seen since the 2009 lows as the longest bull market in history, it has been far from a globally rewarding experience.

The year ahead, then and now!

As each year comes to a close and a new year is set to begin the forecasting industry, especially on Wall Street, goes into overdrive publishing reams of forecasts for what markets, the economy, interest rates and politics are going to deliver over the coming twelve months. I have always cautioned setting too much, if any, store in these forecasts and have often reminded readers of the eminently sensible comment from J K Galbraith;

"Pundits forecast not because they know, but because they are asked."

Nonetheless, many are asked as the year turns and whilst there may be limited value in the actual forecast, they can provide something. A broad array of forecasts undoubtedly provide insights in to where expectations currently sit, and therefore where surprises or disappointment may arise.

On January 7th CNBC published their survey of 'pundits' forecasts for the 2019 year ahead, and, despite the volatility and downside shocks that had been seen in the market over the previous twelve months, and the year having delivered nothing like the 'melt up' so many were forecasting just twelve months earlier, their optimism remained almost unbounded. Their average forecast for the S&P500 over the next twelve months was for a rise of 15% to 2980, and even the most cautious 'pundit' forecast a 6% rise. Interestingly a virtually identical group of 'pundits' produced an average target on the S&P500 for the year just gone of 2963!

As I read the forecasts for 2019 I got a very strong sense of Déjà vu, or as Yogi Berra so famously put it, it was like Déjà vu all over again. I went through many of my older articles and found the following extracts from one of Barron's magazine's year ahead forecasts that certainly seemed remarkably familiar.

- THE STOCK MARKET HAS JUST EXPERIENCED its most volatile year since the current bull market began.
- And a few weeks ago, it looked as if (the years') gains might disappear before the first strains of Auld Lang Syne.
- Against this troubling backdrop, it's no wonder investors are worried that the bull market might end in (next year). But Wall Street's top equity strategists are quick to dismiss such fears.
- Indeed, the dozen seers we've surveyed all have penciled in higher stock prices in (the year ahead), although their estimated gains vary widely, from 3% to 18%. On average, the group sees the Standard & Poor's 500 about 10% higher than the recent (level).

All of this could have been written as 2018 ended and 2019 began, except perhaps that all of 2018's gains had been lost before 'the first strains of Auld Lang Syne'. But it wasn't another forecast for 2019, this was the forecast as 2007 came to an end ahead of what would actually be a disastrous 2008.

In January 2008 the US market had just suffered its first 20% setback of the then record setting bull market and a rally of 13% was just beginning. Late last year the same indices suffered a similar set back and have now rallied 11% from their late 2018 lows.

These optimistic, and seemingly measured and sensible, forecasts probably do provide some comfort to investors shocked by the dramatic uptick in volatility that has recently been seen, but they shouldn't. A perfect illustration of this can be seen in the forecasts of a highly eminent economist, professor, author, and pundit, Jeremy Siegel. Just last week I was watching CNBC's Closing Bell when Jeremy Siegel was interviewed. His message was very clear;

I think we've seen stock market bottom, says UPenn's Jeremy Siegel CNBC, 8 Jan 2019

This may encourage investors to begin buying what still is 'a dip', however, before being tempted by Siegel's comforting outlook it is worth looking at what the same professor was saying eleven years earlier when all of Wall Street was looking for a bumper 2008 after a rocky end to 2007.

On January 7th 2008 Siegel, as a contributing columnist to Kiplinger's, wrote his lengthy forecast for 2008. His forecasts included;

- There will be no recession in '08. The economy will start the year slowly, with the gross domestic product growing less than 1% in the first quarter (after a similar increase in the last quarter of 2007). By the middle of the year, the economy should begin picking up steam; it should grow 2% to 3% in the second half.
- By June, the subprime-mortgage disaster will ease. As the housing crisis eases, the flow of credit will return to more normal levels and lending will revive.
- The slow economy will keep inflation under wraps, but energy prices are likely to stay high.
- I don't believe we will see yields on ten-year Treasury notes below 3.5%, and these rates are likely to rise to well beyond 4% in the second half of 2008.
- Shares should have a good year, returning 8% to 10%. Stocks will rise as economic growth picks up in the year's second half and head winds from the credit crisis ease.
- Stocks are reasonably valued, even when priced against poor earnings. Once earnings increase, stock returns will be considerably better.
- Financial stocks, by far the worst-performing sector in 2007, could well be the best in 2008.

He concluded his outlook with;

> But strengthening U.S. and global economies will keep the market on track for still another winning year.

Reviewing each of those forecasts;

- There was the worst recession in seventy years beginning in 2008.
- The subprime disaster only grew.
- Energy prices collapsed in 2008.
- By November the 10 year treasury was yielding less than 3% and ended the year closer to 2%
- Share prices collapsed throughout 2008.
- Earnings did not increase.
- Financial stocks were amongst the worst performers in 2008.

Finally, it is now obvious that 2008 was certainly not 'another winning year'.

My intention here is not to ridicule the forecasts of an eminent academic. Rather it is to highlight; the futility of taking comfort in such seemingly sensible and considered forecasts, that the emotional and expectational roller coaster that has been endured over the last few months does have some unfortunate precedents, and that it is expectations, and the surprises and disappointments that follow, that drive markets. Not the actual economic, or other so called fundamental, factors, that are so widely analysed and form the basis of almost all investment forecasts.

Revisiting 2008 again I discovered that I had made this point in a quite different, and somewhat amusing way in the April 2008 edition of Strategy Thoughts. Back then, as the turmoil continued to grow, I wrote;

> Anyone who doubts that markets are driven by psychology should read the following and consider what ***it*** is;
>
> *"**It** is characterised by repeated episodes in which... mood and activity levels are significantly disturbed, this disturbance consisting on some occasions of an elevation of mood and increased energy and activity (mania), and on others of a lowering of mood and decreased energy and activity (depression). Characteristically, recovery is usually complete between episodes."*
>
> ***It*** sounds like a share market to me, but it is actually the description of Bipolar Affective Disorder by the World Health Organisation.

In the conclusion to that edition of Strategy Thoughts, that now with hindsight we can see was being written as the first, of what would be many, bear market rallies was coming to an end, I wrote;

> Despite all the calls to look across the valley or that we're in the closing innings of the current unwinding perhaps the most ominous warning sign to me that this is just a bear market rally has been the virtual stampede that has been seen to get back into the markets and the alacrity with which previous caution has been thrown away.
>
> There will be great buying opportunities, in many asset classes, over the next year, but when they arrive it will take great resolve and discipline to take them up, that's what bottoms feel like.

Everything that I wrote then could be applied to the current situation. The mere fact that there is such a proliferation of measured and comforting 'pundits' so ready to call the bear market over almost certainly means that it is still only in its early stages. The rally that I have described in early 2008 lasted until late May, by which time it had risen 15% from its lows but was still well below the highs seen in October of 2007. Hope had certainly returned to the market, hope that perhaps the worst had been seen, and maybe even that Jeremy Siegel would be proved correct. Obviously, we now know that such hope was badly misplaced. In May of 2008 I concluded an article with;

> Over the last eight months each worsening announcement seems to have been greeted by a relief rally, relief that this may finally be the last. Unfortunately, history has shown that the best buying opportunities come when the consensus view is that things will only get worse, bottoms aren't widely embraced until well after the fact and by the time a recovery is obvious an important low will already have been made.
>
> It seems that the longer we hear calls for the worst now being over the longer we may have to wait for a really important buying opportunity.

The bottom, and so the eventual buying opportunity, did finally come in March 2009, but very few saw it as such. No longer were pundits looking over the valley, or rushing to buy the dip, expectations had totally reversed. I highlighted this in the March 2009 edition of Strategy Thoughts;

> Bloomberg recently ran a story based upon Citibank research titled;
>
> "**Cult** of **Equity**' Is Under Attack"
>
> More of the same should be expected at the approaching bottom. Some similar themes are already being picked up on by the media as the following headline from the Wall Street Journal in the after math of another sharp fall in markets illustrates;
>
> Market's 'Hope Balloon' Loses Air
>
> ***Tepid Upturns Haven't Stopped the Slide; 'Hard to Make a Cheery Story'***
>
> WSJ 17^{th} February 2009
>
> Somewhat ironically the more that these sort of themes and stories begin to fill the media then the closer we are likely to be to that long awaited cyclical bull market opportunity, or the bottom of the current slope of hope.

I concluded that month's edition with;

> Markets breaking down to new lows, as many already have, and further evidence of continued deterioration in the global economy may ironically be all that it takes to deliver the best opportunity in markets since 2003.

Mood and expectations are currently nowhere near where they were ten years ago, but a similar buying opportunity will eventually arrive. Currently, as I have repeatedly illustrated this month, both mood and expectations are eerily similarly positioned to those seen in early 2008, not early 2009.

However, not all asset classes are in the same position they were eleven years ago.

Oil

Last month I updated my observations on the collapsing oil price, that had been anticipated by virtually no one, I wrote;

> 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.

Since then oil has delivered a further fall followed by what so far can only be described as a short term rally that has brought the price back to where it was in early January;

Expectations have, perhaps surprisingly, become even more negative in the wake of this steepest oil price rally in more than two years;

> **Goldman Sachs slashes 2019 oil price forecast amid oversupply concerns** CNBC 7 January

> **U.S. bank Morgan Stanley cut its 2019 oil price forecasts by more than 10 percent on Wednesday, pointing to weakening economic growth expectations and rising oil supply** CNBC 10 January

All this probably leaves room for further upside surprise in the price of oil.

Gold

For the last few months I have been highlighting the possibility of upside surprise in the price of gold. In October I wrote;

> 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.

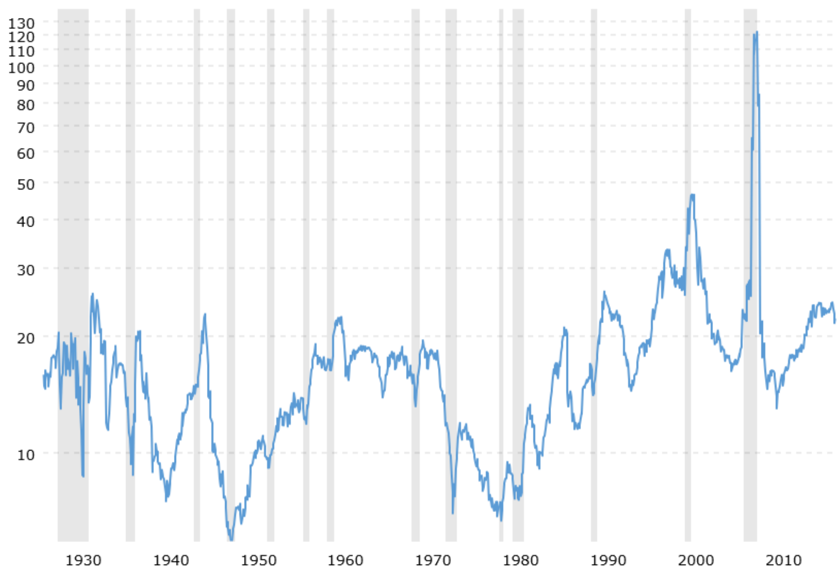
Since then gold has indeed rallied, albeit initially in a slightly faltering fashion, as I highlighted last month, but since then gold has continued to rise to its highest level since mid last year.

Expectations have understandably finally become slightly more optimistic, nonetheless, there still exists room for further upside surprise.

A note on equity valuations

Many of those optimistic 'pundits' described earlier point to the fact that the US market, after its recent setback, is no longer expensive. In fact, it is apparently cheap given that it was recently trading below its ten year average price earnings ratio. Charts such as the following often appear in these articles.

Unfortunately, a longer term perspective reveals that this recent ten year average PE ratio may be the anomaly. History shows that high PE ratios have always, eventually, been followed by very low PE ratios. The chart below reveals that from an historical perspective the current valuation should be considered far from cheap. Prior to 1990 it would have been amongst the highest valuations ever seen!



'https://www.macrotrends.net/2577/sp-500-pe-ratio-price-to-earnings-chart'

Finally, valuation has never been a useful timing tool, at least over time frames of less than several years, but it can serve to highlight where long term expectations are, and for much of the last quarter century they have been very elevated.

Conclusions

History does not repeat itself, but as Mark Twain is supposed to have said, it does rhyme, especially in investment markets, and there are some strong rhymes currently between now and eleven years ago. This doesn't mean that 2019 will be a replay of 2008, but it should raise a degree of caution amongst investors that is not currently being encouraged by the vast majority of financial commentators and headlines.

I have long felt that the huge speculative peak seen in 2000, with the crescendo of the largest speculative bubble in history, was the end of a great secular bull market that began either in 1974 or 1982, what has been endured since are a series of cyclical bear and bull markets that will ultimately be looked back upon as one protracted secular bear market that will eventually deliver historically low valuations. Through much of Europe this description remains valid, whereas the magnitude of the rise in the US since 2009 brings this view into question. Nonetheless, whether a secular bear market is merely resuming or just about to begin is largely irrelevant, the caution that I have been encouraging for some time is still warranted and will continue to be until long term investor expectations become substantially more subdued. Preservation of capital continues to be my favoured investment strategy.

15th January 2019