Strategy Thoughts

March 2019

The Dip has been bought, and the 'Dead Cat' has bounced!

But so too have expectations

Introduction

Since late December stock markets around the world have rallied markedly and accompanying these rallies has been an increasing level of confidence and expectation on the part of investors and commentators. In this month's Strategy Thoughts, I will firstly put the rallies that have been seen into a global context, examine how far both short and longer term expectations have moved and finally illustrate that it is always at times of extreme confidence that both bear markets, and then recessions begin.

The dip that was bought and the bounce that has been seen

The poster children for the rally that has been seen since Christmas Eve are undoubtedly the US markets. The reason is clear to see in the chart below of the Dow Jones Industrial Average.

The Dow has very nearly recouped all its late 2018 losses in rallying more than 4,000 points (20%) in just ten weeks. The S&P500 has not delivered quite so much but has still recovered more than 75% of its previous losses. However, whilst some markets, such as the Australian and New Zealand markets have recovered almost all, and all, of their losses, this has not been the case in many other major regions of the world.

In Europe the broad EuroStoxx 50 index fell 21% through the last couple of months of 2018 and has so far only recovered only a fraction more than half of this fall and in Germany the recovery has been only 45% of the prior fall. In Asia, the broad MSCI Asia Pacific Index fell, through most of last year by 25% and from its low point has only recovered 39% of that bear market.

It is clearly the case that the 'dip' seen globally late last year, has indeed been bought, however, the magnitude of that buying has varied and in many markets it is still reasonable to suppose that what has been seen over the last ten weeks is just another example of the 'dead cat bounce'.

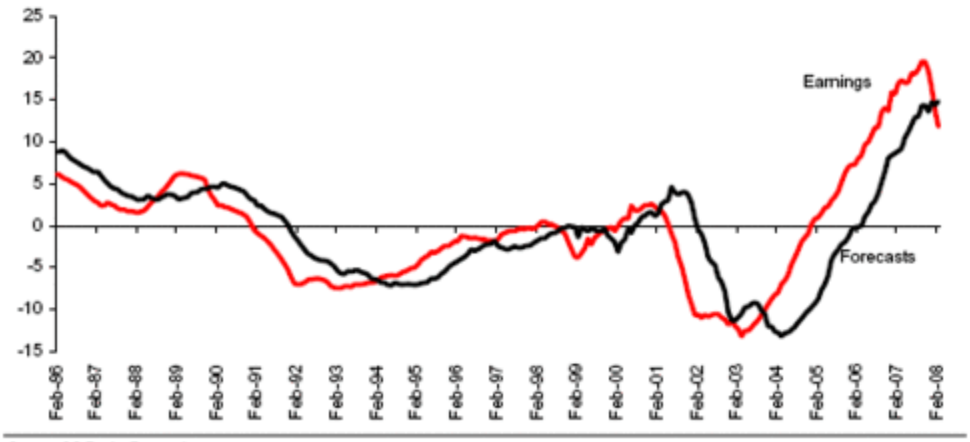
> "A **dead cat bounce** is a small, brief recovery in the price of a declining stock. Derived from the idea that "even a dead cat will bounce if it falls from a great height" " Wikipedia

Dead Cat or not, the bounce that has been seen has certainly produced some marked reversals in expectations as the following Bloomberg quote illustrates;

> **UBS Forecast Has S&P 500 Climbing to a Record by June** Bloomberg Feb 19
>
> The rebound in stocks since Christmas has been breathtaking. Sentiment among Wall Street analysts is being repaired with similar speed.
> The latest example is Keith Parker at UBS Group AG. The strategist in January slashed his 2019 forecast for the S&P 500 from the second-highest among those tracked by Bloomberg to below consensus. Now, he says the benchmark will climb to new highs by the end of June, approaching his year-end target of 2,950.

Such reversals should not be that surprising. I illustrated last year in Strategy Thoughts that the year ahead forecasts for the stock market by strategists have almost always been extrapolations of the previous year's performance. In fact, whatever the market did the previous year has been an incredible predictor of what 'experts' forecast for the next year, this is interesting, and to some extent understandable, but unfortunately for investors not at all helpful. James Montier illustrated a similar phenomenon years ago with the chart below showing analyst's forecasts of S&P500 earnings from trend compared to what actually happened.

Analysts lag reality (S&P500 earnings, deviations from trend, $ per share)



Source: SG Equity Research

I included this chart in my book 'Investing – The Expectations Game' and wrote;

> At first blush it appears that analysts may actually have successfully forecast most of the important inflection points in corporate earnings; that is until one realises that the leading line is the actual earnings not the forecast. As long as earnings are declining then analysts will forecast a continued decline, until that is, earnings reverse and begin to rise and then, usually with a delay of about a year, they start to forecast a rise, and so it continues.

Improving expectations on the part of analysts is an understandable reaction to improvement in the markets, it should not, however, be a source of any comfort to investors that the improvement is set to continue.

The enormous change in shorter term sentiment has also been shown in surveys such as the Ned Davis Crowd sentiment survey, that highlighted extreme pessimism at the end of last year but has now moved to a level of extreme optimism. The AAII also recently showed the lowest level of bearishness in over a year and the CNN fear and greed indicator recently jumped back into extreme greed, having languished at its most extreme fear level in several years towards the end of last year.

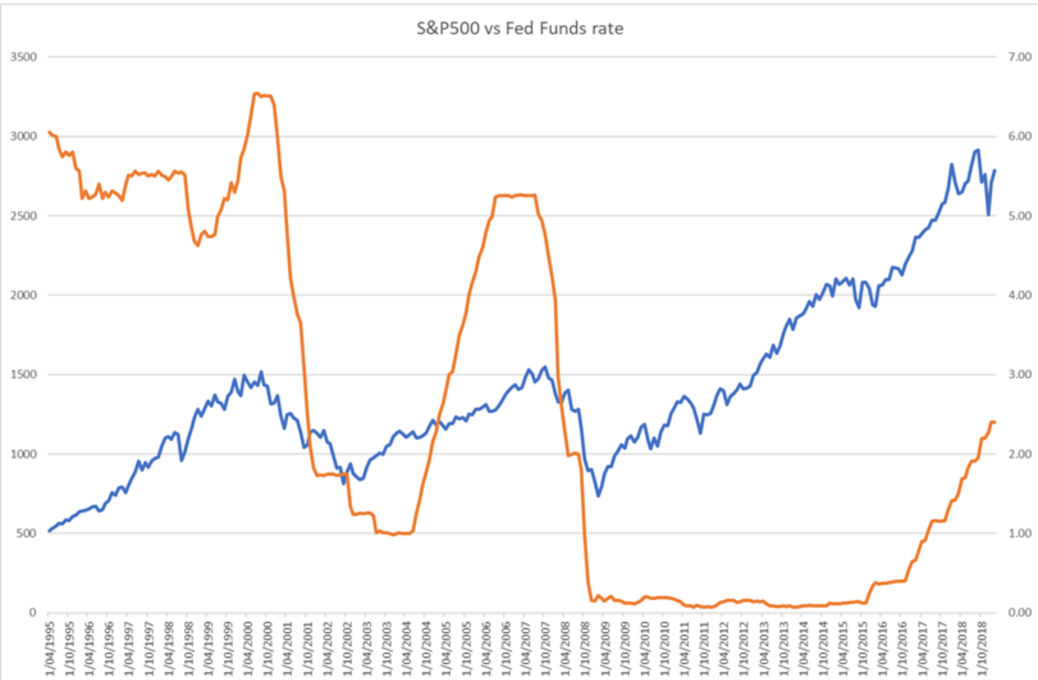
None of these anecdotes, indicators or measures imply that a reversal is imminent, however, the speed and enthusiasm displayed by both commentators and investors over this recent bounce should serve as a warning sign, and should certainly not be seen as a reason for further comfort in or extrapolation of the current trend.

Be careful what you wish for!

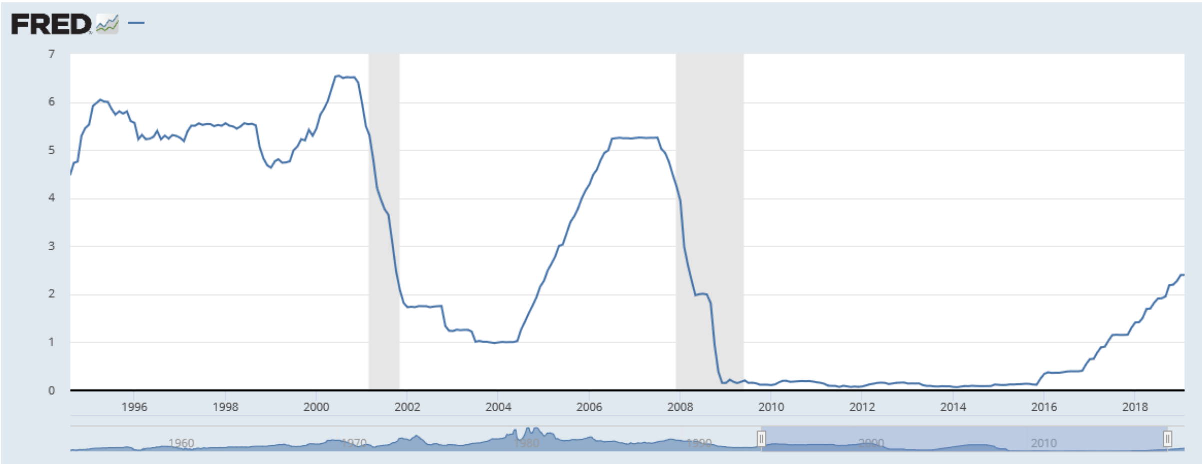
It should also be a source of some concern that investors are currently placing so much store in the recent apparent reversal, or pivot, in Fed policy. It seems that the more dovish behaviour and commentary of the Fed, and the increasing likelihood of their next move being a cut rather than continued hikes, is being seen constructively by the market

> U.S. Stocks Rise as Fed Confirms Dovish Pivot hacked.com 20/2/19
>
> **Why the Fed's next move may be a rate cut CNBC 27/2/19**

Whilst it may seem intuitively sensible to many that a rate cut would be constructive for the market, history does not confirm that such an assumption is valid. In fact, history seems to imply that investors should be hoping for many more rate hikes, not cuts! It may well be a case, as so often happens in markets, of being careful what you wish for, and not confusing what is in fact cause and what is effect.



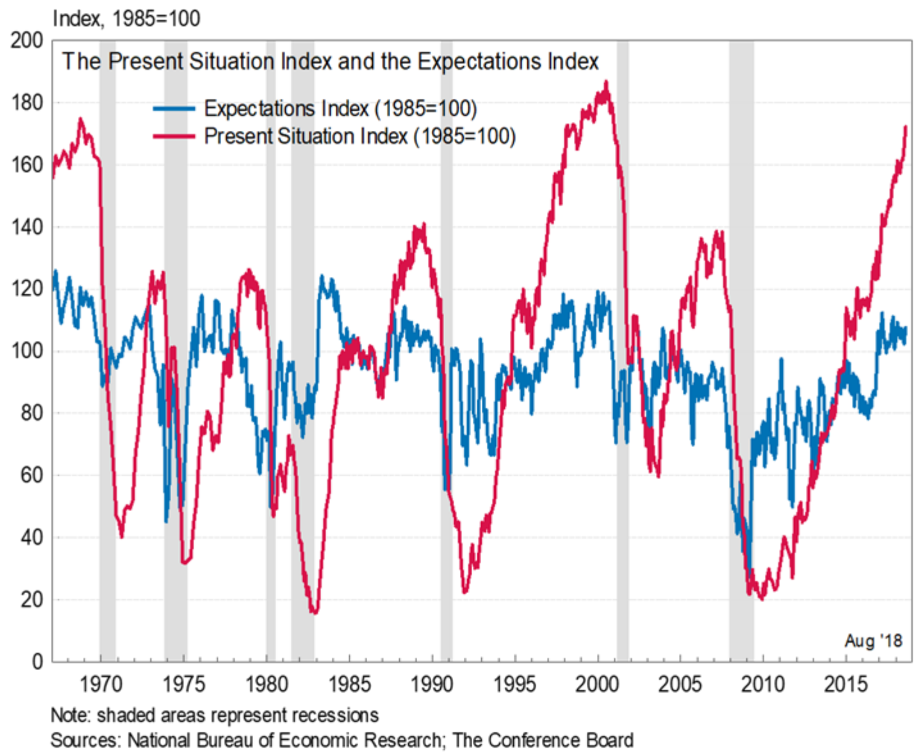
The chart above shows the S&P500 compared to the Fed funds rate since the mid nineties. The first fall in the Fed funds rate in 2000 occurred in August, which was also the month that saw, up until then, the all time high in the S&P500, from there the funds rate and market declined together with the S&P ultimately falling by about 50%, all while the rate was also falling. The next bear market in the S&P began in October 2007, a couple of months after the funds rate began to slide and the two indices plunged in tandem through to the early months of 2009, bottoming within a couple of months of each other. Since then the stock market has only had flat and rising interest rates to deal with and has rallied throughout.

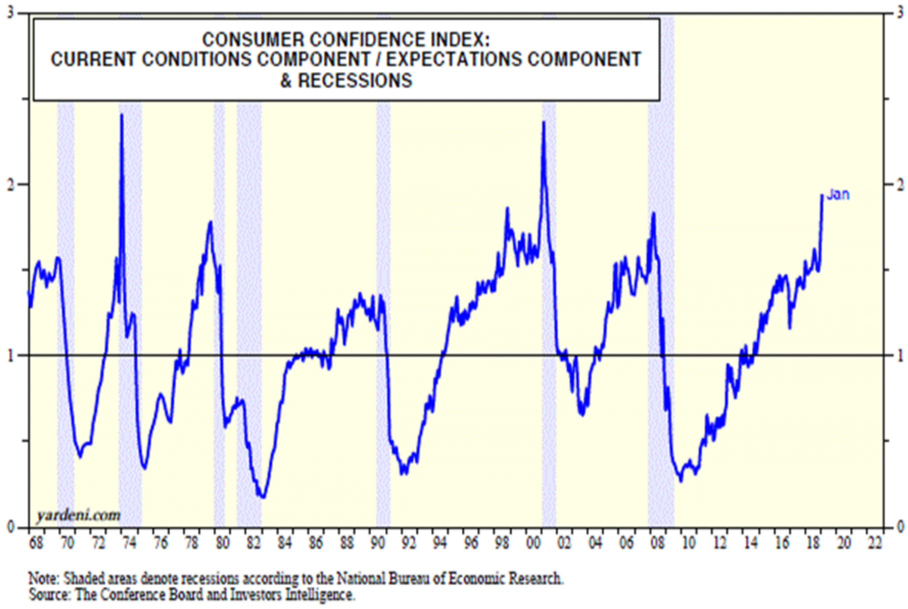


The chart above of Fed funds rate and recessions highlights that a falling Fed funds rate not only might indicate the end of a bull market, but also, eventually, the start of a recession.

Is Confidence Good?

The following are a selection of charts gathered over the last month indicating various measures of consumer confidence and expectations





The graphs all show that consumer confidence, especially the measure of current conditions compared to expectations tend to peak, and indeed spike, ahead of recessions and often after a bear market has already begun. Investors should therefore not be too surprised, unlike the following headline, if markets do in fact fall while confidence is at a high level.

Stock Market Forecast – Prices Slip Despite Strong Consumer Confidence FXEmpire.com 26 Feb

Bull markets have always begun amid deeply depressed expectations and confidence, that is when the possibility of positive surprises is highest, and they have always ended amid extreme confidence as that is when the risk of disappointment is highest.

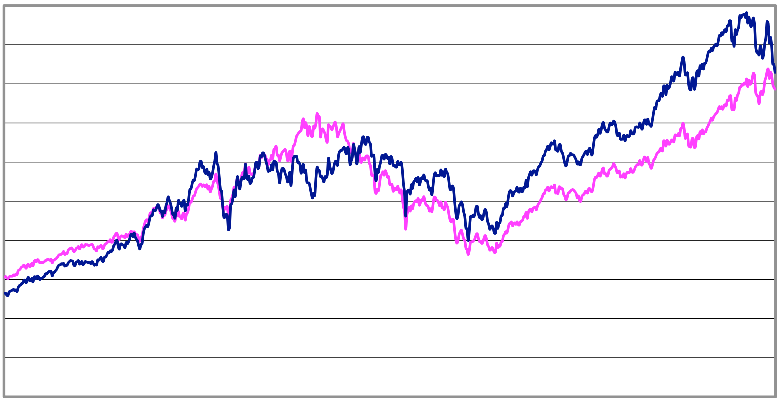
The risk of disappointment, over both the long, and short term given the recent rebound, remains very high indeed

Are financials telling us anything now?

Back in December 2007 I wrote the following;

> It is a little hard to see on the chart below but globally financial companies have been markedly underperforming the broader averages for most of this year. This is perhaps not that surprising given the multibillion dollar write offs being, almost continually, announced in the wake of the subprime and related unwind. However, what is clear from the chart is that financial underperformance is not necessarily a healthy sign for the market. The last time such financial weakness was seen while broader averages continued higher was in the late nineties. Admittedly the financials did then out perform in the subsequent bear market but financials weakened for more than a year before the final speculative peak in the market.

World index compared to world financial stocks since 1995



In addition to the strength of investor and consumer expectations currently it should aslo be of concern that financial stocks have once again been under performing, especially since the late September peak in the S&P500

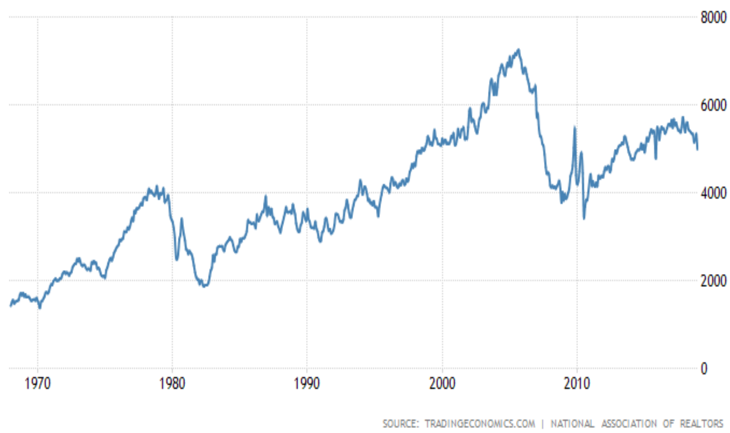
The chart above shows the Financial sector ETF XLF compared to the S&P500. The financial sector actually peaked over a year ago in late January 2018 and has been underperforming the market ever since. Such divergence in performance did not bode well eleven years ago and may well be a warning now

Housing

Perhaps one of the reasons for the underperformance in financials can be found in the US housing market, that also gave an early heads up to the impending financial crisis back in 2006,7 and 8

In the May 2008 edition of Strategy Thoughts, I highlighted the warnings that were being flashed in the US housing market with the chart below;

An update of that chart shows the anaemic recovery that has accompanied the most recent bull market, and also that home sales peaked more than fourteen months ago (a couple of months ahead of financials) and have so far declined by 13%.



Conclusions

Back in the May 2008 edition of Strategy Thoughts I commented that it was too soon to be 'looking across the valley', a phrase that was prominent at the time and frequently employed as justification for buying whatever bounce was then taking place. I would express the same sentiment now, except the vast majority of investors are yet to recognise that any sort of 'valley' has yet appeared. This despite so many markets still at levels well below their all time highs.

I still maintain, as I did in May 2008, that it is too soon to be 'looking across the valley'. The dip has been bought, and the dead cat has bounced, but now it is beginning to roll over!

In the last edition of Strategy Thoughts I wrote in the conclusion;

> 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.

A number of readers have questioned this description of Europe, it is therefore worthwhile including the following longer term chart of the French CAC index;

And the price, as opposed to the total return index, for Germany

Both these major European indices continue to display all the characteristics of what one would expect in a still unfolding secular bear market, with both still languishing well below their highs recorded nearly two decades ago.

With another cyclical bear market likely in the offing, if it has not already started, within these still unfolding secular bear markets, preservation of capital continues to be my favoured investment strategy.

5th March 2019