Strategy Thoughts

April 2019

Expectations have become more elevated, and

Europe is once again 'The Canary in the Coal Mine'

Introduction

Over the last few weeks equity markets have continued to rise while longer term bond yields have continued to trend lower as concern over further Federal Reserve tightening has diminished. The result of all of this has been that expectations for even further gains have risen, fear has evaporated, levels of complacency have grown and speculation has arguably become rampant. All of these things can continue; however, it is important that all investors realise that such a combination is invariably seen very close to the end of a bull market, not at a time when sustainable long term healthy returns can be expected. It is also a concern that European markets continue to dramatically lag those of the US, a trend that has seemingly inexorably grown over the last nine years. Whilst this may be an indication that relative outperformance could be expected from Europe, it in no way means that European markets should rally. Rather, European weakness may merely reflect the deteriorating fundamentals within Europe and this deterioration may eventually be looked back upon as having been the 'Canary in the Coal Mine' for a deeper and more troubling global economic and stock market malaise.

Speculation

The Financial Times in mid March described the rise in the US market as being driven by 'a burst of merger activity and 'speculation'. Both these behaviours, M and A and speculation, are related and worthy of further consideration. Neither are actually drivers of the market, rather they reflect the same underlying characteristics that do drive the market, the aggregate expectations of those involved in the market, and they rise and fall together. As such they tend to be coincident (or possibly in the case of M and A very slightly lagging) indicators of the market rather than leading indicators. Over the very long term it is clear that M and A activity has always peaked close to the market's peak, and that the largest deals tend to be closed at or near that peak. A recent report by Deloitte 'The Future of the Deal' highlighted how strong M and A activity has been, but also how things may be about to change;

> The last five years have witnessed an unprecedented bull run in global M and A markets and 2018 was the fifth consecutive year when deal values exceeded the $3 trillion mark. However there are signs we may be witnessing a late cycle phase. Indeed last year was a tale of two halves, with H1 contributing nearly 60% of the year end total, while for the first time since 2014 we saw a year on year decline in M and A volumes.

It would not be surprising to see equity markets resuming their downtrends coincident with a rolling over in global M and A activity.

In 1932 Robert Rhea, in his book 'Dow Theory' wrote;

> There are three principal phases of a bull market: the first is represented by reviving confidence in the future of business; the second is the response of stock prices to the known improvement in corporate earnings, and the third is the period when speculation is rampant.

Speculation, and therefore expectations, are also nearing levels that have in the past accompanied previous market peaks and could now be described as ‘rampant’.

Two recent articles on Yahoo Finance illustrate the degree to which speculation and elevated expectations have returned;

> **Why the stock market's amazing start to 2019 could be just the beginning** Yahoo finance 10 April 2019
>
> **Uber, Lyft, Slack, Pinterest, Other Hot IPOs & ETFs: What You Need to Know** Yahoo finance 9 April 2019

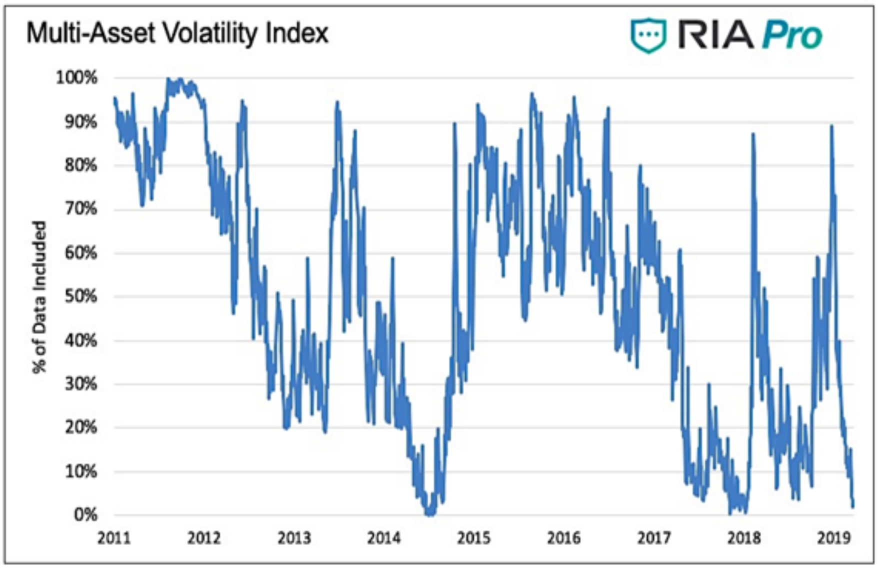
These huge IPO’s are great news for investment banks, but huge peaks in IPO activity tend not to lead to riches for the underlying investors. There is more than a little wisdom in the old adage that IPO doesn’t necessarily stand for initial public offering, rather, that it stands for ‘its probably overpriced’. History shows that this has certainly been the case when IPO volume soars, as the second article above seems to imply it is set to. It should also be something of a cautionary flag to investors that so many of these enormous companies that have already come public, and are about to go public, do not make any money. In 2018 a staggering 83% of all IPOs in the US were for companies that lost money. This even surpasses the 81% figure that accompanied the historic peak of the dotcom boom in 2000. Everyone now knows how ludicrous the situation was back then as what followed was an 80% decline in the NASDAQ in the early years of the new millennium.

Cracks in the current boom in profitless IPOs may already be being seen with the recent miserable performance of ride sharing company Lyft. The company listed at a price of $72 on the 29th March and immediately shot up to a high of $88.60, since then it has fallen more than 32% in value.

Rampant speculation usually occurs towards the end of a bull market as fear subsides, extrapolations of the bull market that has already been seen grow longer and ever more optimistic, and levels of complacency grow. Such attitudes are clear in a recent CNBC poll where 66% of respondents believed new all time highs were only weeks away. This may be understandable given the dramatic plunge in volatility so far this year, as can be seen in the chart of the VIX index below.

And it is not just the VIX index that has plunged, so too has volatility across most asset classes, as the following headline and chart from Yahoo Finance illustrate.

Complacency is sweeping through the stock market Yahoo finance 9 April



Data Courtesy Bloomberg

On the same day as that article appeared CNN highlighted the danger of such complacency

Nobody on Wall Street seems afraid. Here's why that's scary

CNN ran this headline when they reported that their fear and greed index so far this year had rocketed from the depths of extreme fear to a level approaching extreme greed. All this while the US stock market has risen, in a virtually uninterrupted fashion, from the depths of its worst sell off in years to a level approaching its all time high.

A similar rebound in expectations has been seen throughout Europe, although here the recoveries in the markets have been more subdued An example is the UK, where the FTSE100 index has recovered less than two thirds of its 2018 fall, yet expectations, as measured by levels of bullishness, have recovered to the same levels (88%) recorded at the all time high.

Europe, the canary in the coal mine!

Whilst the broad EuroStoxx 50 index has rallied nicely from its late 2018 lows it has continued to lag behind the US market. Europe has rallied 18% from its low while over the same period the S&P500 has rallied 24%. This is a continuation of the underperformance of the US by Europe going back years, as can be seen in the chart above.

This underperformance is even more apparent over a much longer term as shown in the chart below.

Whilst the US market has been recording new all time highs for more than five years the broad EuroStoxx50 index remains 10% below its 2015 high, 25% below its 2007 peak, and a staggering 38% below its 200 peak.

This relative underperformance could present either an opportunity, or reflect some very real underlying problems.

For there to be an opportunity it would probably need to be the case that the idea of investing in Europe would need to be almost universally shunned. This was the thinking behind a recent CNBC article;

> **Go in when you're the most scared:' BNY Mellon lists Europe as top global play** CNBC 8th April19

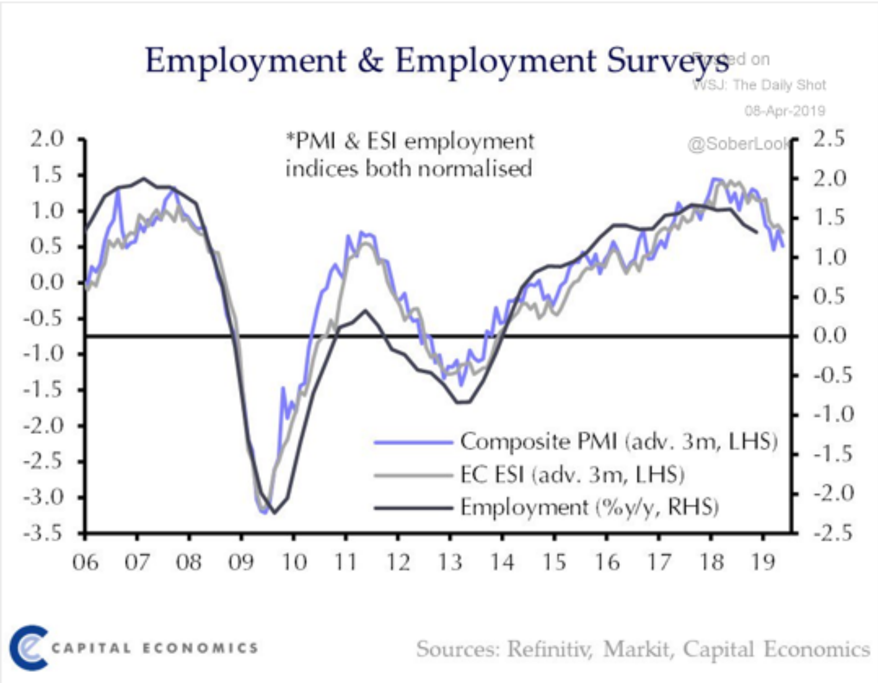
The article quoted a chief strategist;

> "There are great opportunities in the places where people feel the worst about. And, that would be Europe," she said Thursday on CNBC's "Futures Now." "Europe looks terrible, and everybody is scared of Europe."

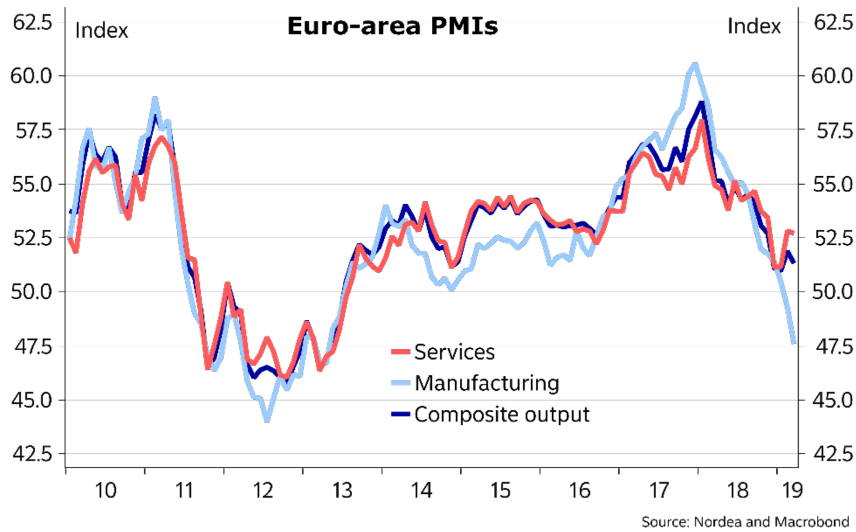
The problem with this thesis is that not everyone seems to be as terribly scared as the strategist believed. At the bottom of the article was a survey asking would you consider investing in Europe now. 57% of the respondent said yes, almost twice as many as those voting no! This is not the kind of expectational set up one would expect to find at a great buying opportunity. As I wrote last month, investing in Europe may be a better bet than investing in the US, but the payoff maybe that European markets just don't go down as much as the already very extended US market.

Some economists are now beginning to highlight the very real danger that things are set to get worse, not better in Europe as the following selection of charts highlight.

Economists are concerned that the latest weakness in business activity will pressure the labor markets.



Manufacturing PMI leading the decline



Vast German manufacturing industry shrinks at quickest pace in more than six and a half years

A little over a year ago an analyst wondered whether European stock could be the 'canary in the coal mine.

Why European stocks could be a canary in a coal mine 27 Feb 2018CNBC.com

The article pointed out, amongst other things;

> Equity markets in the U.S. are on the road to recovering post-correction losses, but European stocks may be set to stall out, according to a recent Oppenheimer report.
>
> European markets are increasingly a potential warning for the overall global equity cycle. In other words, major European stock markets' relative underperformance could be the weakness showing its head before other markets follow suit.

Following on from this US markets continued to rally, as discussed earlier, and the divergence between the two regions has only grown greater. Rather than proving the idea of the 'canary' wrong I believe we are now just witnessing an even greater warning than that fourteen months ago.

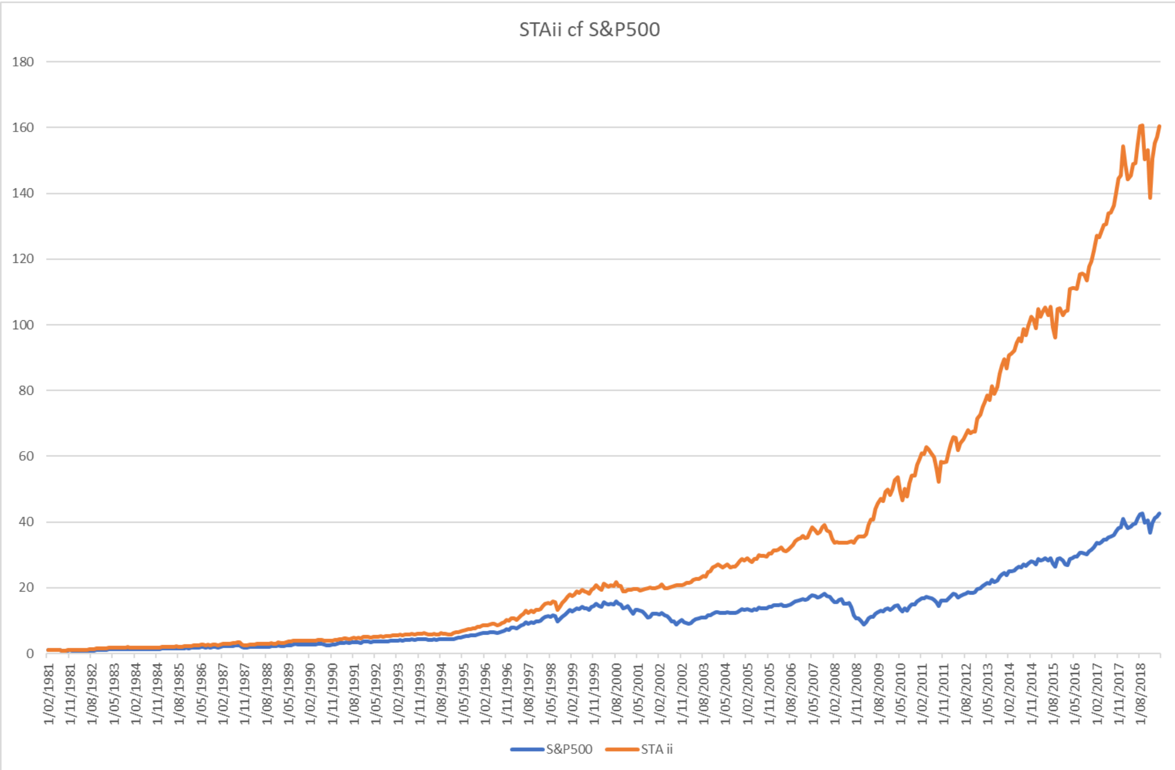
Updated STA

Over the last few years I have introduced readers to the STA model, a simple, rules based approach to investing, one that would only require action at most once per month and one that would take emotion out and eliminate the influence of the unfortunate behavioural biases that beset us all. Originally this model was purely driven by a 13 month moving average, this has been substantially refined and is now driven by a combination of two time periods, five and thirteen months. An investor would be in the market if;

- Either the 5 or 13 month rate of change of the price history was positive.
- Or, the 5 month MA was above the 13 month MA

When not invested in the market the STAii invests in a hybrid fixed income model split between high yield and intermediate treasuries driven by the same model described above. This approach has delivered the following results in a back test to 1981 and required only 24 trades in 38 years.

It was invested 85% of the time and produced a CAGR of 14.2% compared to the S&P's 10.3%. It delivered a 12% probability of a down rolling twelve months.



Conclusions

Last month I concluded that the dip had been bought, and the dead cat had bounced, but now it is beginning to roll over! Well, this was clearly premature, the dead cat has shown even more 'bouncibility'.

However, this bounce has only continued to spawn greater levels of expectation and hope amid rampant speculation and ever greater levels of complacency. Each of these characteristics on their own would be a warning sign to investors and such a confluence of warning signs should not be overlooked.

My closing sentiment last month continues to be an appropriate approach for all but those prepared to attempt to be the nimblest of traders. 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.

11th April 2019

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