Strategy Thoughts

May 2019

If this was the 'Melt Up' then fear the melt down!

Pay attention to expectations and don't CHASE YIELD

Introduction

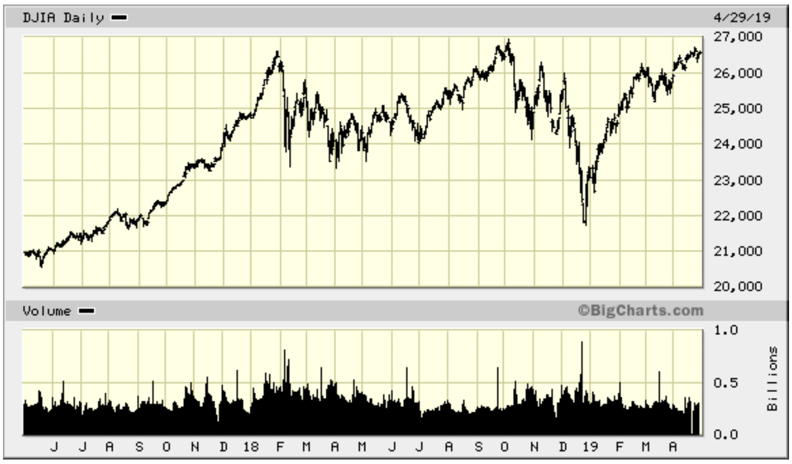
Over the last few weeks there has been a growing chorus amongst prominent market commentators stating that the biggest risk facing the stock market currently is that of a 'Melt Up'. This is **after** US markets have risen more than 25% in four and a half months from their lows late last year, European indices more than 20% and Asian indices 15% to 35% (in the case of China). In some ways the current 'Melt Up' calls are an eerie echo of similar extrapolations that were being heard in late 2017, early 2018, again after a wonderfully rewarding preceding rise. Those extrapolations delivered nothing but multiple disappointments and were only useful in that they served as a great barometer of just how elevated expectations had become. The same is probably true now. In this month's edition of Strategy Thoughts, in addition to looking at these 'Melt Up' calls I once again examine the danger of chasing yield, no matter how tempting it may be, and also illustrate, once again, the value of taking an expectational approach to markets using oil's recent volatility as an example.

Was that the melt up?

In the January 2018 edition of Strategy Thoughts I highlighted the then prevailing obsession for analysts to raise expectations as to how high the bull market could run, and the increasing expectation for a 'melt up';

> On 22nd December Bloomberg reported;
>
> **Wall Street's Rushing to Raise S&P 500 Forecasts for 2018**
>
> Two more Wall Street strategists bumped up their 2018 forecasts for the S&P 500 just days before the new year starts.
> Jonathan Golub of Credit Suisse Group AG now predicts that the benchmark index will end next year at 3,000, up from a previous target of 2,875. Wells Fargo & Co.'s Chris Harvey boosted his projection to 2,863 from 2,784.
>
> On the same day CNBC reported similar news;
>
> **The stock rally is unfolding so fast investment banks are already raising their 2018 forecasts**
>
> That article concluded;
>
> The flood of optimism on equities comes even as the S&P notches daily records: The index closed at an all-time high Monday and fell just short of beating that record Thursday, up more than 20 percent this year. For its part, the Dow Jones Industrial Average has closed at a record high 70 times this year, the most record closes in a single calendar year. The index added 55 points Thursday.

Since then this is what the US market, as measured by the Dow Jones Industrial Average has delivered;



The crescendo in 'melt up' calls coincided with the accelerating peak, so obvious in the chart above, in late January 2018. Since then the market has meandered sideways in an extremely volatile fashion. It would be hard to describe what has been endured over the last 15 months as even a bull market, let alone a melt up.

And Now the MELT UP is back!!!

Over the last few weeks, with equity markets the world over having rallied enormously from their late December troughs, calls for a 'Melt Up' are increasingly being heard

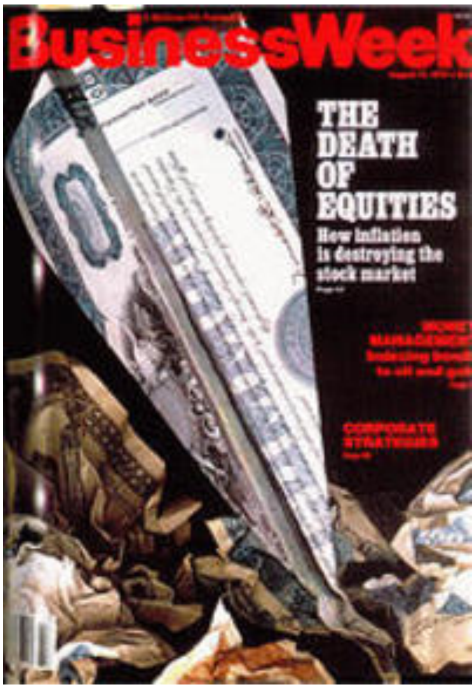
> "We have a risk of a **melt-up**, not a meltdown here. Despite where the markets are in equities, we have not seen money being put to work," the head of the world's largest asset manager tells CNBC. CNBC 16th April
>
> Two major banks highlighted the possibility of a rapid, surprise jump in the stock market known as a "melt-up," driven by investors looking to get in on a positive momentum shift. CNBC 2nd May

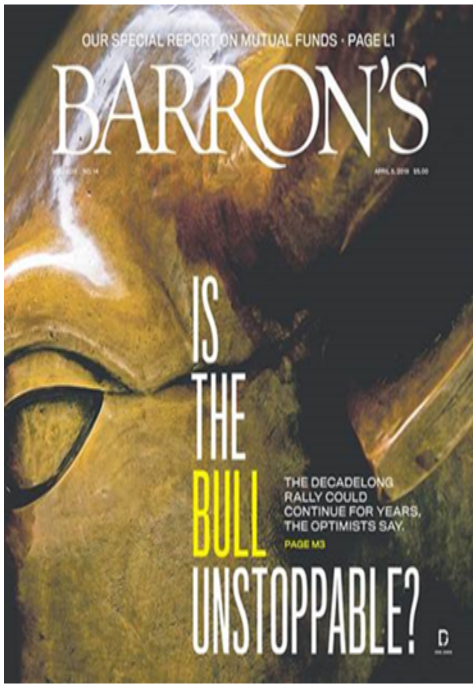
Not only is it a few outspoken commentators calling for a 'Melt Up', the respected business magazine Barrons last month ran a front cover that asked; "Is the bull market unstoppable? The decade long rally could continue for years the optimists say".

Such ultimately misplaced hope has been seen before. In late 1999 Wired Magazine ran a story title 'The Roaring Zeros'. This appeared just ahead of the peak of the largest speculative boom in history, one that saw the NASDAQ accelerate higher for almost a decade. The article's subtitle was 'The Dow 100,000' and forecast that the Dow would hit 50,000 by the end of 2010 and 100,000 by 2025. We now know that the first of those targets was missed by a mile as the bear market of the early 2000s wiped 80% of the value of the NASDAQ and cut the S&P500 in half. Such extrapolations, and that is all they ever are, are understandable but not helpful except as contrary indicators, and are naturally the mirror image of the type of covers, articles and extrapolations one would expect to see when a great buying opportunity was presenting itself.

In the past I have referred to the famous 'Death of Equities' Business week cover which appeared just before the start of the great bull market of the 1980s, that cover in 1979 demonstrated just how bleak expectations had become. The recent Barron's cover clearly illustrates exactly the opposite expectations.

One was a great long term buying opportunity, the other probably isn't!





Much of the enthusiasm seems to stem from a belief (or hope) that central bankers will ensure that nothing bad can happen. Inside the article one strategist is quoted;

> *We are all used to using the word ‹cycle›; we're all used to looking at historical charts and graphs and equations and relationships. The reality is that maybe the word ‹cycle› is no longer even relevant, given that we have so much unconventional central-bank involvement.*

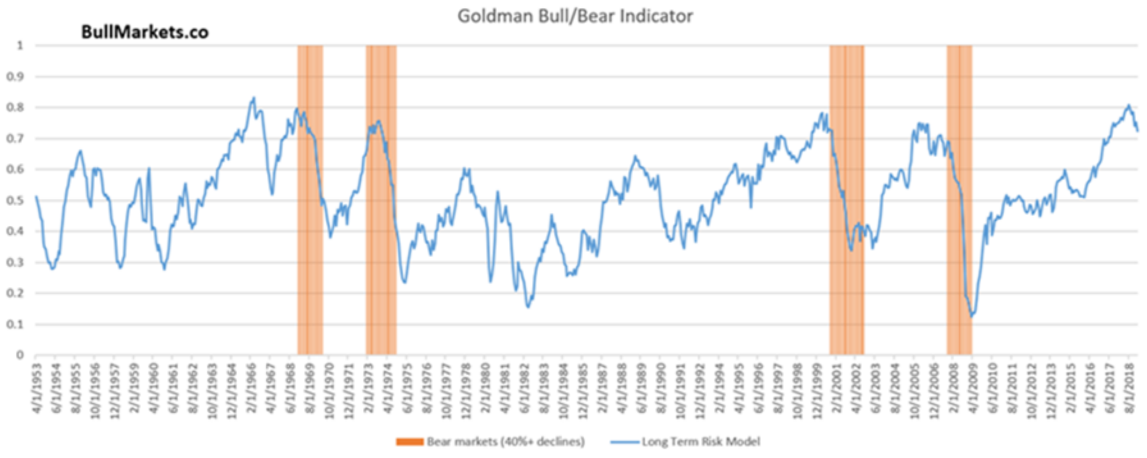
Such ultimately misplaced faith has been seen before. In February of 1999 Time Magazine's cover story was 'The Team to Save the World' and portrayed images of the so called 'Plunge Protection Team'; Fed chairman Alan Greenspan, Treasury secretary Robert Rubin and his deputy and ultimate successor, Larry Summers. The belief was that this 'team would avert another crash or LTCM type of melt down. History shows that since this team was put together two of histories largest ever 'plunges' have been endured, with apparently no 'plunge protection' in sight.

Looking back even further it should be a salutary reminder, for all those investors taking comfort in the certainty of central bank foresight and support, that back in 1929 Financial World wrote;

> *It may be well again to stress the all-important point that the Federal Reserve has it in its power to change interest rates downward any time it sees fit to do so and thus to stimulate business.*

And just a few months earlier Andrew Mellon, the secretary of the Treasury was quoted 'There is no cause for worry. The high tide of prosperity will continue'. There was no 'plunge protection ' team back then but it is clear that any comfort was totally misplaced as the worst stock market crash and economic depression ever was about to begin.

With expectations for equity markets once again so elevated it is also concerning to see Goldman Sachs' Bull/Bear indicator rolling over in a very similar manner, and from similarly elevated levels, as it has done ahead of the last four major bear markets.



It is highly likely that this bull market is indeed stoppable, and it will ultimately be clear that it stopped when expectations and extrapolations were at their highest.

FTSE 100 expectations

It is certainly not only in the US that expectations have once again become stretched.

In early 2018, when the FTSE 100 was hitting its all time high sentiment readings showed a fairly one sided 88% bulls. What is remarkable is that the rally so far this year, that has to date only recovered a little over two thirds of last year's correction, has witnessed an incredible surge in bullishness towards the UK market. At the recent peak in late April bullish readings had surged to 94%. This doesn't leave an awful lot of room for disappointment and makes upside surprises most unlikely.

Expectations and the danger of chasing yield!

In the first week of April Reuters ran the following headline;

Huge inflows to U.S. high-yield bond, investment-grade debt funds

The article pointed out;

> Investors' appetite for risk-taking was strong in the latest week, as U.S.-based high-yield junk bond funds attracted more than $2 billion in the week ended Wednesday, marking the group's fourth consecutive week of inflows, according to Refinitiv's Lipper research service data.
>
> Investors' appetite for risk assets and their **hunt for yield** intensified after the Federal Reserve on March 20 brought its three-year drive to tighten monetary policy to an abrupt end. (emphasis added)

Chasing yield has always been dangerous, as the cartoon below and Ray DeVoe's now famous quote make clear.

"More money has been lost reaching for yield than at the point of a gun." – Raymond DeVoe Jr.

Yet it is a lesson that it seems investors never learn. A little over a decade ago the chase for yield lured unsuspecting investors into esoteric products like CDOs and even CDOs squared. Products which the vast majority didn't, and probably couldn't, understand but they were told they were triple A rated and just yielded more than traditional AAA rated bonds. Ultimately many lost more than they could afford.

Expectations as reflected in Argentinian bonds and the 100 year issue!

More recently, in 2017, with longer term interest rates having only a year before recorded all time low yields, Argentina went to market with a 100 year government bond. And with the chase for yield well and truly on the bonds were aggressively sought after, this despite Argentina having defaulted on its own debt eight times in the previous two hundred years, and most recently just sixteen years earlier.

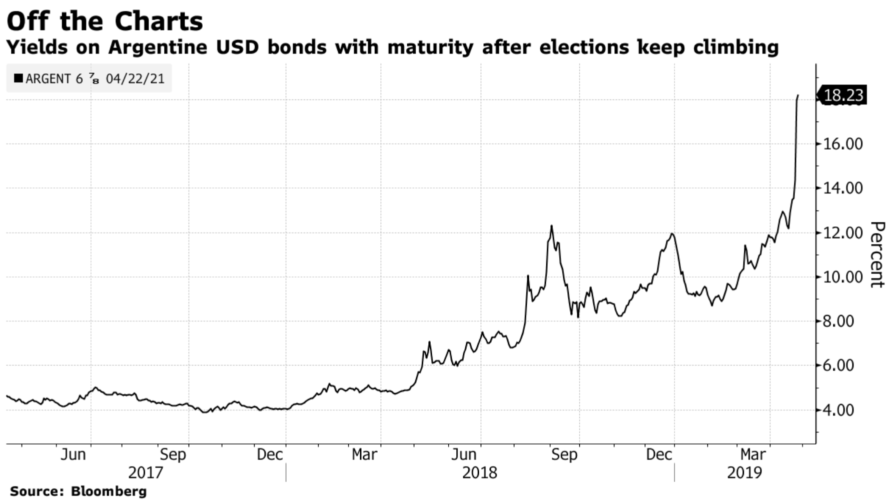
Long term treasury yields troughed in mid 2016

One year later problems were beginning to surface as qz.com reported twelve months ago;

> In June 2017, Argentina sold $2.75 billion of US dollar-denominated 100-year bonds at an effective yield of 8%. The history of defaults seemed to be forgotten—nearly $10 billion in bids were placed for the bonds. The sale came at a time when investors were hungry for high yielding debt, but it also showed confidence in president Mauricio Macri and his program of pro-market reforms.
>
> Less than a year later, Macri has asked the IMF for a $30 billion loan to help it combat a currency crisis and limit further damage to the Argentinian economy from a dangerous outbreak of market turmoil.

Since then things have only become more dire as the FT reported two weeks ago;

> **Argentina's century bond caught in dash for exit** Just two years ago investors rushed to snap up 100-year debt sold by Buenos Aires

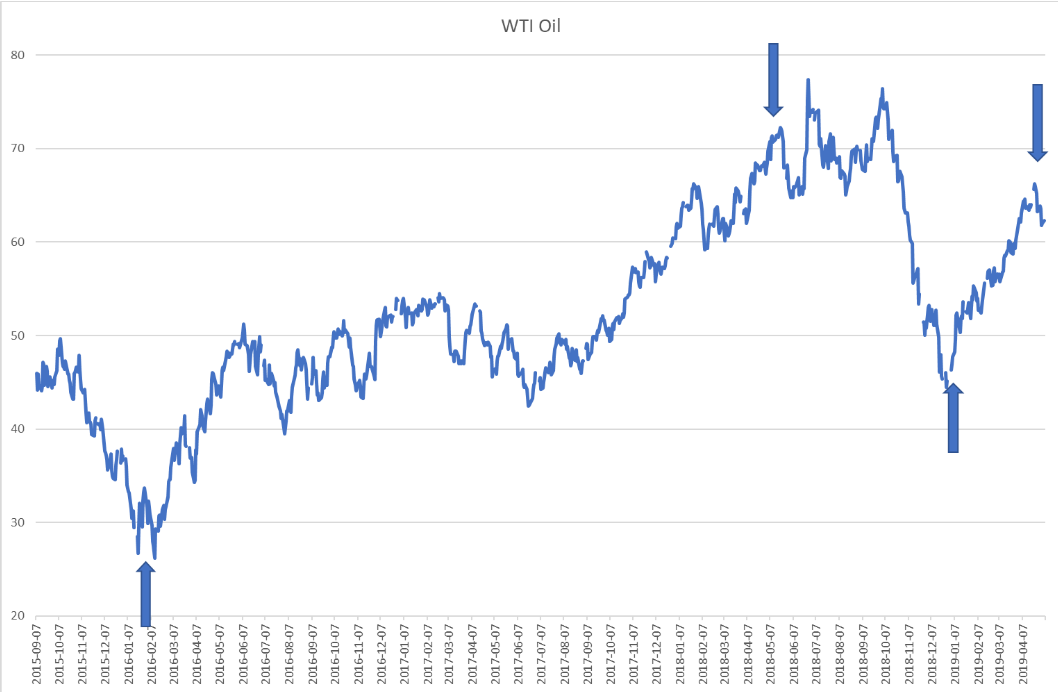


The chart above illustrates just how dire things have become and whilst the bonds have not yet defaulted the market is not painting a very rosy picture for those holders that still have 98 years to wait until maturity!

Just because interest rates are low and investors think they need a particular return it does not necessarily mean that such a return is available, and if it is there is no reason it will be sustainable just because it is needed. Chasing yield is never a good idea.

Oil and the value of monitoring expectations

Over the last few years I have periodically commented upon the level of expectations that had become obvious, and potentially extreme, regarding the price of crude oil. The chart below shows the daily price of oil since late 2015 with some arrows illustrating where extreme expectations, both bullish and bearish, had been highlighted in Strategy Thoughts.



- The first arrow, in early 2016, coincided with analysts ‘slashing’ their forecasts for the price of oil with some predicting a fall to as little as $10. This was after it had already fallen from $60 seven months earlier, and over $100 in mid 2014. Those extremes were obvious extrapolations of the preceding plunge and not surprisingly marked a bottom in oil and the beginning of a tripling in the commodity’s price.

- By May of 2018 expectations were understandably very different. In that month’s Strategy Thoughts I highlighted the forecasts of two major Wall Street firms forecasting $90 and $100 price targets driven by factors such as supply and demand and a shipping revolution! I commented that if there was a surprise or a disappointment for oil investors going forward it was far more likely to be a disappointment.

- Prices did struggle on upward for a few more months, accompanied not surprisingly by evermore optimistic extrapolations, and then dramatically reversed in October of 2018 dashing those increasingly positive forecasts. In December, after the oil price had already fallen by 35% I commented that expectations had by then become less extreme and I wondered whether a rally may be overdue. At the end of December the oil price did indeed bottom and embarked upon what I described in January as ‘the steepest oil price rally in more than two years’. Remarkably, even with the oil price rising from those late December lows expectations continued to be bleak. Two major Wall Street firms cut their oil price forecast on weakening economic growth expectations and rising oil supply. Despite this, and no doubt helped by these gloomy forecasts, the oil price continued to rally through the early months of this year.

- Over the next three months the price of oil continued upwards rising 45% from its December low and on the heels of this rise came an unsurprising rally in expectations. On April 2nd the Wall Street Journal announced;

Banks Lift Oil Price Forecasts for 2019 Brent crude is now expected to average just over $68 a barrel

Two weeks later;

EIA revises up oil price forecasts for 2019

And;

Crude Oil Forecast Remains Bullish as Prices Ride Momentum Higher

Oil continued to rise to its recent peak of $66.30 on 23rd April and then reversed. Not surprisingly expectations once again lagged the price movement and, in an extrapolation of the early 2019 rally, continuing elevated expectations were apparent in a Reuters poll of economists

OPEC supply squeeze seen supporting higher oil prices: Reuters survey 30th April.

Their forecast, from 31 economists, was that oil would average $68.37 for the whole of 2019

Monitoring expectations regarding the outlook for oil has been far more rewarding than believing that somehow an understanding of supply and demand would give an investor an insight as to where the next inflection point may be. I illustrated the shortcomings of this supply / demand approach at some length in chapter 3 of 'Investing-The Expectations Game' and David Orrell's analysis of the Energy Information Administration's (part of the US Department of Energy) forecasts, which were notoriously simple extrapolations that deeply lagged important inflection points. Reinforcing these shortcomings were some comments on CNBC by the head of the International Energy Agency oil industry and markets division;

> "In a world where we saw Brent at $86 a barrel in October, $50 a barrel in December and now back to over $70, I think it is a very brave person that attempts to forecast what the price will be at the end of the year," Neil Atkinson, head of the oil industry and markets division at the IEA, told CNBC's "Street Signs" on Thursday 11th April.

Despite this cautionary note from the IEA regarding forecasting it does currently appear that there is a far greater chance of disappointment in the oil markets than a positive surprise.

Conclusions

Sixteen months ago, in the January 2018 edition of Strategy Thoughts, I began the conclusion with;

> Last month's comments focussed upon FOMO, fear of missing out, and this has obviously continued in equity markets where enthusiasm and expectations are rising daily. This has resulted in FOMO morphing into, and being justified by, an expected Melt Up. This may transpire, however, investing in the hope of a continued melt up is speculation in the extreme and all those doing so would do well to note what the 'melt up' spokesman Grantham expects as the aftermath, a 50% bear market. A few very nimble and lucky traders may be able to extract some further value out of this extended market before the melt up reverts to a melt down but history shows that majority do not. Caution and preservation of capital, so one in is a position to take advantage of such a bear market, continue to be the most appropriate strategy for those not currently invested.

In that edition I noted that it was not only Jeremy Grantham of GMO calling for a ‘melt up’, so too were legendary investor Bill Miller and Blackrock’s Rupert Harrison. Now we have Harrison’s boss, Larry Fink of BlackRock, on the melt up band wagon and Bill Miller, despite not yet having had the 50% melt up he forecast in late 2017, continuing to see this bull market as ‘far from over’ and that the path of least resistance for stocks continuing to be higher, according to his first quarter letter to investors.

The last anticipated ‘Melt Up’ came to nothing but a rapid 10% correction and then later last year an almost 20% correction. It is unlikely that the outcome will be any better this time.

9th May 2019