Strategy Thoughts

June 2019

Has the Melt Down begun?

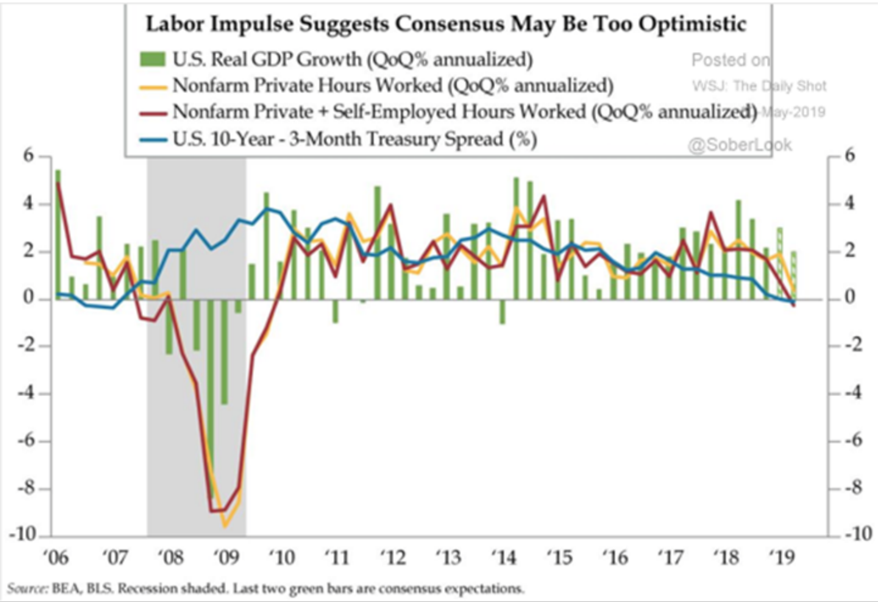
Be Careful What You Wish For!

Introduction

The last month has been mostly ugly for equity market investors. The major US markets are down sharply with the NASDAQ down 10% at its recent low, European markets down 5% or more and the major Asian markets of Japan, China and Hong Kong having all fallen between 7% and 11%. Despite this, expectations remain positive and the media is full of comforting messages. Investors undoubtedly, and understandably, welcome these messages; however, no comfort should be taken, I have often written that comfort and success in investing rarely travel together. This month's Strategy Thoughts highlights just how difficult the economic outlook is becoming, and also the degree to which these messages are being ignored. It also demonstrates just how little comfort anyone should take from the most widely promulgated 'comforting message', that the Fed will ride to the rescue with a rate cut.

Recession warnings!

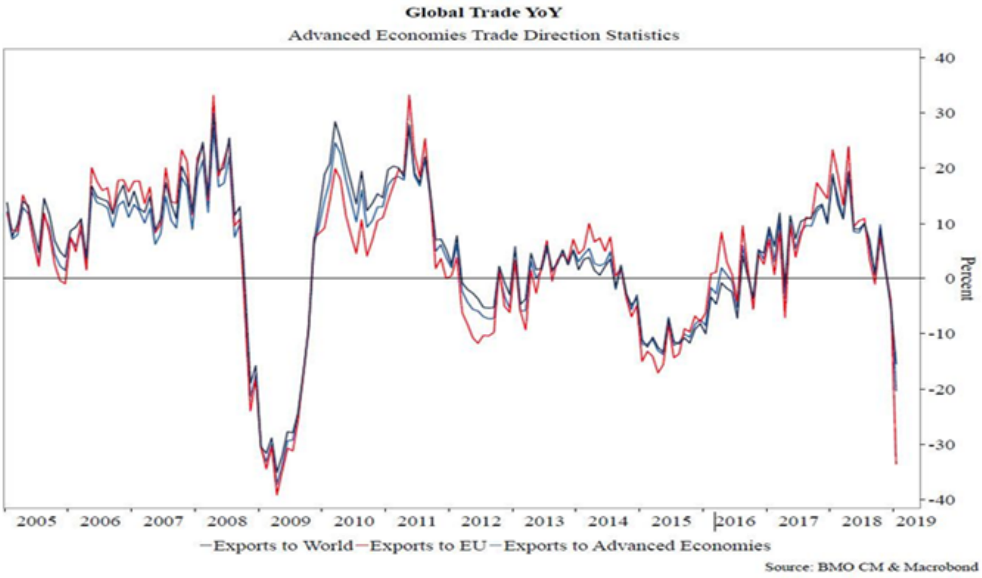
There have been many illustrations of just how weak the global economy has become over the last few weeks. Below is just a selection;



Australia's Imploding Housing Market Now Threatens To Unleash Nasty Recession

Global trade levels are also pointing toward severe economic weakness. Zerohedge a couple of weeks ago highlighted some research from CCLA illustrating just how weak global trade has become;

> But the best way to visualize just how serious the threat to global flow of trade, and the world economy in general, below is a chart on the year-over-year changes in global trade as measured by the IMF's Direction of Trade Statistics, courtesy of BMO's Ian Lyngern. It shows the absolutely collapse in global exports as broken down into three categories:
>
> 1. **Exports to the world (weakest since 2009),**
> 2. **Exports to advances economies (also lowest since 2009), and**
> 3. **Exports to the European Union (challenging 2009 lows).**
>
> In short, even before the latest round of trade escalation, global trade had tumbled to levels last seen during the financial crisis depression. One can only wonder what happens to global trade after the latest escalation in US-China trade war...

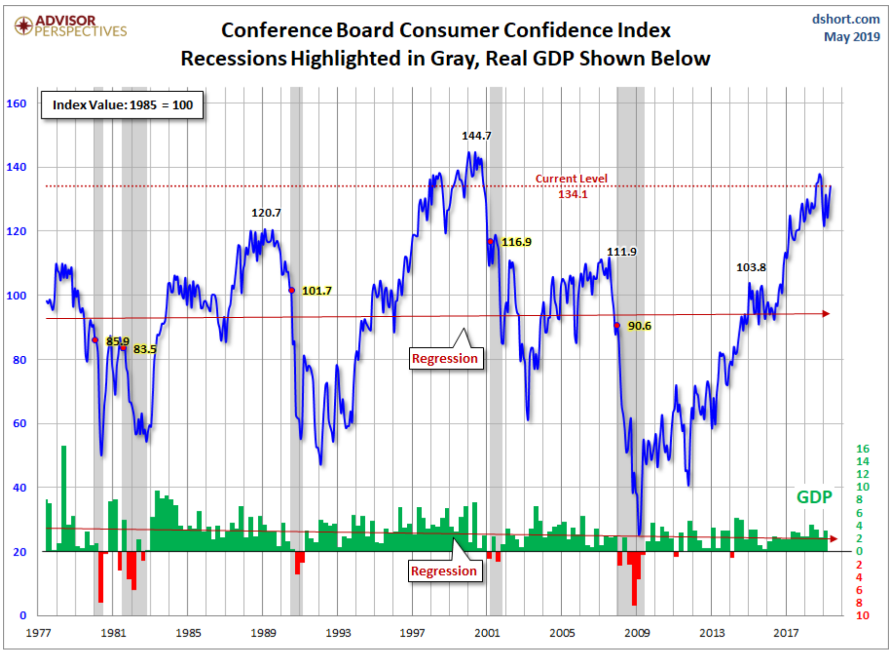


There have been many more illustrations of the growing economic weakness, and more are appearing daily, yet still confidence levels and expectations remain high;

Global Consumer Confidence Drops Slightly, But Remains at Historically High Levels

The Conference Board Launches Global Consumer Confidence Index **(April 2019)**

In the US consumer confidence remains very close to record levels which were recorded just ahead of the bursting of the TMT bubble, arguably the largest speculative bubble in history, and well ahead of the levels seen before other recessions.



Remarkably through May, despite the growing evidence of economic gloom global investor sentiment improved;

The State Street Investor Confidence Index (ICI) showed an increase in confidence of 6.6 points in May.

State Street's Global ICI increased to 79.5 in May, up from 72.9 the previous month. The results found that confidence among North American and European investors improved, with the North American ICI rising from 71.3 to 76.7, and the European ICI rising from 86.6 to 92.5.

Some may see all these economic concerns as constructive, and merely more bricks in the 'Wall of Worry' that bull markets climb. Unfortunately, this would be misconstruing the meaning of the old adage. There are always things for investors to worry about, what the adage is getting at is that as long as investors choose to worry then the market can continue to climb, and the climb will continue until a point is reached where seemingly no one is worrying about anything and expectations are sky high. It should therefore be of concern that currently, despite there being plenty to worry about, investors are seemingly choosing not to worry, and even getting more constructive.

In late October 2007, in the November edition of Strategy Thoughts, I included the following prescient extracts from the Wall Street Journal;

Food for Thought
A US Recession?

Given all my comments on the credit crunch and the US real eastate slump I have included b some extracts from this mornings Wall Street Journal. Columnist David Wessel wrote an excellent and considered piece titled "Three Ingredient Recipe for Recession;

"There are three rules to keep in mind when reading a recession prediction.

• ***Rule No. 1:*** *Forecasters rarely call the turn in the economy accurately. Even the wisest business-cycle veterans have a hard time.*

• ***Rule No. 2:*** *Once forecasters start shaving their growth forecasts, they tend to keep shaving them.*

• ***Rule No. 3:*** *There are always good reasons to argue, "This time it'll be different." But "this time" is usually different in specifics, not in the overall outcome.*

These 'three rules' are worth keeping in mind right now. Don't expect 'experts' to forecast a recession, be aware that forecasts are already being 'shaved'and be really concerned when you are told it will be different this time!

I illustrated rule one above in 'Investing-The Expectations Game'

In 2011 James Montier of GMO brilliantly illustrated the shortcomings of relying upon economic forecasts in an essay titled 'In Defence of the "Old Ways"'. He wrote:

However, **attempting to invest on the back of economic forecasts is an exercise in extreme folly**, even in normal times. Economists are probably the one group who make astrologers look like professionals when it comes to telling the future. Even a cursory glance at Exhibit 4 reveals that economists are simply useless when it comes to forecasting. They have missed every recession in the last four decades! And it isn't just growth that economists can't forecast: it's also inflation, bond yields, and pretty much everything else.

Exhibit 4: Economists Can't Forecast for Toffee (GDP % YoY, 4q ma)

The chart illustrates just how little help consensus economic forecasts have been, over the last four decades. When the actual GDP growth rate begins to roll over they eventually start to reduce their forecasts, but seemingly never enough and not in time. The same is true with recoveries.

Rule number two is currently playing out as illustrated below;

J.P. Morgan economists slash their outlook for second-quarter growth to just 1% from a previous 2.25%. CNBC 24 May

Goldman lowers U.S. growth view, sees higher rate cut chances on 'trade war' Reuters 3 June

Investors should expect further growth forecast cuts over the coming months, ultimately a bottom is reached when expectations are dire and forecasters are seemingly leap frogging over each other to come out with ever bleaker forecasts. Ironically, history shows that forecasts continue to get cut, even after the ultimate equity market bottom has been recorded. This was clearly seen through most of the last nine months of 2009 when the ‘Wall of Worry’ was clearly beginning to be scaled.

This time it’s different

Rule three gets to the heart of what have been described as the most dangerous words in investing. The fact that the danger of these words has been frequently and repeatedly, recited over decades illustrates just how ingrained behavioral biases are; we all find it very difficult to learn from the lessons of the past and the longer ago a lesson was learned the easier it is to forget. We all find much greater comfort in any extrapolation of the recent past than attempting to remember long forgotten lessons.

Over the last few weeks much has been made of the significance of the inversion of the yield curve and some have highlighted its recession forecasting ability;

Morgan Stanley says economy is on ‘recession watch’ as bond market flashes warning CNBC 28 May

However, the ‘this time it’s different’ crowd have been far more vocal;

The yield curve is no longer a reliable recession predictor, according to Wells Fargo Securities CNBC 2 June

The yield curve has inverted, but this time is different CNBC 30th May

Also, on 30th May a CNBC contributor pointed out;

> Some people seem keen to dismiss the yield curves' warning. Tom Lee, co-founder and head of research at Fundstrat, for example, thinks that **this time is different** because the U.S. inversion is caused by the 10-year yield falling rather than the 3-month yield rising. (emphasis added)

Thinking, or rather hoping, that things may be different this time undoubtedly provides some comfort, particularly when it is being voiced by a seeming majority, however, as rule 3 from October 2007 points out, the overall outcome will probably not be materially different. Back then the warning provided by the Wall Street Journal article I took the extract from was undoubtedly timely, sadly it undoubtedly fell on mostly deaf ears that didn't want to think about just how bad things could get.

Don't worry, the Fed will come to the rescue!

With markets down sharply over the last five weeks a comforting proclamation was heard from a top strategist on CNBC. It echoed a headline a few days earlier in The Wall Street Journal;

Fed Would Consider Interest-Rate Cuts if Growth Outlook Darkens WSJ 30 May

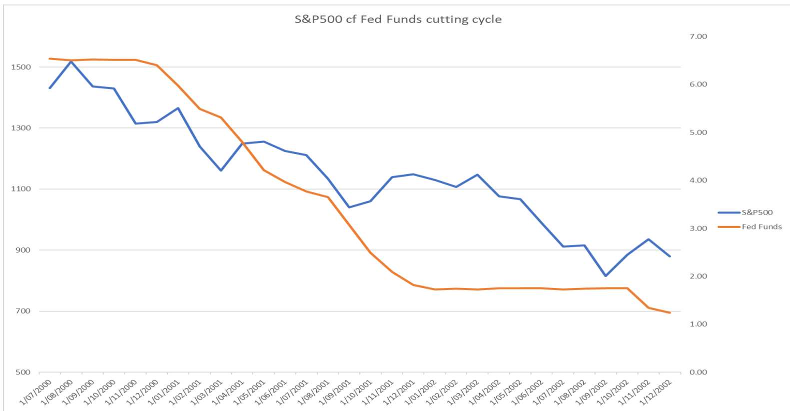
A few days later, after a severe market swoon, stocks rallied when Fed chairman Powell explicitly supported the concept of the Fed riding to the rescue.

Powell says the Fed will 'act as appropriate to sustain the expansion
CNBC 4 June

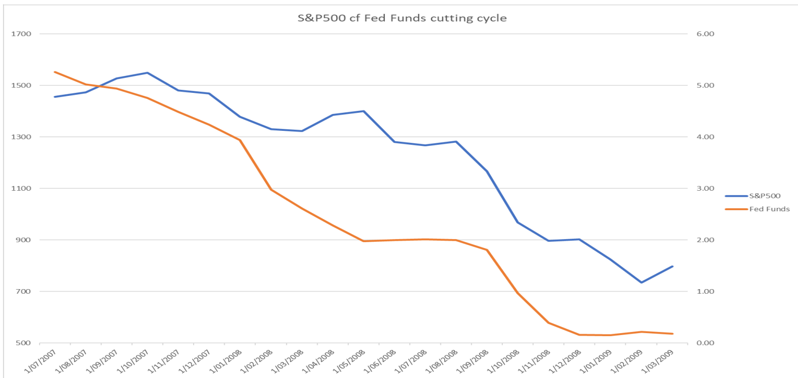
In the wake of this message US stocks bounced. The simplistic idea that somehow the Fed can prevent a bear market or recession is appealing, and understandably comforting, however, it flies in the face of both long term history and the evidence of the two severe bear markets and recessions since 2000.

The chart below shows the long term history of the Fed Funds rate with recessionary periods highlighted in grey.

Historically it is almost always the case that the Federal Reserve starts cutting rates just before a recession begins. Perhaps even more importantly, from an investing perspective, the last two rate cutting cycles highlight just how damaging a series of rate cuts can be to investors.



The chart above shows the rate cutting cycle through the early 2000s that saw the effective Fed funds rate drop from 6.5% to a little over 1%. Throughout this cycle equity markets collapsed as the TMT bubble burst.



The most recent rate cutting cycle, from mid 2007 through to 2009, saw Fed Funds plunge from over 5% to close to zero and once again these cuts were accompanied by a devastating bear market. History would suggest that those commentators seeking comfort in the prospect of an imminent rate cut should perhaps be careful what they wish for.

Oil expectations update

For more than the last year oil prices have illustrated the value of looking at markets from an expectational perspective, this continues to be the case.

Despite prices rolling over early in May expectations for the price of oil remained elevated, on May 13th the following headline appeared;

Tight Oil Markets Could Be About To See A 'Violent' Price Spike

Over the next few days oil did rally about $2 but since then it has fallen by $10, a more than 15% collapse in the space of a couple of weeks.

In the wake of that collapse it seemed that expectations were beginning to reverse. Reuters ran the following story on 31st May;

Oil falls over 3% on fresh trade worries, posts biggest monthly drop in six months

However, the accompanying article revealed that 'hope' remained the predominant emotion amongst the economists in the Reuters survey. At the end of April, as noted in Strategy Thoughts last month, the Reuters survey was very upbeat;

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

One month later, despite the plunge reported in their headline optimism remained;

> A Reuters survey showed Brent crude prices are likely to hold near $70 a barrel for the rest of the year as elevated supply risks in the Middle East offset risks to demand.

I ended last month's discussion on expectations around oil with, '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.' What has been seen over the last month would clearly qualify as a disappointment, however, it still seems that further disappointment would continue to be the most likely outcome.

Conclusions

Last month I concluded with;

> 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.

Since then equity markets have weakened further, rather than melting up! At the same time ever more evidence of economic weakness has emerged, all while confidence levels have remained elevated. I continue to believe that disappointments continue to be more likely than surprises and continue to favour preserving capital rather than chasing profits or yields.

5th June 2019