Strategy Thoughts

September 2019

The clearly absurd continues!

And expectations have only become even more stretched

Introduction

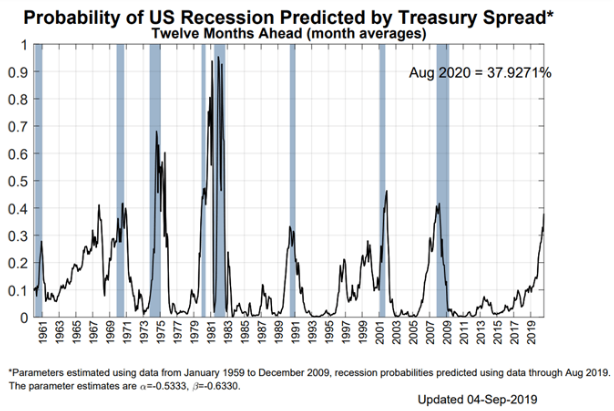
Over the last month longer term interest rates have risen, unwinding the much discussed inverted yield curve, risk appetites have been renewed and equity markets have rallied. As a result, expectations have once again become stretched despite growth prospects continuing to slow and the absurdities discussed last month continuing. In this month's edition of Strategy Thoughts, I question the possibility that a recession risk has passed, review the sustainability of the current rally, and the stretched expectations on the upside for gold and the downside for the UK and Sterling.

Has the recession risk passed?

One month ago, as discussed in the last edition of Strategy Thoughts, there was a growing concern that a recession was imminent given the US yield curve had inverted. To illustrate this I included a chart put together by the New York Fed that had successfully predicted previous recessions. One month ago that chart indicated a 33% chance of a recession next year. Interestingly, since then the yield curve has 'uninverted' and so investors and commentators have once again become far more sanguine about the probability of a recession, as illustrated by the following headline.

Surge in Treasury Yields Highlights Easing Economic Worries WSJ 14/9/2019

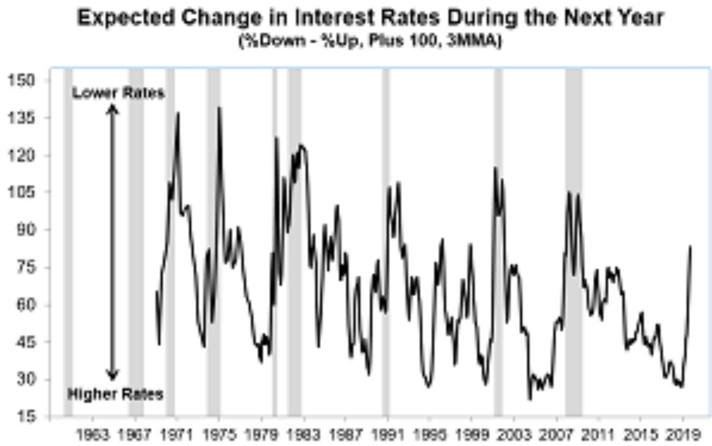
Despite the rise in longer term yields, which has been remarkable, that same model from the New York Fed, updated through 4th September, shows an even higher, almost 38%, probability of a recession next year.



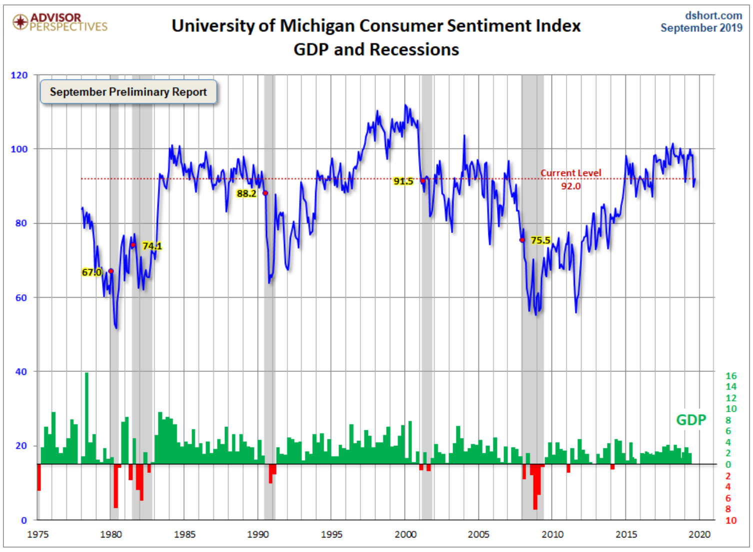
It seems that the optimists may be just a little early in declaring that the recession risk has passed as the following headlines and selection of charts highlight

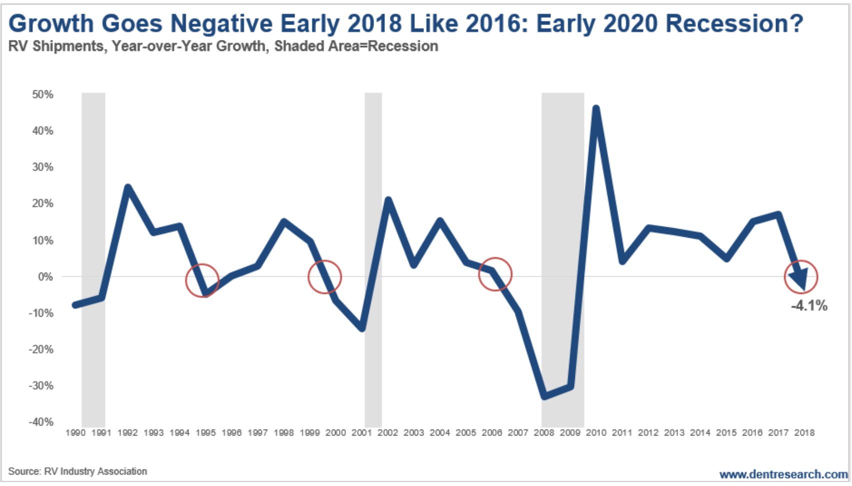
China's slowdown deepens; industrial output growth falls to 17-1/2 year low Reuters 16/9/19

E.C.B. Acts to Head Off Recession Threat in Europe, With a Caveat
NY Times 12/9/19 (the caveat was that it, the ECB, was reaching the limit of what it could do!)



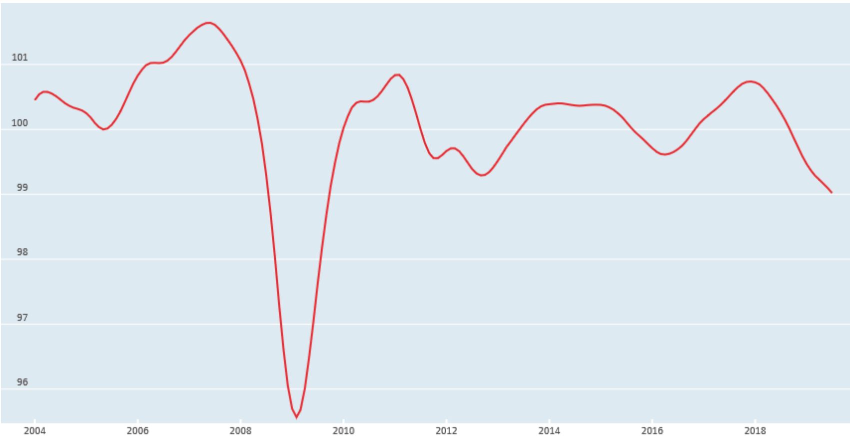
Consumer sentiment in the US had been plateauing but now appears to have rolled over.





Composite Leading Indicator for the OECD

This indicator is now at its lowest level since the Global Financial Crisis!



It is understandable that many would hope that the recession risk has indeed passed, and they may take some comfort from these recent comments from the IMF;

Global economy 'far' from recession, IMF official says Reuters 14/9/2019

However, little if any comfort should be taken from such observations from the IMF. Investors should remember that in the second half of 2007, just ahead of the stock markets of the world rolling over into a fearful bear market and the onset of the worst global recession in seventy years the IMF's first two bullet points in their July 25th 2007 update were;

- Strong global expansion continuing
- Growth projections revised upward for 2007 and 2008

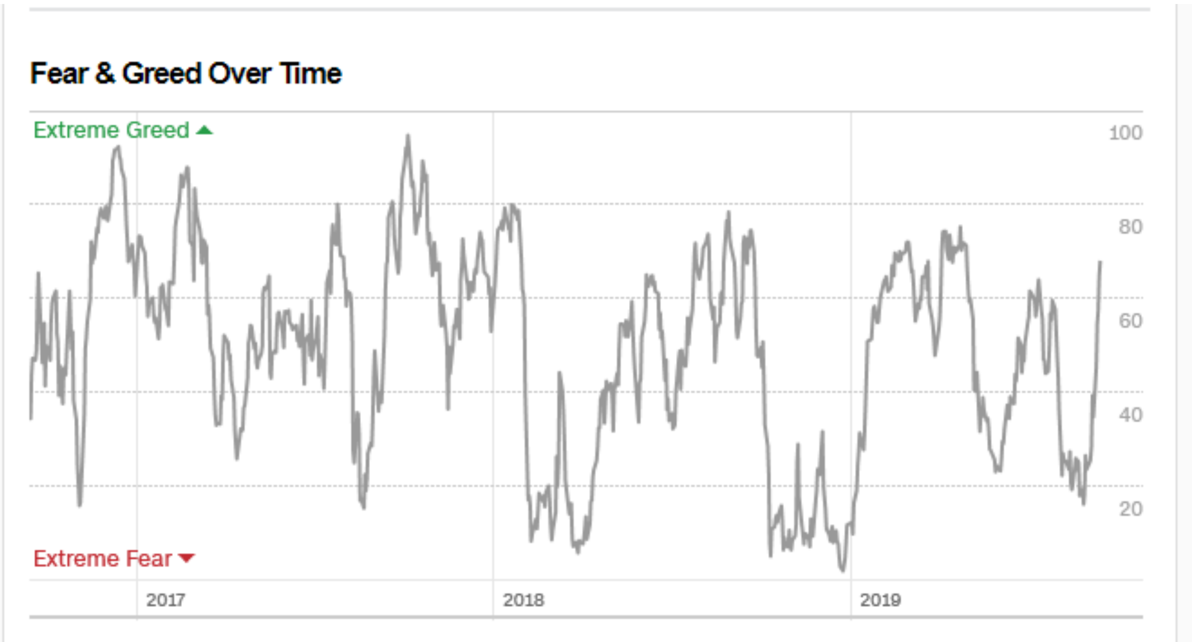
Sadly, it is hard to imagine comments that could have been less helpful or further from what actually eventuated.

Nonetheless, despite everything I noted earlier, hope and expectations among stock market investors are once again elevated, now that the recession risk has supposedly passed, and many equity markets have rebounded along with the rise in longer term yields, as can be seen in the chart below of the longer term treasury etf, TLT, compared to the S&P500. From late July the S&P500 sold off as longer yields plunged (prices rose) and this was followed by a reversal in both trends so far in September.

The questions this raises for investors are; is this just an example of the 'buy the dip' behaviour increasingly seen in the late stages of a bull market, or was this just a 'dead cat bounce' that ultimately frustrates the dip buyers once a bear market begins?

Buy the dip, or a 'dead cat bounce'?

Through most of August expectations, as measured by the CNN fear and greed index were fairly depressed, below 20 on the chart below, however, with the rise in long term interest rates and the bounce back in equity markets fear has been evaporating with the index now standing close to its high for the year.



The speed with which attitudes have been reversed should be seen as a cautionary sign, and an indication that the majority are happy to 'buy the dip'. During the healthy stages of a bull market it takes a substantial recovery and usually time for enthusiasm to overcome scepticism.

Early in the great bull market that began in March 2009 sell offs were seen as a resumption of the bear market, not a dip that should be bought. Sentiment remained dire for a very long time. However, early in the preceding bear market attitudes were quite different, as I wrote in the May 2008 edition of Strategy thoughts;

> Last month's Strategy Thoughts was titled, "Do Dead Cats Bounce?" and since it was written there seems to have been a growing ground swell of opinion that, yes they do bounce, and more recently that perhaps the cat isn't dead after all. Most share markets, with the notable exception of China, have now rallied something between ten and fifteen percent from their low points in March. These strong bounces have precipitated, and in turn been fed by, a growing bullish sentiment and increasingly constructive commentary.

The growth in bullish sentiment then was clearly misplaced as, with the benefit of hindsight, it is now clear that most of the damage of the great bear market was still to come. That rally in early 2008 was indeed a 'dead cat bounce' and not a dip that should be bought, and it was in fact the first of many.

The next bear market, whether or not it has already begun, will also be characterised early on by many dips that are bought, but that turn out to be dead cats bouncing.

Expectations and interest rates

As noted earlier, expectations around interest rates were recently at an incredible extreme. Prompted by ever easier central banks it had become apparent to everyone that interest rates could only head one way, and probably for a long time.

> **QE infinity? Economists believe that Europe's bond buying could run for years** CNBC 13/9/2019
>
> **Record low interest rates are here to stay, and may even sink lower, economists predict** ABC News 26/8/2019

Unfortunately, in investing, by the time a certain outcome appears inevitable to a vast majority, something other than the expected occurs as whatever was expected has usually already been priced in. Given the current one sided outlook for interest rates, with economists seemingly leapfrogging over each other to come up with a lower and lower forecasts for where rates are headed, something other than the expected almost certainly lies ahead.

Sterling, a surprise?

Last month, in the wake of Boris Johnson's ascension to the premiership in Britain I highlighted that expectations for Britain and the pound were incredibly bleak and that Brexit should not necessarily be the primary concern regarding the outlook for Europe. I wrote;

> Expectations for Brexit and sterling are obviously very depressed and, as the long term chart of the sterling / dollar exchange rate shows, these dire expectations come **after** sterling has already suffered a miserable, more than decade long, bear market that has seen the value of a pound fall by more than 40%. Sterling has recently recorded its lowest value against the US dollar in more than three decades, now is probably not the smartest time to be extrapolating what has already been happening for more than ten years.

Since then the outlook for Britain and Boris Johnson have become apparently even more difficult;

> **Johnson humiliated by Luxembourg PM at 'empty chair' press conference** The Guardian 16/9/2019

Yet despite this apparent turmoil and uncertainty, rather than continue its fall, Sterling has been rallying.

After briefly breaking below its August low, and below 1.20 against the US dollar, Sterling has been rallying, even in the face of continued negative press regarding the outlook for the UK economy.

> **Britain facing most prolonged investment slump in 17 years** The Guardian 16/9/2019
>
> **UK employers cut growth forecasts as Brexit, global slowdown weigh** Reuters16/9/2019

Given the continued prevalence of bleak expectations for the UK it seems that a positive surprise is far more likely than further disappointment.

Gold

Over the last couple of months my inbox has been inundated with bulletins highlighting the great opportunity that is now at hand in gold and headlines such as the following have been everywhere.

> **'The great gold bull market has begun'**
>
> **Gold Prices up 19% in Just 3 Months – How to Multiply Your Money Faster in a Gold Bull Market**
>
> **Gold bull market upon us & US dollar may be replaced by crypto as reserve currency - Keiser report**
>
> **Here's What's Next In the Gold Bull Rally Landscape – Expert**

The important thing for investors to remember is that all of these headlines are appearing **after** gold has enjoyed its best bull run since its last major peak in 2011 rising almost 30% over the last twelve months at its recent peak, and almost 25% in just a little over three months.

These attitudes are understandably a world apart from those seen almost four years ago at golds most recent trough. Then, with the price having fallen by 45% over the prior four years expectations were grim. Bullionvault.com in late November 2015 ran the following story;

Black Friday Sees Gold Hit New 6-Year Discount, 'Only 1 in 10' Signs of Capitulation

The article claimed that only one out of ten indicators of capitulation showed any sign of the weakness being over. As so often happens when expectations are so bleak and extrapolations of further weakness abound, the market rapidly reversed.

There are currently many reasons being touted for why this current bull market should continue, they range from the level of indebtedness globally and the inherent risk in the US dollar, to the fact that in a world of negative yielding debt gold is no longer at a disadvantage due to its lack of yield. What this argument misses is that even negative yielding government bonds do have a maturity value, albeit below what your purchase price may be. Gold has no such fixed future value. Perhaps the most worrying justification for gold is the fact that central banks are again big buyers of gold

Central banks make record $15.7bn gold purchases FT 1/8/19

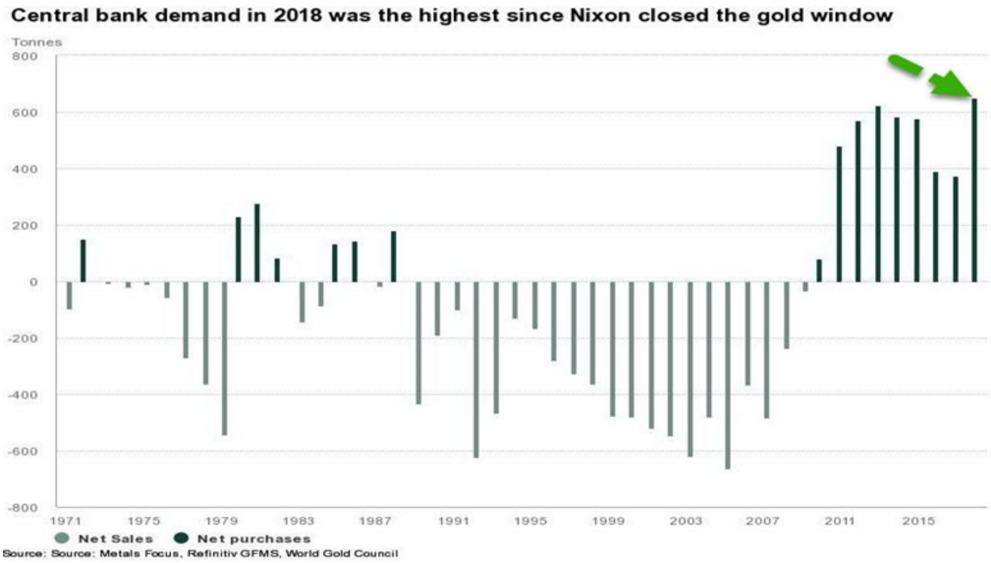
This may provide some comfort to would be gold investors, however, history shows that central bankers are just as much trend followers, rather than trend setters, in the gold market as the IMF is in forecasting global growth.

This was famously evident back in May 1999 in Britain when the then Chancellor, Gordon Brown, announced that he would be starting a programme of selling a substantial portion of the UK's gold reserves. This was after the price of gold had done little but decline for most of the previous two decades. He eventually completed that selling programme and achieved an average price of just $275 an ounce, as the chart below shows, this sale could hardly have been more badly timed.

The lagging trend following behaviour of central banks in the gold market can more broadly seen in the chart below that tracks their aggregate purchases or sales over the last half century. Throughout much of gold's bull market in the 1970s central banks sold into that strength, only finally becoming nett buyers as gold peaked. They remained nett buyers over much of the next decade before finally becoming sellers as gold meandered sideways through much of the 1990s. That selling finally reached a crescendo as the millennium passed, so Gordon Brown was not alone!

From its low in 1999 gold rocketed higher and the central bank selling began to reduce but it wasn't until 2010, after gold had risen four fold in value, that they became nett buyers once again, just in time to capture the historic peak in gold in 2011. From 2011 gold fell sharply and central banks continued to buy gold, although at a gradually reducing rate, and then, with a characteristic lag of about two years, they once again increased their buying as the price rose in gold's latest bull market.

Record buying by central banks should be seen as a warning sign to investors, just as record selling earlier in the millennium highlighted an opportunity.



Conclusions

Last month I concluded;

> The fact that ever lower rates are currently forecast and negative rates becoming increasingly accepted and rationalised, should be seen as a warning sign and an end of an extrapolation, rather than a justification to continually increase risk exposure in the pursuit of yield or return. It should also be a concern that interest rate cuts are not delivering what so many had hoped they would, and, just as through the last two bear markets and recessions, central banks are pushing on the proverbial string. It is becoming increasingly hard to see how, in the shadow of an increasing number of rationalised absurdities, things can end as well as so many hope and expect.

Worryingly those hopes continue in the face of even greater deterioration and stretched expectations. The possibility of disappointments or surprises, driven by extreme expectations, can currently be found in; interest rates, gold, Sterling and many equity markets. With so many markets, despite their recent strength, having made little if any progress over the last year or more, preservation of capital should continue to be an investors primary aim, particularly in the face of continued subdued inflation.

18th September 2019

information is believed to be-but not guaranteed-to be accurate. Past performance is never a guarantee of future performance. Kevin Armstrong's Strategy Thoughts nor its author accepts no responsibility for any losses or damages resulting from decisions made from or because of information within this publication. Investing and trading securities is always risky so you should do your own research before buying or selling securities.

Last word

As I was editing this edition of Strategy Thoughts this morning Federal Express announced their earnings, they were very disappointing and the stock in after hours trading plunged $16 or about nine percent. For a $45 billion dollar company, and the ninth largest private employer in the US, to fall so severely is understandably headline grabbing news, however, it needs to be put in perspective. Even before todays drop Federal Express' stock price had fallen by one third since early 2018. The reason for their disappointing results today was summarised by the CEO;

> "Our performance continues to be negatively impacted by a weakening global macro environment driven by increasing trade tensions and policy uncertainty,"

This ties in with some of my comments earlier on the risk of recession. Interestingly Federal Express has been a valuable leading indicator of the last two major bear markets and recessions.

The chart above shows the historic price of Federal Express over the last quarter of a century compared to the performance of the S&P500. It is difficult to see but FDX's own bear markets began long before those seen in the broader S&P.

In 1999 FDX peaked in May before entering a severe bear market, this was more than eight months prior to the S&P500 beginning its own 50% bear market.

In 2007 FDX peaked in February before beginning a fall of more than 60%, again this was eight months ahead of the peak in the broader market.