Strategy Thoughts

October 2019

The importance of Long Term Valuation

It's all about Expectations

Introduction

Valuation is frequently discussed, both about individual stocks and markets as a whole, however, it is rarely used in a way that is useful to investors over a meaningful time span. Valuation is a very useful indication of where aggregate expectations lie and so, over very long time frames, can be indicative of where the greatest surprises or disappointment are likely. This month's Strategy Thoughts reviews the 'value' of valuation, how it can be meaningfully used, and highlights a number of areas where warning signs are clear. This month's edition also updates the expectational backdrop in both gold and sterling, and illustrates how useful this approach has been over the last couple of months and finally I make my third attempt in more than seven years to pick the end of the long term bull market in treasury bonds.

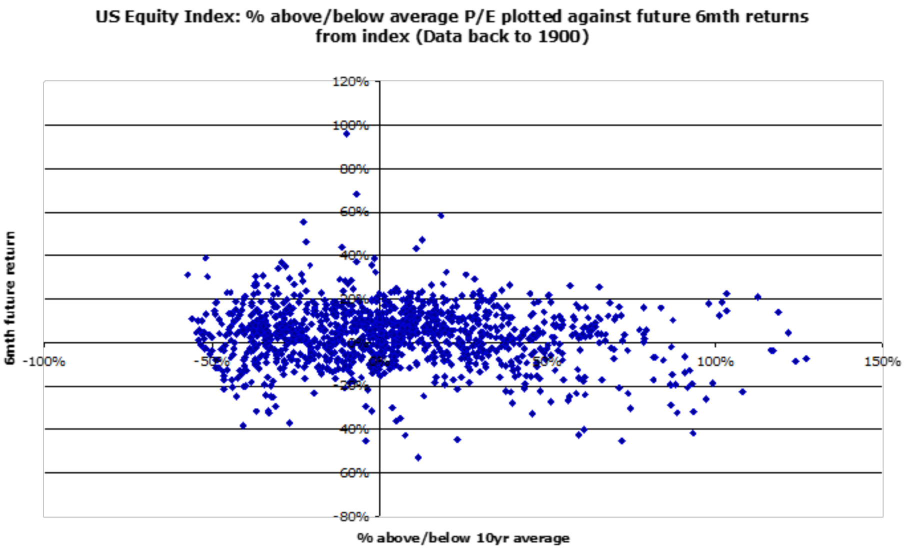
Expectations and Valuations

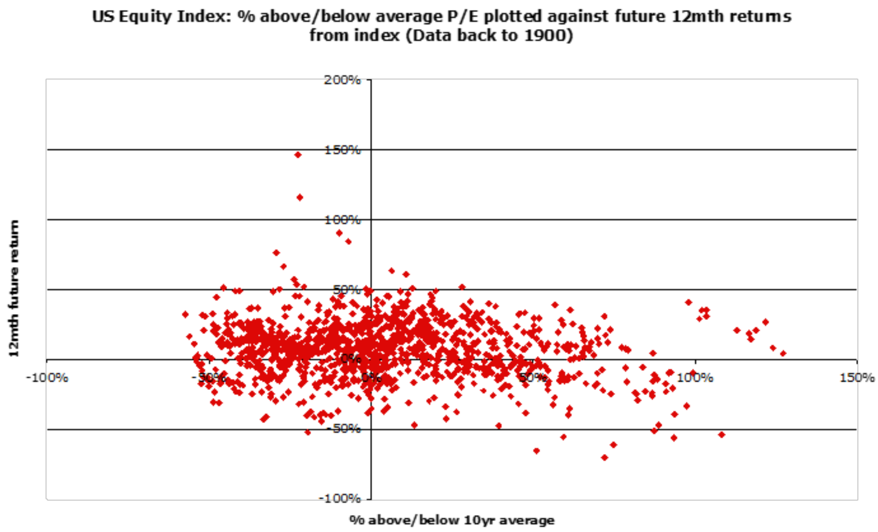
Valuation is perhaps the most frequently employed justification for any market view, unfortunately, as I illustrated at length in "Investing-The Expectations Game", it is of no use over the time frames that the majority of commentators would like it to be. The business media regularly justifies short term moves in the markets as being down to valuation. In June the Wall Street Journal reported;

Stocks Lure Buyers With Cheapest Valuations in Months

This was after stocks bounced after having previously fallen for much of the prior five weeks!

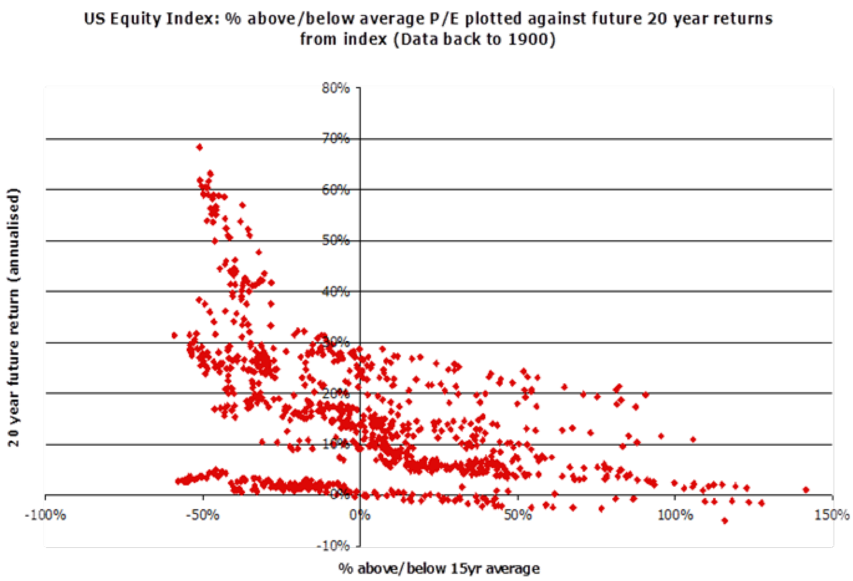
In "Investing" I demonstrated the futility of listening to commentary on valuation with the following charts;





The charts show the subsequent 6 month and 12 month returns the US market has generated for each month of the twentieth century compared to how cheap or expensive the market was at the time. If there were any value in employing valuation as a market indicator over such time frames then the scatter plot would reveal a marked diagonal trend from the top left to the bottom right, indicating that cheaper starting points generate superior returns. This is clearly not the case, both scatter plots can best be described as horizontal 'splodges'. Some of the best returns have been generated from historically expensive markets, and equally some of the worst have come off historically cheap valuations.

None of this is to say that valuation measures are useless, far from it, however, the time frame has to be far longer. Later in "Investing" I showed the same scatter plot only looking at subsequent long term (20 year) returns.



Now the intuitively expected result emerges. There is a clear relationship sliding from the top left hand corner to the bottom right hand corner, the best long term returns are indeed generated from low valuations and the reverse is also true. However, this in no way means that valuations drive market returns as is so often heard, this is a clear case of confusing cause and effect, something so often seen in markets.

It is not simply that a cheap market or even a cheap stock somehow produces long term returns, one has to look a little deeper and ask why are valuations where they are. This then gets to the heart of what drives markets and why I subtitled “Investing” the expectations game.

Any stock market becomes historically very cheap because expectations on the part of market participants are exceptionally low, they don’t want to own that particular market and certainly won’t pay up for it. Such valuations usually come after very long periods of poor performance and so aggregate expectations are shaped as a result of extrapolating that long standing trend way into the future. This is the environment found at the beginning of great and rewarding long term bull markets, as when expectations are so bleak it is incredibly easy for even modestly positively news to be greeted as an incredible positive surprise.

The reverse is also true. Extremely high valuations, such as those seen at the peaks of the NASDAQ in 2000, Japan in 1989 or the Dow back in 1929, all come about as a result of incredibly heady and optimistic expectations. Expectations that have been ramped higher and higher the better the news became and the longer the market moved higher. With such lofty expectations’ disappointments, and so a bull market top, can arrive very suddenly.

It is not that valuations drive long term bull and bear markets, it is the long term ebb and flow of expectations, and the subsequent surprises and disappointments that stretched expectations leave markets vulnerable to, that drive markets. However, this does mean that valuations are an excellent tool to understanding exactly where long term expectations may be.

Where are Valuations now?

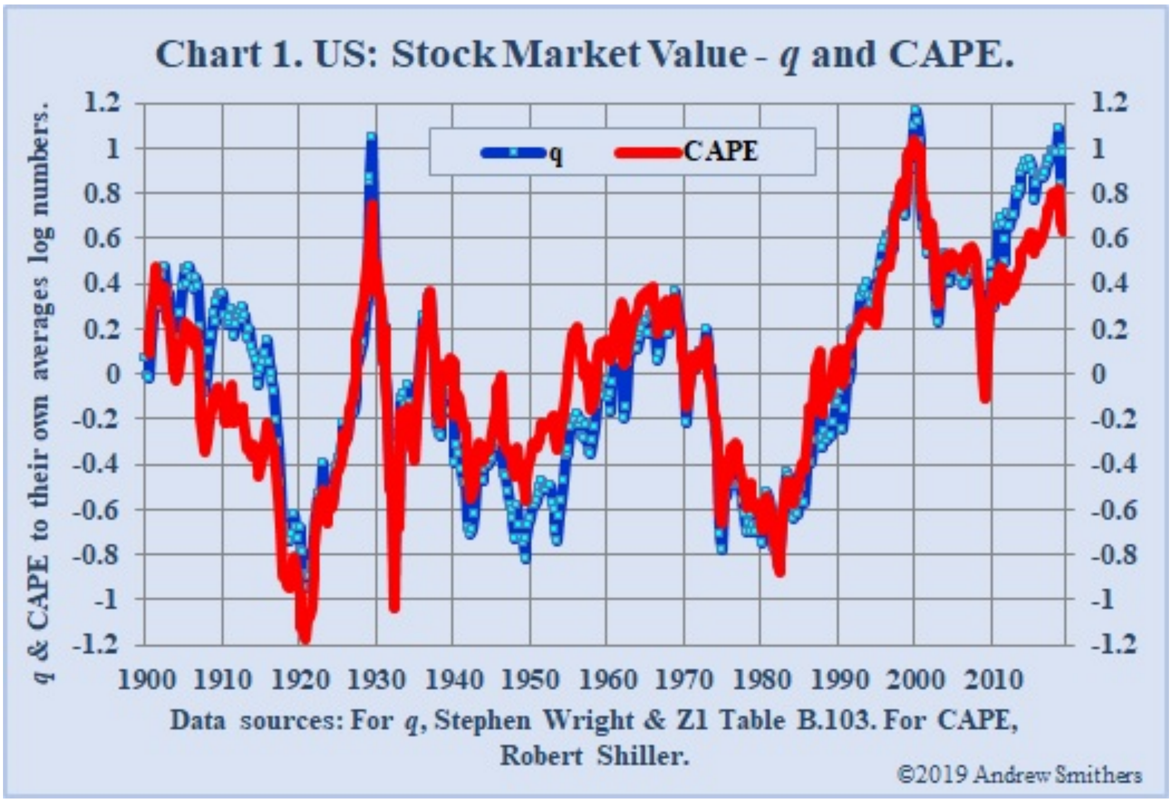
It is interesting to see how selective the media can be about valuations, at great peaks they are happy to dismiss extreme valuations, and the reverse is also true. Back in early 2000 The Wall Street Journal was keen to debunk a negative take by two authors, in a then new book on Tobin’s Q, on long term valuations.

Smithers' Contention About Q Is All Fouled Up WSJ March 15th 2000

> Early on, the authors warn, "Since q shows the stock market to be overvalued by more than twice, a fall of 50% to 60%, or more, is likely [which] could easily bring the Dow Jones Index down to under 4000."

The long term chart below of q and Robert Shiller’s CAPE valuation of the US market illustrates just what an extreme March 2000 was, and why Smithers and Wright brought out the book on valuing Wall Street that the Wall Street Journal was so critical of.

With the benefit of hindsight we now know that subsequent to their warnings, based upon their study of q, that the major US markets all plunged. The NASDAQ, that was clearly the poster child for that bull market, fell by close to 80% over the next two and a quarter years, the Dow Jones Industrial Average by 35% and the S&P500 by 50%. It clearly was a win for Smithers and Wright rather than the Wall Street Journal.



Perhaps more worrying is where both the US market's CAPE and q are now.

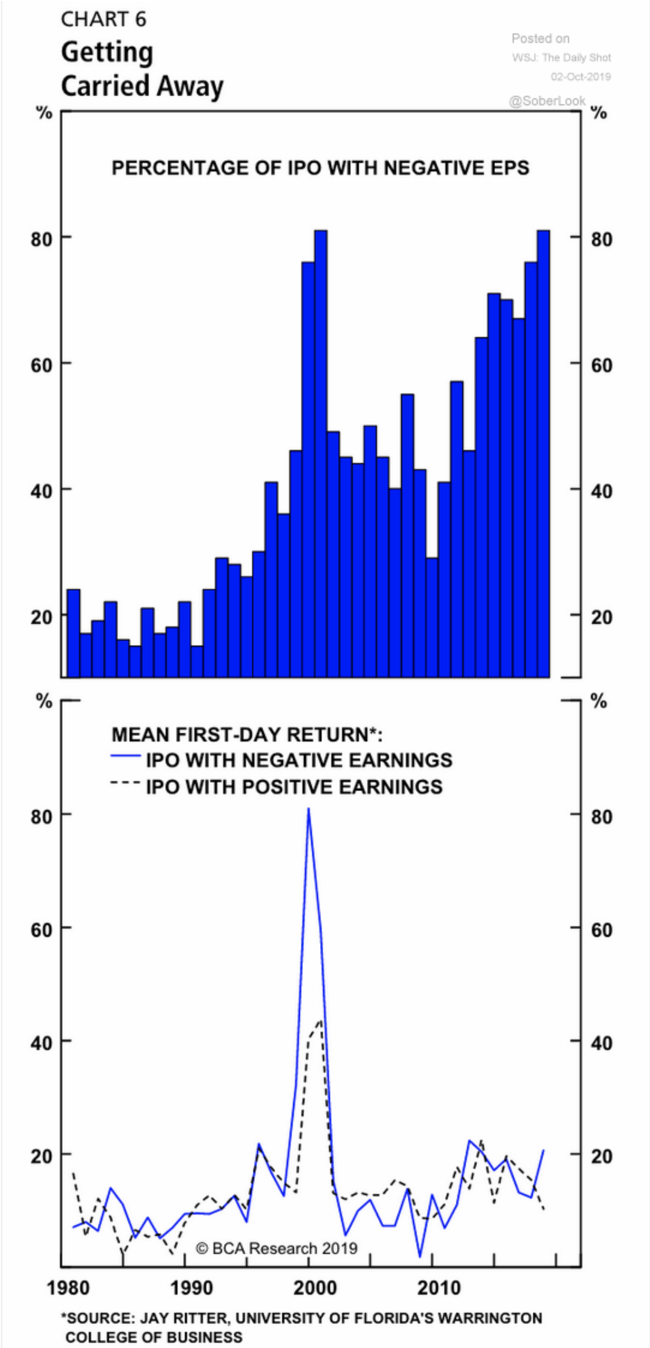
Smithers own website updated these valuations late last month;

> As at 25th September, 2019, with the S&P 500 at **2984.87**, the overvaluations by the relevant measures were **171%** for non-financials and **91%** for quoted shares.

Speculative Fever

In 1999 and into early 2000 there was undoubtedly speculative fever, particularly in the tech, media and telecommunications space. This is what drove one of history's most spectacular investment bubbles. Most obviously seen in the boom and bust of the NASDAQ but also apparent in the valuation of the broader market as illustrated by both q and CAPE.

Whilst neither measure is currently quite at the record level seen in 2000, as noted earlier, both are historically very high, in fact, they have rarely been higher in the US. This is not a healthy backdrop for long term returns, and signs of both lofty expectations, and the current fragility of those expectations, can be seen in the US market for initial public offerings. Over most of the last decade the percentage of companies coming public that had no earnings has grown from less than one third to over eight out of ten.



This was a similar ratio to that seen at the peak of the TMT bubble in 2000, but this time around the rewards have been substantially less and there have been a growing number of very public disappointments, from Uber and Lyft to Peloton and Smile Direct Club. Concern surrounding the poor performance of these high profile IPO's has resulted in proposed government action;

> **A new SEC rule could stave off disappointing IPO debuts like Peloton and SmileDirectClub** CNBC 27th September 2019

Unfortunately, history shows that governmental intervention in markets always comes after the horse has bolted in an effort to prevent whatever has already gone wrong from going wrong again. This proposed 'new rule' is more likely indicative of us now being on the other side of the speculative bubble, rather than being a tool to make it endure for even longer, and that we entering the 'Slope of Hope' always seen during the early stages of bear markets.

Global CAPE valuation 'leaders'

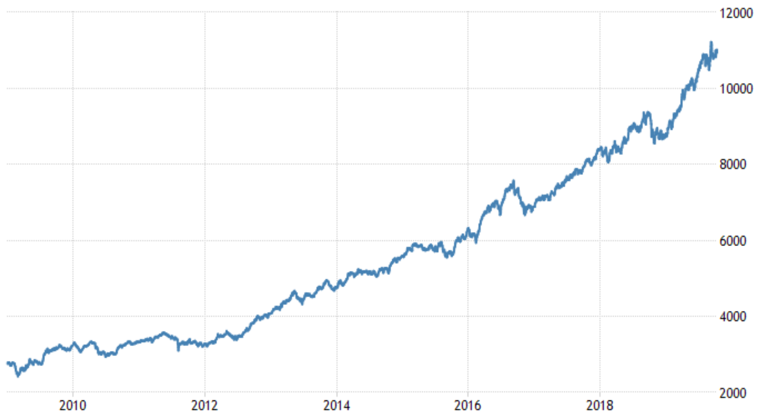
The following charts show a selection of the most long term overvalued equity markets as measured by their CAPE.

Danish stock market CAPE 52x up five fold from 2009 low

Dutch stock market CAPE 25x up three fold from 2009 low

Irish stock market CAPE 52x up three and a half fold from 2009 low

Swiss stock market CAPE 26x up two and a half fold from 2009 low

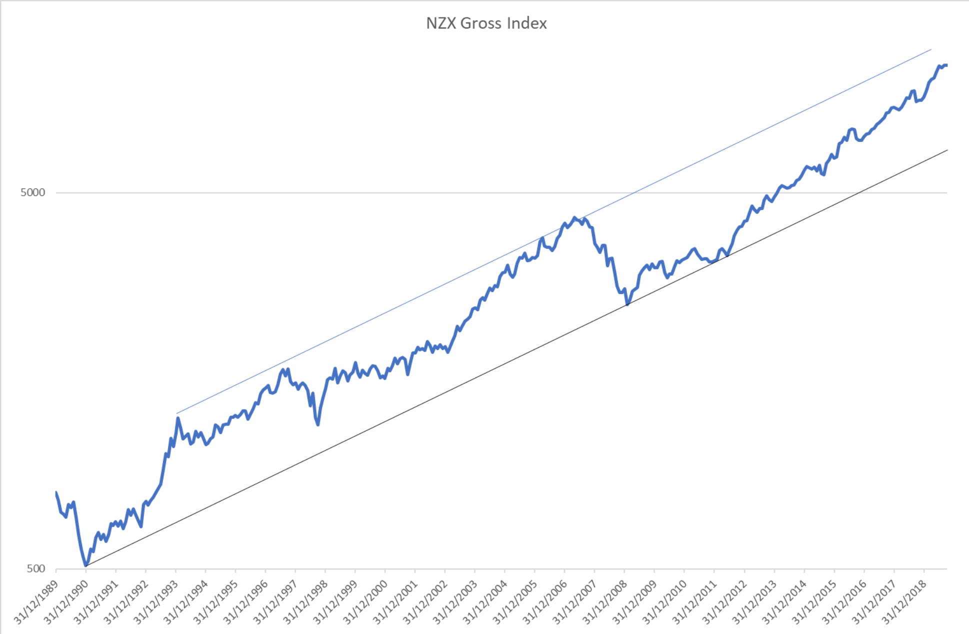


New Zealand stock market CAPE 29x up five fold from 2009 low

US stock market CAPE 29x up four fold from 2009 low

The importance of when you buy and long term returns

This is especially relevant for New Zealand equity market investors NOW.



The chart above shows the long term total return of the New Zealand stock market over the last thirty years. Given the chart is logarithmic the slope indicates the long term return which superficially seems to have been fairly steady, at close to nine percent, however, huge volatility in returns is hidden by the logarithmic scale. An investor who bought the market in early 1990 would have to have been incredibly brave, given the devastation that befell the NZ market post the 1987 crash, but they would have been handsomely rewarded as their annualised return from purchase would never have been less than the almost nine percent indicated by the trend, and would have been substantially more up until the Global Financial Crisis of the late 2000s. Any investor getting into the market after that point would not have enjoyed anything like the same returns. The unfortunate buyer in early 1994 would only be breaking even four and a half years later and would have to wait until the crescendo preceding the GFC to finally see the almost nine percent long term trend return. By the depths of the GFC that 94 investor would by then only have seen a 4.7% return over more than fifteen years. Almost half the annualised return the investor in 1990 was still enjoying.

When you buy and the price you pay for any investment forever determines your long term return.

Over the very long term it has not been rewarding to buy into historically expensive markets that have been rising in a steady or parabolic fashion from a bear market low. This is a fair description of the New Zealand market now. The only redeeming feature of the current position and valuation of the New Zealand market is that finally, after twelve years of waiting, those investors that got involved in mid 2007 are getting close to the long term trend return that they may well have been led to believe was all but a minimum certainty back in the heady days of 2007

Expectations continued

Gold

Last month I commented on the extremely stretched expectations surrounding the price of gold and the avalanche of breathless recommendations I was seeing to get into gold before it was too late. I concluded those comments with;

> 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.

Since then gold has drifted lower, and fell sharply last Friday as equity markets rallied, from what may prove to be the price peak for this recent bull market in gold. Despite this the bullish recommendations still abound. No doubt those bulls are viewing this recent weakness as nothing more than an oxymoronic 'healthy correction' and a dip that should be bought.

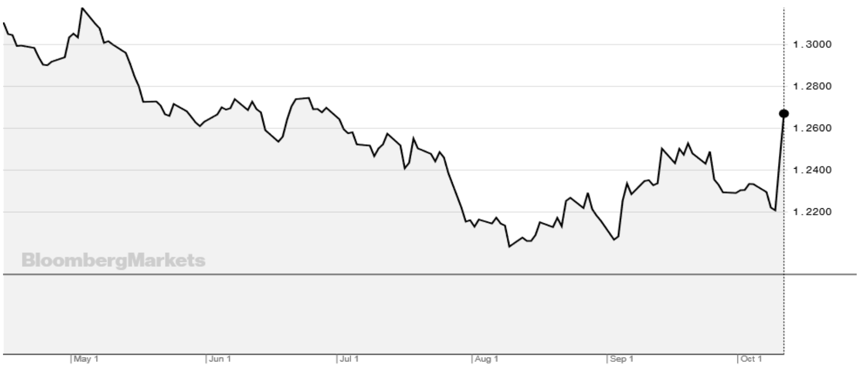
The price of gold has once again illustrated the value of looking at investments from an expectational view point. When expectations are ridiculously optimistic the probabilities substantial favour some sort of disappointment. This seems to be playing out in gold and the opposite has been evident in another asset I have been focussing on for the last few months, sterling.

Sterling's positive surprise

Two months ago, in the August edition of Strategy Thoughts I highlighted the extremely negative expectations surrounding the outlook for the UK and its currency that I had witnessed while travelling. I concluded those comments with;

> Expectations are obviously currently bleak, and possibly 180 degrees apart from those seen in 2007, but given the current situation in much of Europe it is quite likely that the biggest disappointments may lie in the near term future of mainland Europe rather than the UK.

At the time sterling was flirting with new lows around 1.20 versus the US dollar.



What has been seen since will no doubt have caught the many sterling doomsters by surprise with the currency, rather than continuing to collapse, rallying 5%. Expectations for sterling and the UK remain bleak with the BREXIT deadline moving ever closer. I continue to believe that the risk of disappointment for Europe, over and above BREXIT, remains high, and that the still depressed expectations for the UK and sterling will be delivered even more positive surprises.

Have bond yields bottomed?

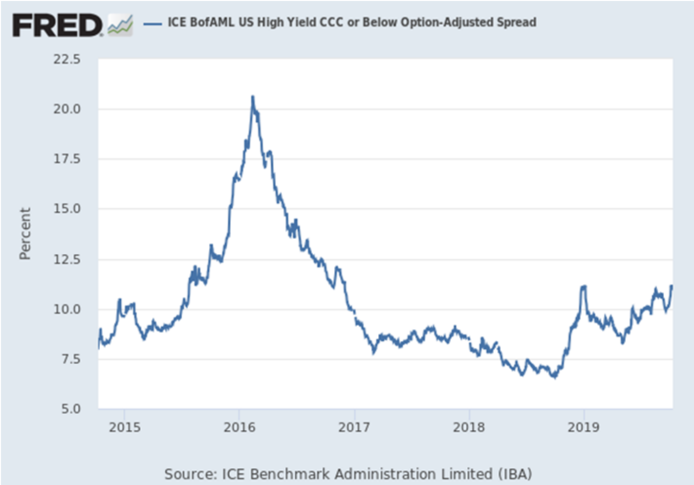
Over the last seven or eight years I have attempted to pick the bottom in longer term bond yields in the US a couple of times, primarily based upon the then prevailing expectational backdrop. The first time was in 2012 and what followed was a more than doubling in longer term yields from below 1.5% to over 3%. However, this did not turn out to have been THE bottom in the incredibly long secular bull market in US treasuries as four years later, in 2016, new record lows were recorded.

At the time I highlighted just how extreme bullish expectations were towards treasuries and the danger of chasing yield in lower quality issues. I wrote in August 2016;

> These new low yields and the understandable increased interest in higher yielding bonds has resulted in a remarkably similar expectational backdrop to that seen in the second half of 2012 as can be seen in the sentiment chart from Investup (not shown).
>
> Currently sentiment towards US Treasuries is as optimistic as it has been for four years. Obviously this does not mean that bond yields are necessarily set to surge higher but it should raise a cautionary flag, particularly for those investors chasing yields in lower quality instruments.

That cautionary flag was indeed warranted as once again longer term treasury yields more than doubled. Now those record low yields are once again being challenged and the expectational backdrop towards how low yields will go seems similar, and perhaps even more extreme given the growing acceptance of negative yields I have discussed over the last few months.

Apart from the broadly accepted assumption that yields are destined to head ever lower there is also another warning sign that investors should be aware of, and that is the deterioration in the performance of the lowest rated junk bonds. The chart below shows the premium in yield offered by CCC and below rated bonds. This spread bottomed late in 2018, just as equity markets began to roll over, and has since been rising despite equity markets largely recovering. This divergence in performance, along with continually stretched expectations, should be seen as a cautionary sign for both bond and equity markets.



Conclusions

I have had a substantial amount of feedback pointing out that my conclusions have barely changed for a number of years. I make no apology for this, because in the main my outlook has not changed, but then many markets are still in broadly the same place they have been for several years despite substantial volatility in between times. There have been expectational opportunities along the way, such as those in sterling and gold touched upon this month, but broadly speaking expectations across many asset classes are still stretched. Preservation of capital ahead of the next great buying opportunity still remains my preferred strategy.

No change!

14th October 2019