Strategy Thoughts

March 2020

It's STILL, and always has been, all about Expectations

Introduction

It is six months since I last wrote an edition of Strategy Thoughts, this hiatus was initially due to a planned trip to Europe, but also, and more importantly, due to the fact that I had just about run out of ways of illustrating just how stretched expectations were and the dangers that any, even minor, disappointment could bring about. In the intervening months things have certainly changed, but worryingly expectations remain far removed from those that typically accompany a major buying opportunity.

In this edition of Strategy Thoughts in addition to reviewing what has been already endured I will discuss what needs to be seen for a great buying opportunity to be close.

Equity markets

I concluded my last edition of Strategy Thoughts, in mid October last year, with the following;

> 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!

Since then, as noted in the introduction, things have changed dramatically and preservation of capital has been an outstanding, albeit relatively unexciting, investment strategy.

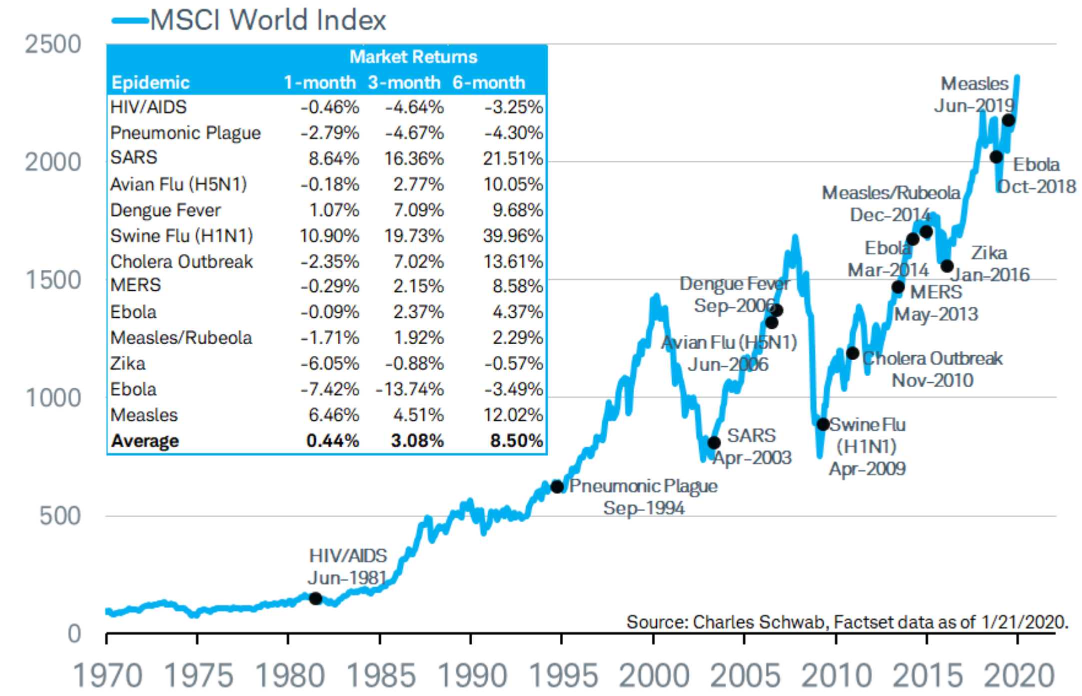
The chart above shows the MSCI World Index over the last five years and the fall over the last five or six weeks is undoubtedly historic, having begun with probably the fastest 20% decline from an all time high ever, and wiping out, in a matter of just a few weeks, all the gains recorded since early 2016.

The 'disappointment' to the ridiculously elevated expectations seen earlier this year was the outbreak of the coronavirus, initially in China. Obviously, I had absolutely no idea what the disappointment would be that could upset the longest bull market in history, but it was clear through much of last year that there was very little room for any disappointment and that the markets would react badly when one arrived. This outbreak has turned out to be far bigger than anyone forecast, and so has the market reaction, at least in terms of speed if not magnitude. However, in the early stages of this outbreak complacency was rampant amid those previously extremely elevated expectations. In late January CNBC ran the following story.

> **Here's why the stock market may be overreacting to the coronavirus threat** PUBLISHED MON, JAN 27 202011:44 AM ESTUPDATED MON, JAN 27 202011:59 AM EST

The optimism expressed in the article was based upon how markets reacted to the SARS outbreak in late 2002 and early 2003.

Immune: world epidemics and global stock market performance



	Market Returns		
Epidemic	1-month	3-month	6-month
HIV/AIDS	-0.46%	-4.64%	-3.25%
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	8.64%	16.36%	21.51%
Avian Flu (H5N1)	-0.18%	2.77%	10.05%
Dengue Fever	1.07%	7.09%	9.68%
Swine Flu (H1N1)	10.90%	19.73%	39.96%
Cholera Outbreak	-2.35%	7.02%	13.61%
MERS	-0.29%	2.15%	8.58%
Ebola	-0.09%	2.37%	4.37%
Measles/Rubeola	-1.71%	1.92%	2.29%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-7.42%	-13.74%	-3.49%
Measles	6.46%	4.51%	12.02%
Average	**0.44%**	**3.08%**	**8.50%**

The MSCI World Index captures large and mid cap representation across 23 Developed Markets countries. With 1,646 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. **Past performance is no guarantee of future results.**

But what is abundantly clear from the chart above is that the outbreak of SARS, that was widely feared at the time may be the world's next pandemic, occurred amid an expectational backdrop quite different to that seen earlier this year. Then the markets were in the depths of the worst bear market since the 1970s in the wake of the bursting of the dotcom bubble, and the NASDAQ was well on its way to a more than 80% fall. Despite SARS ultimately not becoming the pandemic that so many feared it is not surprising that a new bull market began from the depths of that expectational low.

The Slope of Hope!

Just as bull markets climb a ‘wall of worry’ so bear markets slide down a ‘slope of hope’. This ‘hope’ has been very clear in the early stages of this bear market.

On the 25th February Donald Trump tweeted;

> “stock market starting to look very good to me’

That day the Dow fell more than 200 points and closed below 28,000, down only 5% from its all time high.

One day later his chief economic adviser, Larry Kudlow joined the stock market ‘hope’ brigade, stating;

> “I would suggest very seriously taking a look at the market, the stock market, that is a lot cheaper than it was a week or two ago.”

That day the market fell more than 1,000 points to close below 27,000.

A week later Kudlow once again beat the ‘buy the dip’ drum;

> “Long-term investors should think seriously about buying these dips,”

Six days later the Dow was more than 5,000 points lower.

On the 13th March, Treasury secretary Mnuchin described the virus as;

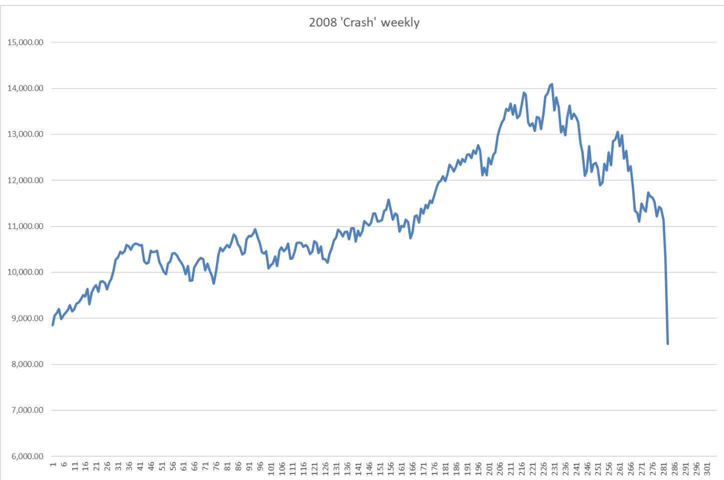
> "a great investment opportunity,"

Unfortunately, history repeatedly shows that such public proclamations from officials rarely accompany great long term opportunities.

In addition to being wary about the continual calls to ‘buy the dip’ investors should also be cautious about the many commentators currently on the search for, and some even finding, capitulation in the market that might signal the all clear for the nimble investor.

Capitulation?

The last time stock markets saw downward volatility anything approaching that which has been seen recently was in 2008 during what would become known as the Global Financial Crisis. The chart below is one I included in a report immediately after the most dramatic falls of 2008.



At the time the US market had fallen a fraction over forty percent from its all time high, yet there was still hope that the final bottom had been seen. This 'hope' was frequently justified on the seemingly sensible observation that capitulation had been seen. Eleven and a half years ago, after the 'crash' of 2008 and accompanying the chart above, I wrote the following;

> Over the last few weeks the search for a climactic sell off or 'capitulation' has become substantially more than a cottage industry with virtually every investor the world over now knowing about capitulation and how it will mark a great long term buying opportunity. Given this, everyone seems to have taken it upon themselves to look for signs of capitulation. Unfortunately, markets are never quite that obliging. Capitulation is not something that one group does so as to allow all those looking for it to take advantage, true capitulation is seen by the overwhelming majority as the last chance to get out before things really get bad, not a widely recognised great buying opportunity.

I concluded that piece with;

> All we can conclude from last week's devastation is that the world has woken up to the enormity of the deleveraging that still lies ahead. Share markets did crash last week, whether that indicates an important reversal or merely an interim recognition only time will tell. However, on a constructive note, if last week was THE bottom of the recent cyclical bear market and a cyclical bull market is imminent then history strongly indicates that there will be a retest of that recent low, all bear market bottoms since the 20's have offered a retest of some sort. My feeling is that any 'test' may not be successful and a final low may still lie some way in the future and the last cyclical bear market of 2000 to 2002 may be a better road map for the current market than other crashes. True capitulation, at a major low, is not usually obvious in real time, only long after the bottom has been confirmed. 13th October 2008

That conclusion proved correct, the true low had not been seen and it did indeed still lie some months in the future. Over the next almost five months the market fell another twenty five percent, in an enormously volatile fashion, finally bottoming on the 9th March when finally, all hope was apparently gone. From there, anything, no matter how bad it appeared, was probably not going to be as bad as so many were by then fearing. In such an environment even what appears on the surface to be bad news can constitute a positive surprise to the market. This is what was seen in early March 2009.

In late February 2009 I noted the following;

- Nobel laureate economist Paul Krugman commented last week that the current Obama stimulus package was too little
- The IMF recently dramatically cut their forecasts for world growth
- Bloomberg recently ran a story based upon Citibank research titled; **"Cult** of **Equity**' Is Under Attack"
- Market's 'Hope Balloon' Loses Air ***Tepid Upturns Haven't Stopped the Slide; 'Hard to Make a Cheery Story'*** WSJ 17th February 2009

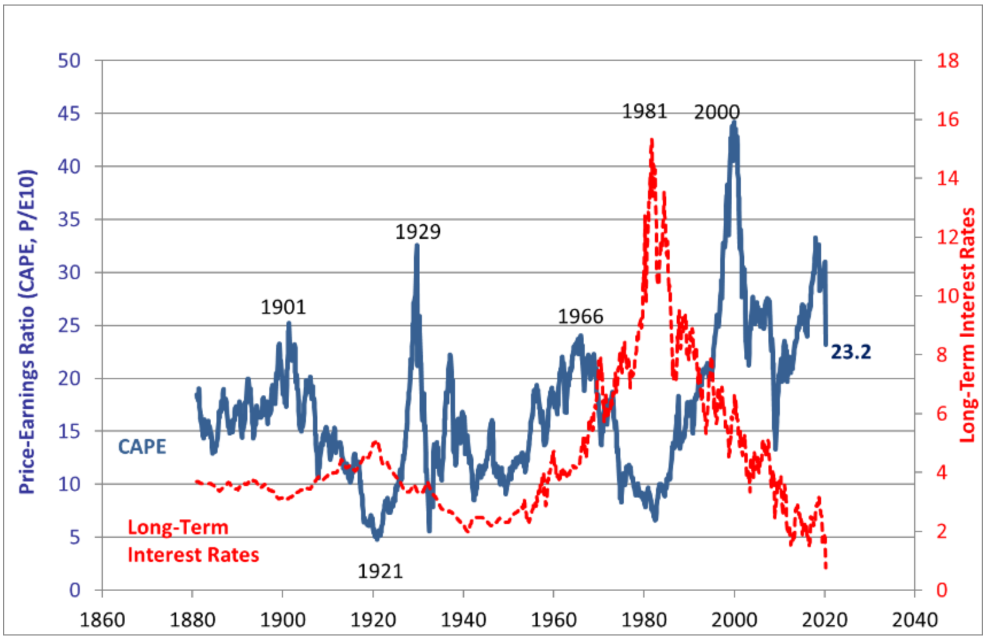
This is the mood, or sentiment backdrop, that accompanies a major buying opportunity, rather than calls for investors to 'buy the dip' or forecasts of how things will be recovering soon.

What do Bottoms feel like?

In the mid stages of the GFC associated bear market I used the above as a title for Strategy Thoughts, and not in a facetious way. I wanted to highlight just what important lows in equity markets felt like, because they do not feel good, in fact at the time it feels like things are destined to only get worse. In that edition I included a review of several bottoms that I had utilised six years earlier in late 2002 near the bottom of the previous bear market;

> *One thing that can be said for sure though is that whenever the bottom is made, it will not feel like the time to be buying. Just as at the peak in early 2000 when, as we said earlier, the future seemed assured, it did not seem sensible to sell shares and buy boring bonds.*
>
> *The truth in this last statement can perhaps best be seen by examining the environment at other important market lows and buying opportunities of the last century.*
>
> *By 1932, the major markets of the world had suffered their most dramatic declines ever, falling for nearly three years; the mood was grim with one in four Americans out of work. The economy was not going to truly recover for several years as the depression wore on, yet from the low point in 1932 shares rallied by almost 600% over the next five years.*
>
> *With the world at war and with Pearl Harbour having been bombed less than a year earlier, 1942 was a time of deep concern. Markets had more than halved over the preceding five years. Memories of the depression were fresh in investors' minds and fears over the end of capitalism abounded. Over the next four years markets recovered by over 100%.*
>
> *The worst recession since the depression was suffered all over the world in 1974 and share markets from the UK to New Zealand were hit with their worst bear markets for over thirty years. Contributing to the negativity was the oil embargo and associated unrest after the Yom Kippur war. Inflation soared and the Watergate scandal resulted in the resignation of President Nixon. Less than two months after Nixon's resignation, amidst unprecedented uncertainty, markets bottomed and rallied dramatically. The recession didn't end until 1975 and the economy didn't feel "good" until years after the share market bottomed*
>
> *1990 saw the last great buying opportunity, but it was not a pleasant time. The US economy was in its worst recession for a decade, unemployment was rising and the price of oil was soaring after Iraq invaded Kuwait. Fear of war in the Middle East was high. However the market bottomed in October, and really started rising in January 1991 after military action commenced.*
>
> *All of these market lows were different. Some presented long term buying opportunities while others preceded somewhat shorter term bull markets. Yet, what is similar about all these market bottoms is that it took great fortitude to step up and buy. Generally the outlook was at best bleak with many problems and obstacles to be over come. Markets had been falling dramatically for years and shares were generally considered a high risk option.*

It is highly likely that over the coming months there will be hopeful moments that may spark significant rallies in equity markets. Headlines will probably proclaim that the worst is over as far as the corona virus and the accompanying economic contraction is concerned, but ultimately these dawns, and there may be many, will prove false. When the final low is finally seen the consensus economic and stock market outlook will be very bleak indeed, no one will be calling it a dip that should be bought or even looking for signs of capitulation, and importantly, the stock market will be historically cheap, not just less expensive than it had been, but very very cheap. At extremes valuation can be an excellent indication of just where long term expectations lie.



The chart above shows just how extreme valuations, and so expectations, were at the recent peak. The cyclically adjusted PE ratio had only been higher twice before, first at the 1929 peak, and then again at the 2000 peak. Interestingly, the damage done so far in this bear market has only brought the CAPE down to the level seen at the 1966 stock market peak. Most major buying opportunities are accompanied by a CAPE in single digits. It will be interesting to see what expectations look and feel like if the current bear market falls far enough to push the CAPE down to the levels seen at the GFC low in 2009.

Oil

It may not yet have been a final 'crash' in equities, just as it wasn't in 2008, however, the oil market is displaying behaviours much more similar to those seen in the wake of a capitulation crash.

In June of last year I ended an ongoing discussion regarding expectations surrounding the price of crude oil with the following;

> 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.

At the time the price of crude was in the mid fifty dollar range, it then traded around that level for the balance of the year before finally peaking at $63 in early January.

In Mid January, a week after the recent peak in oil prices the Energy Information Agency EIA raised their forecast for the price of oil in 2020 by about 7%;

> **EIA raises 2020 oil price forecasts, sees U.S. crude output records this year and next** Published: Jan. 14, 2020 at 12:29 p.m. ET

They were far from alone in this optimistic outlook, as reported in Petroleum Economist .com;

> Oil prices in 2020 will recover smartly from late 2019 levels, as demand regains its mojo and supply growth continues to moderate. A weaker US dollar—brought about by globally

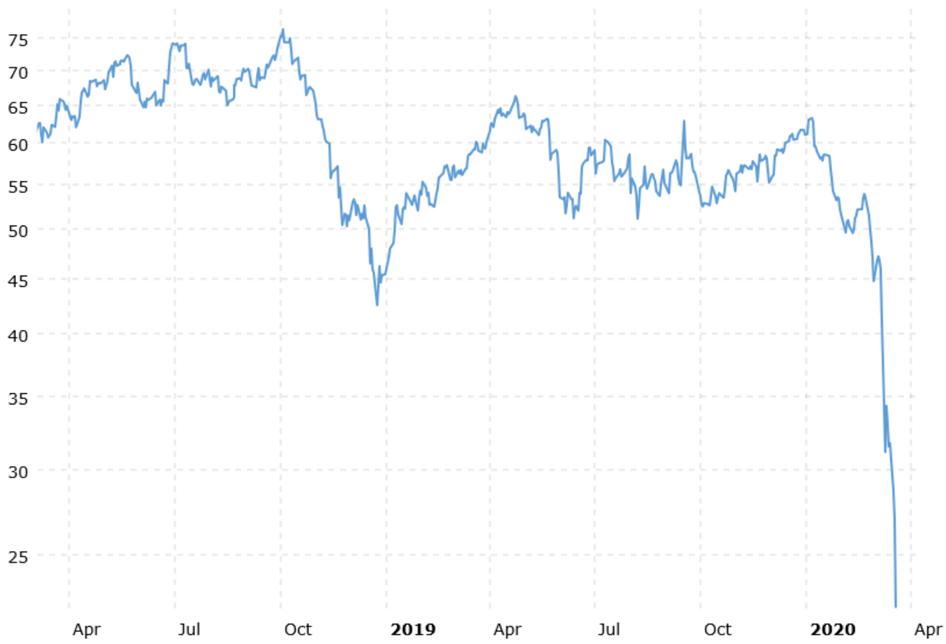
accommodative monetary policies and a reduction in economic policy uncertainty—also will support prices.

As such, BCA Research forecasts 2020 Brent prices averaging $70/bl, well above a consensus forecast of under $62.40/bl produced by over 50 economists and economist survey in an October Thomson Reuters poll.

Expectations around the price of oil were clearly extreme and vulnerable to any disappointment, and they got a double disappointment. Not just the demand destruction associated with the virus but also the production 'war' between Saudi Arabia and Russia. The combined effects have resulted in a market that displays far more characteristics of a crash than equity markets currently. Prices, and expectations, have collapsed!

As reported by CNBC on the 9th March

OPEC deal collapse sparks price war: '$20 oil in 2020 is coming'



https://www.macrotrends.net/1369/crude-oil-price-history-chart'>Source

Midway through this crash in oil prices Donald Trump indicated that he was giving instructions for oil to be purchased for the Strategic Petroleum Reserve. Unfortunately, the history of these purchases and sales has not been particularly indicative of where the oil price was headed, and Trump's comments were about as useful on oil as they were on buying the dip in equities.

Expectations around the price of oil have certainly come down, along with the price;

Morgan Stanley Slashes Brent Oil Forecast To $30 oilprice.com March 17

But they probably still have some way to go.

Conclusions

Equity markets are along way from being cheap, at some point a reflex rally will undoubtedly occur, one that will almost certainly be hailed as a sign that things are on the improve. If that happens it will be an indication that it is just a ‘dead cat’ (albeit a volatile one) bounce that should be sold into. A meaningful long term buying opportunity lies some way off in time and a substantial amount further down in terms of price, and new bull markets are always dismissed for an extraordinarily long time.

This bear market may well be looked back upon as having been the coronavirus bear market, but it was going to happen anyway, perhaps not this quickly or violently, but expectations and hope were just far too stretched.

23rd March 2020