Strategy Thoughts

April 2020

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

And the next Bottom will likely feel as bad, or worse than those of the past

Introduction

A little over a week ago, in the last edition of Strategy Thoughts, I concluded with the following;

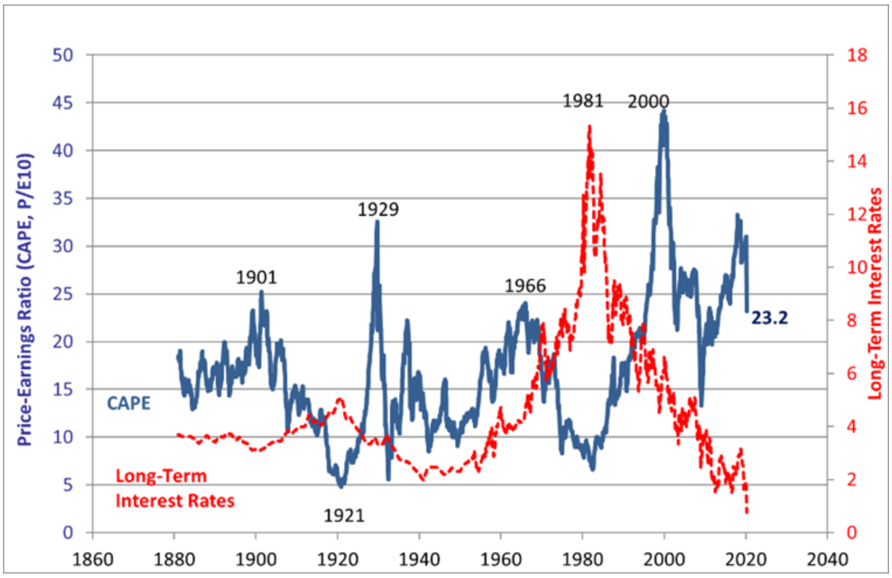
> Equity markets are a long way from being cheap, at some point a reflex rally will undoubtedly occur, one that will almost certainly be hailed as a sign that things are on the improve. If that happens it will be an indication that it is just a 'dead cat' (albeit a volatile one) bounce that should be 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.

Since then we have seen that 'reflex' rally and many are hailing it as being either THE bottom to a painful and fast bear market, or at least a point at which investors should be starting to buy. In this edition of Strategy Thoughts, I discuss the possibility that this first reflex rally may be in the early stages of rolling over, but more importantly I will try to illustrate how this may all end by looking back at a number of other historic buying opportunities.

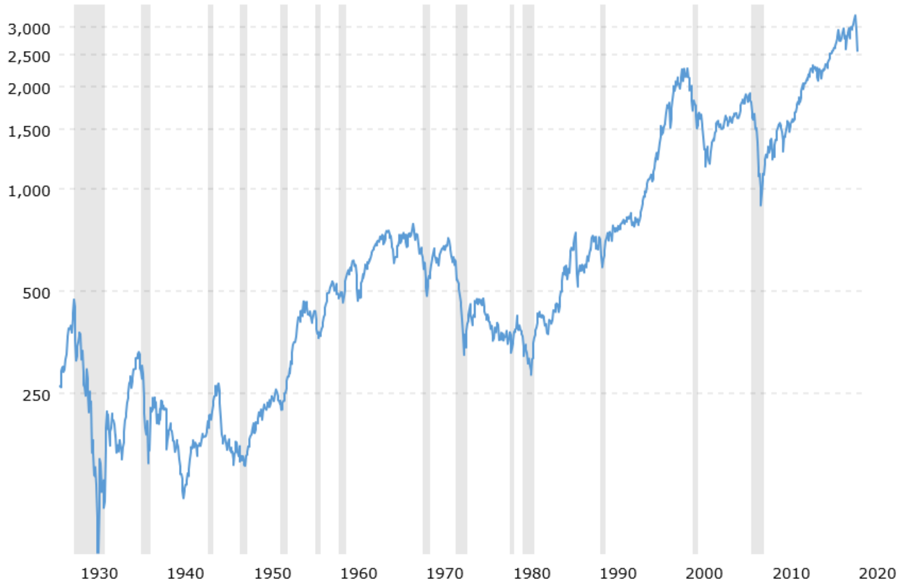
What is needed for a bottom?

Markets do not bottom just because they have fallen a certain percentage, or back to some starting point on a chart, or because they are cheaper than they once were. They also do not bottom simply because central banks or governments do something, as was so obvious throughout the GFC.

Ultimately markets always bottom because expectations become extremely bleak.



Great long term buying opportunities, as can be seen in the charts above and below share a number of consistent characteristics.



www.macrotrends.net/2324/sp-500-historical-chart-data'>S&P 500 Index - 90 Year Historical Chart

The important lows in the US market over the last century, that preceded great buying opportunities; 1932, 1942, 1982 and perhaps 2009, were all accompanied by very low, and in the case of the first three, extremely low valuations as can be seen on the two charts above. It is also clear that these low valuations were not a reflection of either high or low interest rates, the 1942 low was accompanied by historically low rates and the 1982 low by historically high rates. What each of these lows was accompanied by was exceptionally bleak expectations. There was little, if any, hope that things would ever get any better. In fact, it was because of these dire expectations that valuations were so low. The reason we ever pay what we do for anything is down to our own level of expectations, and the same is true collectively. When optimism and euphoria reign then trees apparently truly can grow to the sky and no price is too high, because prices are destined to only go even higher, and so those stretched expectations push valuations to ridiculous extremes, the same is true in reverse. A stock markets valuation is a terrific real time indicator of investor expectations, however, as an indicator it is only of any real value at historic extremes.

At market bottoms things do continue to get worse!

There is a growing feeling amongst investors that the market will only bottom once a number of things fall into place. These include; the virus showing some signs of peaking, volatility declining and an improving economic backdrop rather than the apparent freefall seen currently. All this intuitively makes sense; however, history has repeatedly shown that markets don't bottom when things are obviously starting to recover or improve, they bottom when the collective assessment is that there is no recovery or improvement in either the near or even distant future. Only when expectations are so depressed can the market bottom despite the news continuing to deteriorate. A review of four important buying opportunities illustrates this point clearly.

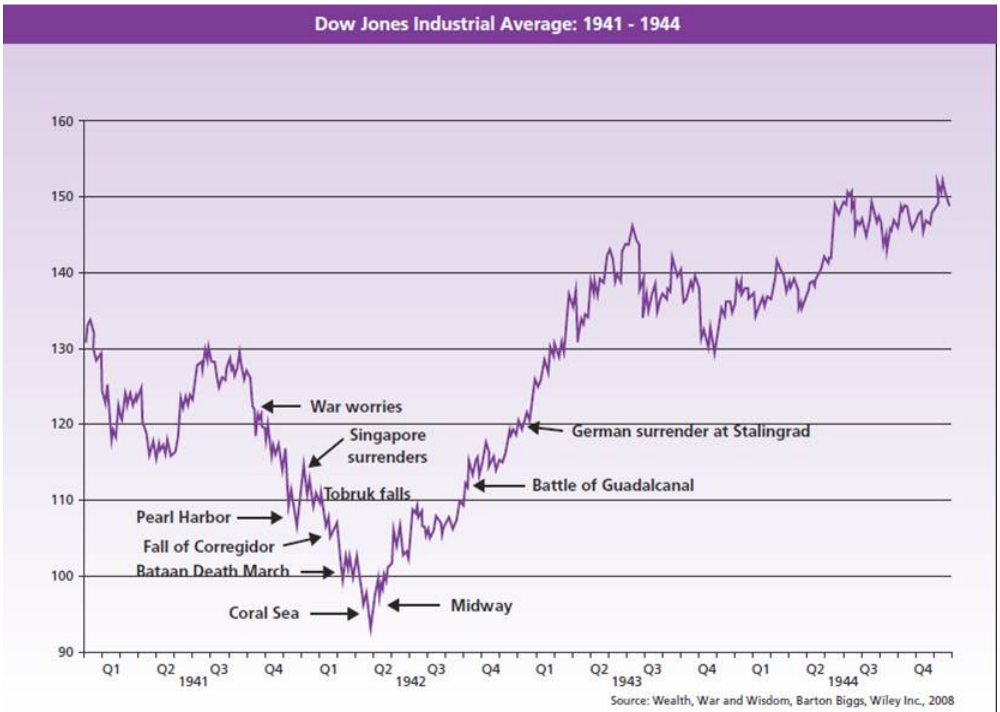
1932

The US market finally hit its Great Depression low in early June 1932, from there the economy continued to contract, only finally hitting its low point nine months later, in March of 1933. However, it is almost certain that the recession was not declared over at that time. Unfortunately the data available from the official dating agency for economic turning points, the NBER, only provides the lag between dating and announcing back to the early 1980s and it is typically six months to more than a year. That is to say investors are typically finally told that a recession ended long after it actually ended, this lag has averaged fifteen months. In the first three months after the 1932 low the market more than doubled, fifteen months after the low the market had already risen two and a half times. All this despite the headline news continuing to be bleak with unemployment hitting a record 24.9% in November 1933, nearly a year and a half AFTER the stock market bottomed.

1942

In 1942 there was no official recession, but as stocks bottomed in late April the world looked a very bleak place indeed. I wrote the following in my 2016 book ‘Investing – The Expectations Game’;

> In mid 1940 the US market tumbled from 150 down to 114 in the wake of the collapse of the French and Belgian armies and the surrender of the Netherlands. From there the market recovered somewhat, on the back of the RAF’s repeated successes through the Battle of Britain, and by the end of 1940 the Dow had rallied more than 20%. Then the Blitz began and the US market rolled over, despite ever improving economic news domestically, as serious questions were raised as to the ability of Londoners to withstand the nightly bombing raids. At the same time the US was gradually becoming increasingly involved in a war it had tried to avoid. It began allowing British ships to be repaired in the US, it dropped depth charges on a German submarine, German diplomats were expelled and in the second half of 1941 president Roosevelt, in the wake of the sinking of US cargo ships, gave orders for the US Navy to fire on sight on German Warships.
>
> Over the next few months the US market continued to slide and then, on 7th December, the Japanese attacked the US Pacific Fleet in Pearl Harbor. The market’s response was understandably to continue the selloff that had already been in train and from the 5th to the 9th December the market fell close to 6% to its lowest point since the onset of war.



> After a brief year end rally the rout resumed as the news continued to get bleaker and bleaker on the back of both German and Japanese successes.

On 28th April 1942 President Roosevelt gave his 21st 'fireside chat' to the American people and there was little he could say that was encouraging or positive. In the five months since the attack on Pearl Harbor the allies had lost most of the Philippines, Singapore and Malaysia, and Burma was under threat. Given the government's need to increase both spending and taxes he urged the American people to exercise self denial. The stock market was far from encouraged by such talk and sold off more than 7%.

At the low point for the market, established after Roosevelt's 'chat', the Dow had fallen to just 93, 40% below where it had been in September of 1939 and more than 50% down from its pre-war high in 1937.

Interest in the stock market, as measured by volume of shares traded, had reached a historically low level, even lower than it had been at the all time low for the market in 1932. Given this low level of activity, and the fact that the majority were by then anticipating even worse to come, the value of a seat on the New York Stock Exchange collapsed. In 1942 a seat changed hands for just $17,000; thirteen years earlier, at the peak of the stock market boom, a seat had traded for nearly forty times as much, $625,000. This lack of interest was also evident in the media where the coverage of stock market activity had also fallen to historic low levels. What coverage that did make it into print was understandably pessimistic.

In March of 1942 *Business Week* ran an article titled:

Wall Street Woes

And *Nation* published one titled:

Wall Street in Two Wars

In the late spring of 1942, with Germany controlling most of Europe and Japan appearing to be in the ascendency in the Pacific, expectations were justifiably dismal. Some form of totalitarianism appeared to be inevitable throughout much of the world and the future of capitalism was under immense threat. Just how dire expectations were on the part of the overwhelming majority of investors can be seen even more clearly through stock market valuations than price levels.

At the low for the market in late April 1942 major US companies were paying dividend yields approaching 10%, almost four times as much as corporate bonds issued by the same blue chip companies. Nearly one third of all companies trading on the New York Stock Exchange had a price to earnings ratio of less than four times 1941's earnings and the average P/E was 5.3.

Looked at with the obvious benefit of hindsight it is clear that the stock market was on an incredible sale, but at the time, amid the ever gloomier war reports, these valuations were rationalised. Leading economic experts were forecasting that the declining birth rate and high tax rates would result in weak economic growth for years to come, government officials were declaring that the cost of the war would push US economic conditions back to those suffered at the depths of the Great Depression, the chairman of one major insurance company stated that there was no place for stocks in the portfolios of life insurance companies and they were banned from the portfolios of insurance companies in New York state by the State Insurance Commission.

With the stock market so depressed, for reasons that were by then overwhelmingly obvious to everyone, and expectations for the future so extremely negative, the possibility for a surprise was both enormous and potentially long lasting.

The news did continue to deteriorate for some time after the 1942 bottom, and of course the war endured for another three years, but that low point was one of history's best ever buying opportunities, as the 1941-44 chart above illustrates.

It is important not to confuse cause and effect in any of these historic bottoms. The market didn't bottom because valuations had become depressed. It bottomed because expectations were so depressed and so virtually any outcome was unlikely to be worse than already expected, a positive surprise! The result of bleak expectations is that no one wants to own equities and so valuations plunge.

1982

By August 1982 the US equity market as measured by the S&P500 had fallen almost thirty percent from its previous high in 1980 and was at the same level it had traded at fourteen years earlier. When measured by the Dow Jones Industrial Average this 'plateauing' had lasted even longer. With interest rates and inflation still high, along with a tense geopolitical situation, expectations were understandably very bleak. The idea of long term equity ownership had already been dismissed as foolish in the now legendary BusinessWeek cover story 'The Death Of Equities'. It seemed no one was recommending 'stock for the long term' at that time. The US was also mired in its second recession in as many years, one that would not officially end until November of 1982, however, the NBER would not actually announce that the recession ended in November until July of the following year.

An investor fortunate enough to have bought in the November after the bottom would have missed the first 40% rise and anyone waiting for the all clear from the NBER missed out on an almost 70% rally. As was seen a half a century earlier, things did continue to deteriorate after the stock market low had been seen and would have felt worse for an extended period. Anyone waiting for an optimistic economic or fundamental event to signal the start of the next bull market has always found that they missed a substantial earlier move, one that at the time was almost certainly dismissed as nothing more than yet another 'dead cat bounce'. However, at market bottoms even though the background news may deteriorate further, it does not deteriorate as much as by then the majority fear. This constitutes a positive surprise and allows the market to move higher. Such an outcome was most recently seen in early 2009.

2009

By March of 2009 the US equity market had been falling for close to a year and a half and had suffered its worst decline since the 1930s. hope was rekindled many times through the decline and the market enjoyed at least five or six meaningful rallies on the back of this hope. However, each of those rallies turned out to be nothing more than a 'dead cat bounce' and the market resumed its frightening fall. Along the way economic forecasts were being continually downgraded. By March of 2009 the IMF published their most downbeat global economic forecast they had ever published, and, despite the market rallying from its March 2009 low, the same organisation was to further downgrade their forecast.

The NBER dated the start of the recession to December 2007, by which time the market had fallen about 7%, but they didn't announce that as the start date until one year later, in December 2008, at that point the market had almost halved and was within three months of bottoming. After the market bottomed in early March earnings estimates and economic forecasts, not only by the IMF, continued to be cut as the news continued to be poor. The recession finally officially ended in June 2009, with the market up 40% from its low point, but that end date was not officially announced until September of 2010, by which time the market was up almost 70% from its low point.

It has never paid to wait until the recovery is obvious to get into the market. Markets have always bottomed when there appears to be no recovery in sight, ever!

As Kenneth Fisher put it;

'In history, the evidence is overwhelming: Stock market bottoms happen, and then stocks jolt upwards while the economy keeps getting worse – sometimes by a lot and for a long time.'

What might the next bottom feel like?

It is very likely that the next great buying opportunity, accompanied by historically low valuations and expectations will share many of the characteristics seen at the last four described above. However, it is clear we are still along way from that point despite the dramatic falls already suffered.

Currently there is a very strong consensus that all that has been endured, both the damage to the stock market and the economy, is the result of the virus, and that once the peak infection rate is seen, and 'the curve' flattens then things can get back to what everyone had become accustomed to being normal, and that pent up demand will push economic growth rates back to where they had been and higher. Perhaps this is the way it will all pan out; however, history shows that economic forecasters have always been lagging indicators, merely extrapolating that which has most recently been either endured or enjoyed, and, most importantly, that their forecasts are always appalling around long term inflection points. It therefore seems that there will probably be more room for continued disappointment, rather than surprise, even after the virus goes into decline!

One set of analysis that I saw recently listed a slew of ingredients for a market bottom, it included measures of the virus' curve flattening in certain countries, certain fiscal and monetary reforms being made, and other measures like bond spreads narrowing. All seemingly very sensible, but many of them, like overall economic stability becoming obvious, will likely only occur long after the stock market has bottomed.

Interestingly, despite the economic devastation that is already becoming evident bond spreads are nowhere near as high as they were at the peak of the GFC. In fact they didn't get back below where they are currently until three or four months AFTER the stock market had bottomed in 2009, by which time markets had risen about 50%.

Over the last week markets have staged their best rally since the rout began, and, not surprisingly, there is a growing chorus that the worst may now have been seen, and that the huge declines of a couple of weeks ago were the selling climax so many were looking for.

The rally, as can be seen in the chart above, was impressive, rising more than 4,000 points in just a few days. However, the fact that it was greeted by so much relief and acclaim, with 'buy lists' abounding, should be a highly cautionary flag.

4 Reasons Now Is the Time to Buy Stocks – Not Sell 30th March 2020

Time to buy stocks again, market mavens say World stocks have risen nearly 8 per cent so far this week and were on track for their best weekly gain since December 2011. 27th March 2020

My 'greed-oriented' algorithm is telling me to buy stocks March 27, 2020

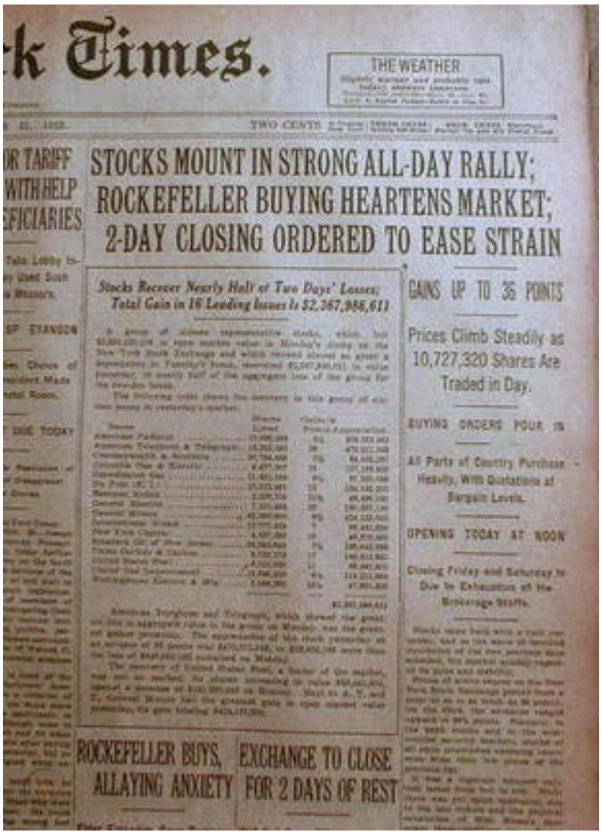
There were far more headlines such as those above, than those one typically sees just after a market bottom. At or soon after a market bottom headlines do not proclaim the opportunity that is at hand, rather they dismiss whatever recovery has already been seen. In late April 2009 I included the following selection of headlines to illustrate this point and to justify why the low, seen on March 9th 2009, was probably an important bottom.

Rally, Yes; Bottom, No
Forbes.com – 3/10/09
No Way You're Getting Me Back in This Market
Yahoo! Finance – 4/8/09
Is this a sustainable bull market?
The March run likely will lead to weakness
MarketWatch – 4/1/09
Warning: The bear isn't hibernating yet
CNNMoney.com – 4/1/09
Goldilocks rally meets the bears
March was good, but a downturn is inevitable
MarketWatch – 4/1/09
Don't Buy the Chirpy Forecasts
The history of banking crises indicates this one may be far from over.
Newsweek – 3/30/09
Bear Rallies Turn Market Into a Circus
Wall Street Journal – 3/23/09

Enjoy the Sucker's Rally, Says Merrill's Rosenburg
***Yahoo! Finance** – 3/19/09*
Roubini Says Rally is a "Dead Cat Bounce"
***The Business Insider** – 3/16/09*
Is This A Real Rally Or Dead Cat Bounce?
***Investors Business Daily** – 3/16/09*

The overwhelming expectation at that time was that things may have been bad but they were set to get worse so don't get sucked into another 'sucker's rally'.

In addition to bearing some similarity to the numerous bounces seen throughout the GFC the most recent rally is also reminiscent of that seen in late October 1929. Then, after a severe two day crash markets rebounded after John D Rockefeller Sr. announced;



k Times.

THE WEATHER

TWO CENTS

STOCKS MOUNT IN STRONG ALL-DAY RALLY; ROCKEFELLER BUYING HEARTENS MARKET; 2-DAY CLOSING ORDERED TO EASE STRAIN

Stocks Recover Nearly Half of Two Days' Losses; Total Gain in 16 Leading Issues Is $2,367,986,611

GAINS UP TO 36 POINTS

Prices Climb Steadily as 10,727,320 Shares Are Traded in Day.

BUYING ORDERS POUR IN

All Parts of Country Purchase Heavily, With Quotations at Bargain Levels.

OPENING TODAY AT NOON

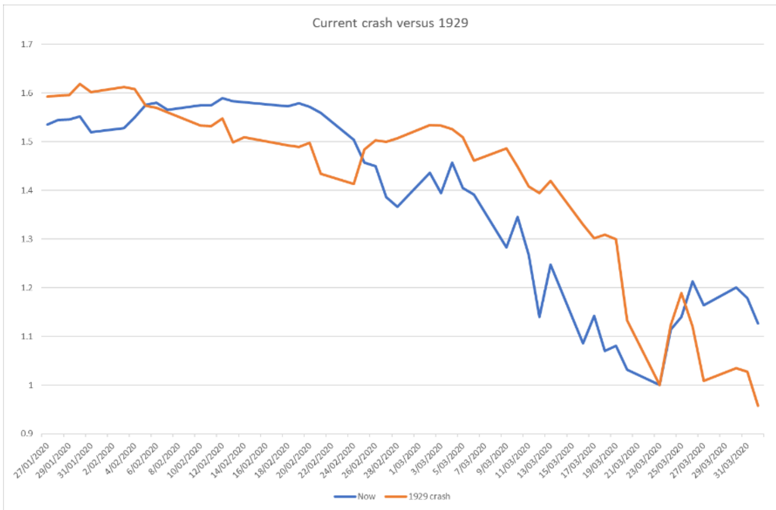
Closing Friday and Saturday Is Due to Exhaustion of the Brokerage Staffs.

ROCKEFELLER BUYS, ALLAYING ANXIETY

EXCHANGE TO CLOSE FOR 2 DAYS OF REST

"Believing that fundamental conditions of the country are sound and that there is nothing in the business situation to warrant the destruction of values that has taken place on the exchanges during the past week, my son and I have for some days been purchasing common stocks. We are continuing and will continue our purchases in substantial amounts at levels which we believe represent sound investment values."

What followed was one of the largest one day percentage gains ever, even larger than that seen on the 24th March this year. That rally was relatively short lived and the current one appears to be rolling over too, albeit a little later than the Rockefeller induced rally of 1929.



That 1929 rally soon petered out and over the next two weeks the market fell to what then seemed a dramatic low below 200, down 48% from the all time high of a few months earlier and 28% down from the Rockefeller rally high. If the current decline were to continue to echo that of 1929 the Dow could fall another 4,000 points to close to 16,000.

Then a more meaningful bottom might be seen, but only time, and an assessment of expectations at the time, will tell. If the next new low is greeted as yet another buying opportunity and any rally celebrated, then it will likely only be yet another bounce on the way to the final low in price, valuation and expectations. Only when expectations and so valuations are dismally depressed will things finally 'feel' more like those environments described earlier in this edition of Strategy Thoughts.

Conclusion

The current bear market was long overdue, by many measures stock prices and expectations were as extended as they have ever been, not surprising after the longest bull market in history. No one could have predicted that the apparent catalyst for the market's reversal would be a virus from China, but no one should be surprised that markets have fallen as dramatically as they have. What is important now is to maintain an investment discipline that will allow one to avoid getting swept up in what will, in all likelihood, be many moments of excitement and enthusiasm that a bottom has been made. One such moment has probably just passed, there will be many more on the way to the final low. When that final low arrives great fortitude and discipline will be required as investing will appear to be the dumbest thing one could possibly do, everything will look incredibly bleak and set to get worse, economic projections will be being slashed, as will earnings forecasts, and the idea of 'stocks for the long term' will have been thrown out of the window, just as it was in 1932, 1942, 1982 and 2009.

In the meantime, the mantra of preservation of capital continues to be the most important thing for all investors to keep in mind.

2nd April 2020