Strategy Thoughts

May 2020

Complacent hope remains, even while the 'disconnects' grow

Introduction

Over the last four weeks, since the last edition of Strategy Thoughts, equity markets have bounced, and not surprisingly these bounces have been accompanied by a growing sense of confidence and hope. Last month I concluded with the following; "frequently heard cries of the worst being over should be seen as a warning sign, and certainly not an indication of the all clear having been sounded." Such calls are now being heard not only for the stock market, but also for the outlook of the virus and for the economy as a whole. These are not the opinions usually heard after a bear market has run it course and a new bull market has begun, they are, however, frequently evident throughout bear market rallies, or 'dead cat bounces'.

This edition of Strategy Thoughts will examine the remarkable disconnects that are emerging between equity market valuations and the very long term damage that has already taken place, the prevalence of the misplaced 'hope' that the worst (on many fronts) is now over, and explore what may need to be seen for an important low to have been recorded.

Misplaced Hope

"Nobody in America's ever seen anything else like this. This thing is different. Everybody talks as if they know what's going to happen, and nobody knows what's going to happen." – *Charlie Munger.WSJ 17/4/2020*

Understandably there have been many 'experts' willing to pontificate on the history making stock market, economic, and medical events that have already been seen over the last few months, and then on what they expect to happen next. All, as Charlie Munger in the quote at the top of this section makes clear, should be taken with a grain of salt. Nonetheless, they do all serve as an indication of just where current expectations may lie and so where the biggest surprises and disappointments are most likely to be seen.

Stock market

Optimism and hope that the worst may now be over for the US stock market has been building as the current rally has unfolded;

- The latest AAII Sentiment Survey also shows a rebound in optimism and a pullback in pessimism. Bullish sentiment, expectations that stock prices will rise over the next six months, rose 5.7 percentage points to 30.6%. Forbes May 1 (Ironically, this was the largest one week rise in the survey's bullish response since March 5th, exactly as the first rally in this historic decline was ending.)
- **Today's US Stock Market says "the Worst is behind us now"** Livetradingnews.com 27 April
- One month ago CNN's fear and greed index was at an historic low of 21, it has now rallied up to a close to neutral 44.
- **Jim Cramer says the bulls are back, and investor confidence is bolstered by support from the Fed and the U.S. Treasury.** Thestreet.com 28 April
- **Buy in May? Analyst who called the March bottom says current pullback is just a bull-market pause** Marketwatch 4 May

Even though many commentators may not be calling for a rampant bull market, the majority appear to be quick to express that the worst has been seen and that the low seen in late March will prove to be the ultimate bear market low. (If this were in fact to be the case it would be remarkable for the longest bull market in history to be fully corrected by the briefest bear market!)

Economy

Despite the incredible damage that has already been done there is a remarkable degree of optimism among economic prognosticators regarding the prospect for an incredible V shaped recovery, undoubtedly, at least to some extent, fuelled by president Trump and his advisors.

> **US economy could see SHOCK growth rebound next year post coronavirus** THE UNITED STATES' economy could see a historic growth rate in 2021, according to Donald Trump's chief economic advisor.
> The Express 4 May

A V would be a highly desirable outcome, unfortunately history shows that such reversals are rarely if ever forecast, and are only broadly recognised and embraced long after they have occurred.

Twelve years ago, in the May 2008 edition of Strategy Thoughts titled "If it was a dead cat bounce has the worst been seen" (a title I could have used this month!) I discussed the then prevalent views of economist and corporate leaders.

> These strong bounces have precipitated, and in turn been fed by, a growing bullish sentiment and increasingly constructive commentary. The majority of this commentary falls into one of three categories; firstly, economists are now urging that investors should now be looking 'across the valley' to the upcoming recovery, this is certainly a positive outlook, however it should be remembered that these economists are telling us to look across a valley that they never told us was there until it was clear we'd fallen in. Secondly, senior executives are now forecasting that the worst of the write-offs associated with the bursting of the credit bubble have also been seen. Like economists it should be remembered that these are many of the same executives under whose watch the now clearly irresponsible practices took place and who failed to see the magnitude of the problem once it was clear there was one.

At that time the US equity market had suffered a more than 20% decline through mid March 2008 and then recovered more than half of that fall. The parallels are clear, as with then we are now being urged to 'look across the valley' economically by economists who never foresaw a valley approaching, and instead of the worst of the write offs being apparently behind us, we are now hearing that the worst of the virus' impact is now behind us.

The virus

The stock market and the progress of the virus appear to inextricably linked with any good news on a treatment or vaccine being greeted by a rallying market, and as the current rally has unfolded there have been a growing number of optimistic news stories on the virus and its progress;

Trump says 'worst days' of coronavirus are 'behind us' The Hill 28 April

We Are Nearly Done with the Worst Five Weeks of Virus Hell National Review 1 May

New NYC grading plan comes amid more signs of virus recovery Associated Press 28 April

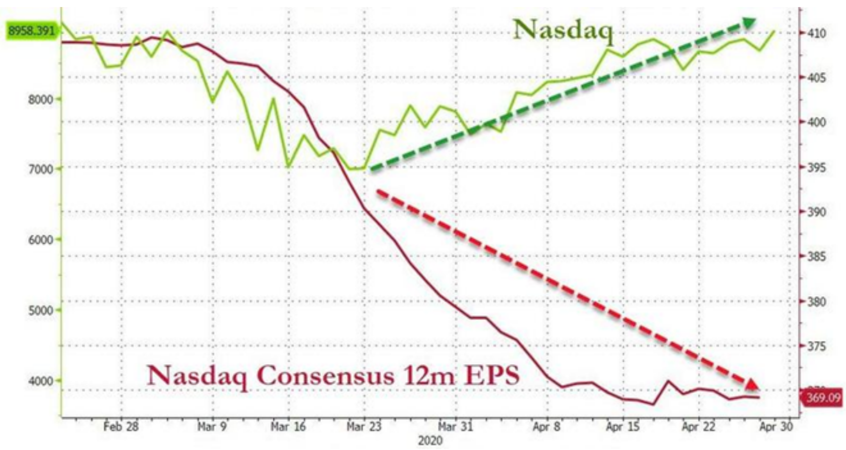
The clearest connection between the market and the virus was drawn by the following Marketwatch story reflecting Deutsche Bank research;

> **This one chart makes the case that the worst is over for the stock market and the virus has peaked** Marketwatch 29 April

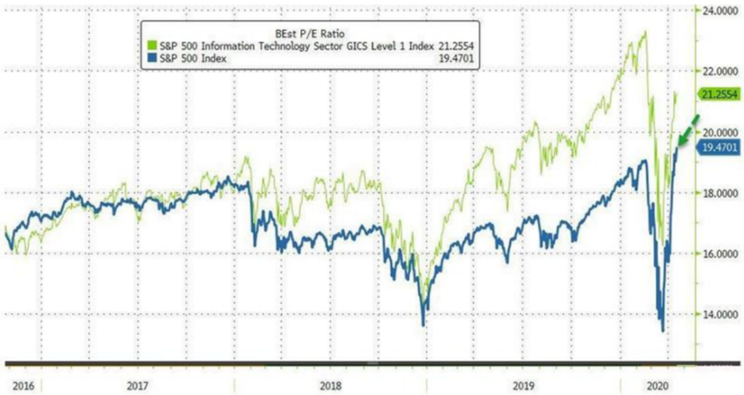
Given the sharp recovery in the market, the apparent improvement in the virus situation, and the continued positive economic narrative based upon the idea of 'looking across the valley' apparently irrespective of how wide or deep it may be, it is understandable that hope exists. Unfortunately, as I have pointed out many times in the past, hope is not what is generally seen at the beginning of a sustainable bull market.

The Disconnects

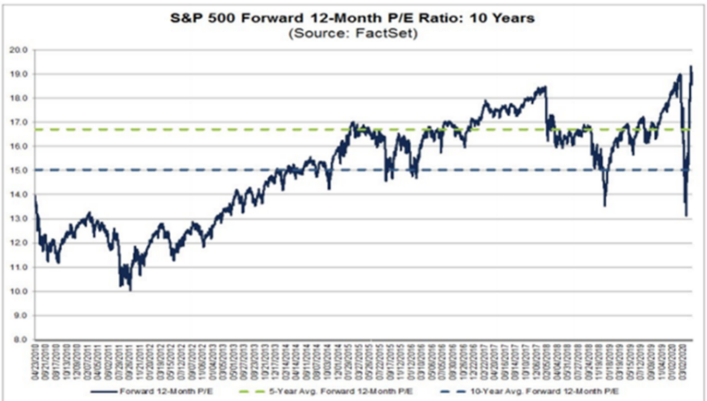
The chart below highlights one of the major disconnects in the current stock market.



The NASDAQ has put on a remarkable display of resilience and strength in the face of what we are being told is going to be the worst economic environment since the Great Depression. Understandably analyst have been slashing their earnings forecasts to reflect this underlying fundamental deterioration, yet despite this the index has done nothing but rally. This has obviously pushed valuations to even greater extremes than they were at the market peak earlier this year. The same has been true in the broader market as the chart below illustrates;



Both the IT sector, and the broader S&P are now close to being as expensive as they have ever been over the last five years. A longer term chart gives an even clearer picture of the current extreme valuation of the S&P;



Another disconnect, highlighted to some extent by the charts above, is the difference between the performance of the largest companies in the US and the rest.

The chart above shows the performance of the Russell 2000 index of small cap companies compared to the performance of the S&P500 over the last three months. It is clear that not only did the small caps fall further than the larger S&P500 companies, but they have also recovered less of that loss. An even more extreme example of this can be seen if one compares the five largest companies in the S&P500 with the performance of the S&P500 itself. Those five largest companies, Microsoft, Apple, Amazon, Google and Facebook are currently up on average 40% from their recent March lows and are only 7% on average below their pre crash high. The broader index on the other hand is only up 29% and still 17% below the previous high.

This kind of concentration, or disconnect, of performance in the largest stocks has historically been very unhealthy. Marc Faber famously described this phenomenon as the San Juan Hill Theory, the idea being that by the time the 'generals' are reaching the summit, long after the 'troops' have already left, the battle, or bull market, is already over.

Exhibit 4: The concentration of market cap in the largest stocks has soared
as of April 23, 2020

Source: Compustat, Goldman Sachs Global Investment Research

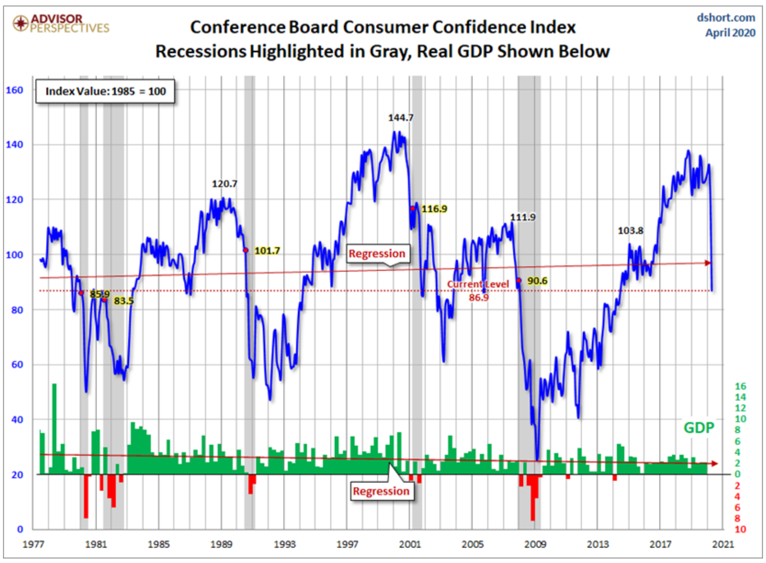
Even before the current crisis the dominance of these five companies was already raising alarm bells;

> **The five biggest stocks are dwarfing the rest of the stock market at an 'unprecedented' level** CNBC Jan 13

The article pointed out that the dominance was even greater than at the peak of the DotCom mania in 2000, and that didn't end well either with the NASDAQ plunging 80% in value.

Confidence

Consumer confidence is a widely followed economic indicator, however, it is only ever at best a coincident indicator, and then only useful at extremes. It can highlight when consumer, and so investor, expectations reach stretched levels from which either disappointments, or positive surprises, are likely.



The chart above shows the Conference Board's consumer confidence survey back into the 1970s. The deep troughs in mid 1980 and late 1982, early 1992, early 2002, and early 2009 were all wonderful indicators that positive surprise was more likely than continued disappointment and all were at or close to important long term buying opportunities. The same, in reverse, can be said about the peaks in 1989, early 2000, mid 2007 and late 2018. What is clear now, however, is that despite confidence having taken a very severe hit over the last month, it is still no where near the level that has accompanied great buying opportunities in the past, in fact it hasn't even declined to the level it fell to in early 2008 ahead of the first dead cat bounce of that bear market.

When the latest consumer confidence numbers were released the accompanying commentary included;

> Consumer survey data cannot predict the progression of the virus, but the data can indicate whether consumers' economic expectations are more or less vulnerable to additional declines.
>
> The second objective of this report is to assess that vulnerability. The only positive aspect of the current situation is that consumers anticipate improved finances as well as overall gains in economic conditions during the year ahead. This reaction is quite different from the typical initial responses to a downturn and is due to the belief that the coronavirus will gradually diminish in the months ahead.

The survey data showed only a slight drop off in future expectations, highlighting the fairly sanguine and measured attitude that the majority are taking to the current crisis. The commentary concluded with;

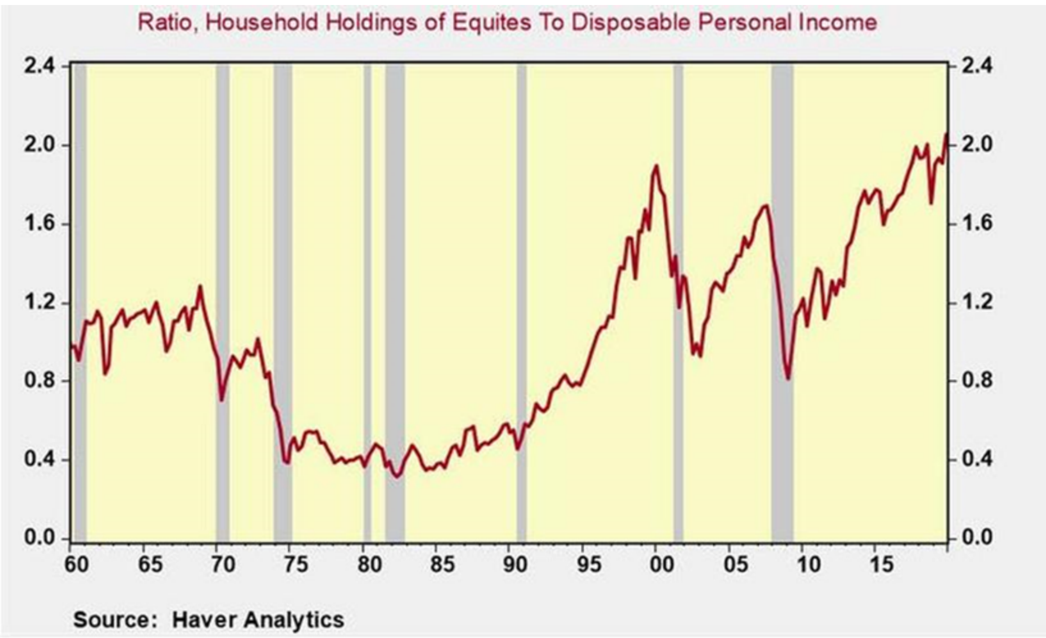
> Overall, the data indicate that further declines in overall confidence due to falloffs in expectations are clearly possible, and are likely to occur due to the continued increases in unemployment and shrinking GDP in the months ahead—both reaching the worst in our lifetimes

Clearly the risk is that current expectations about the future remain elevated and vulnerable to disappointment, again this is not the typical back drop to a sustained bull market. The latest survey from the University of Michigan revealed a similar underlying confidence, and possibly complacency. Despite the headline plunge in their confidence survey, the biggest monthly decline in its history, the most remarkable aspect was the answer to the question regarding expectations for their own economic situation 5 years in the future. That result showed 57% of respondents expected to be better off, up from the March reading of 53% and only just below the all time high reading of 60% recorded in April 2019.

Further indications of just how vulnerable the markets continue to be can be seen in the charts below.

The first shows yet another version of the enormous disconnect that currently exists. Over the last decade and a half the valuation of the equity market has closely tracked the level of consumer confidence, that is until the last few years, and with last month's plunge in confidence and rally in the market the disconnect has dramatically expanded. For the two lines to once again converge either confidence must immediately bounce back to record highs, or the market has to fall faster than earnings.

The second chart shows just how comfortable the public have become with equities. Again, long term buying opportunities arrive when this measure of equity holdings to disposable income falls below 1, not when it is over 2.



Conclusion

When the next great buying opportunity arrives consumer confidence will be at levels substantially below those seen in the most recent surveys, and more importantly consumers expectations for the future will be bleak. At the same time economists will not be looking across the valley, they will be wondering if there is even another side up. In the market, it is quite likely that the most loved, largest, 'generals' in the market will have fallen back in line with the 'troops' and only then will many of the current disconnects have been resolved.

In the meantime preservation of capital continues to be a valuable, and active, investment strategy. Wishing one had been in the best one month rally in decades is foolish, and potentially dangerous. This was famously pointed out by Smith Barney's noted market analyst Alan Shaw many years ago when he wrote;

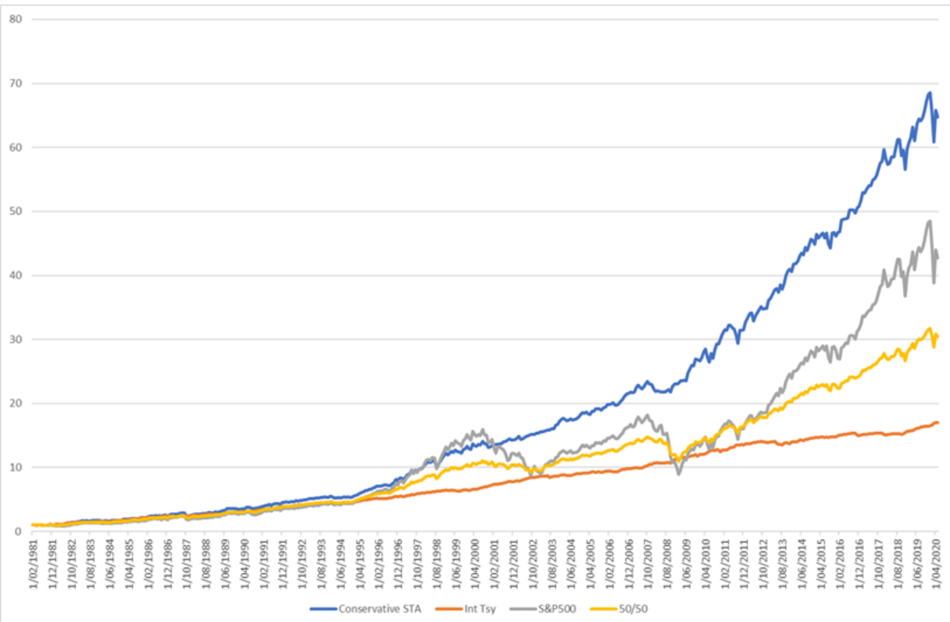
"I'd rather be out of a market wishing I was in rather than in a market wishing I was out."

I fear that once this dead cat bounce rolls over, and the bear market resumes, there will be many in that latter camp.

6th May 2020

STA update

Some months ago I described some changes I had made to the STA portfolio, they were minor and involved the decision to be in the market rather than intermediate bonds being driven by any one of; the market having a positive 5 month or 13 month rate of change, or the 5 month moving average being above the 13 month moving average. This resulted in an investor being invested about 85% of the time, I have modified this by only ever being 60% invested in equities to give an average asset allocation of 50% equities and 50% bonds. The result is shown below



The STA has easily outperformed the market and intermediate treasuries and a regularly rebalanced 50/50 portfolio. Perhaps most importantly as of the 1st of May the STA is once again 100% in intermediate treasuries.

After thought

Twelve years ago, in late April 2008, as the market was approaching the end of the first dead cat bounce in that bear market I included something I had written eight years earlier, so twenty years ago now, and it is still worthy of consideration if we are indeed only in the early stages of a bear market.

> Eight years ago, at the peak of the TMT dot com boom, I raised concern regarding the sustainability of what was occurring, not directly from an investment perspective but from a broader societal standpoint and the inequality of income distribution that the nineties boom had brought about. What sparked my interest back then was the chart below.
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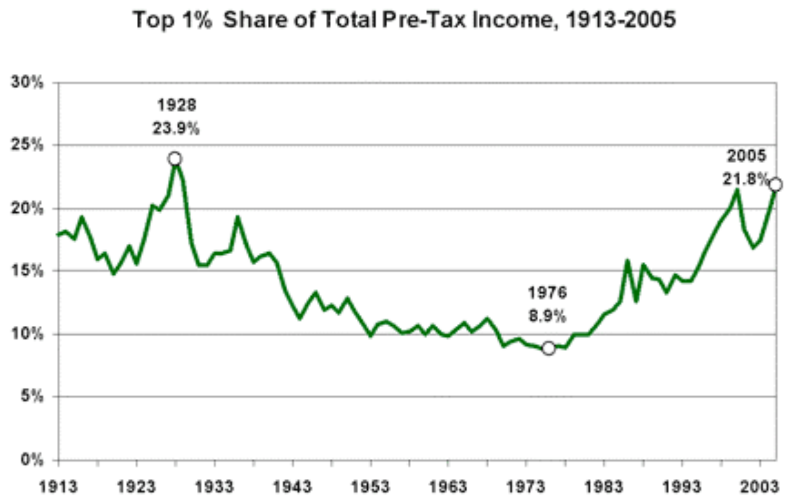
> 
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>
> It shows the percentage of total pre tax income in the US that goes to the top 1% of earners. In 2000 it showed levels of income inequality that hadn't been seen since the share market peak prior to the great depression. After the depression the most equitable distribution of income was seen at the depths of the seventies recession and bear market.
>
> What is interesting now is that the highs of 2000 have been surpassed, not shown on the chart is that in 2006 the ratio rose to 22.9% and it is quite possible that when the numbers are finally calculated for 2007 that the all time high seen in 1928 will be broken.
>
> Similar calculations have been done on CEO compensation compared to their average employee and there the distortions are just as great or even greater. The average CEO in 2005 made 411 times the average employee, up from 107 times in 1990 and about 40 times in 1970.

With the benefit of hindsight I can now confirm that 2007 did indeed take out the all time high from 1928. Through the Great Recession this disconnected ratio did correct a little, falling from 24% down to 18%, a similar rationalisation to that seen after the Dot Com crash. Since then it has been rising again, unfortunately, the most up to date ratio I have is 22% in 2018, so once again approaching the all time high, and CEO pay as a multiple of average workers pay remains at a very elevated level. I concluded with these comments twelve years ago;

> How sustainable this is only time will tell, but it is fair to say that great buying opportunities historically have not been presented when distortions in wealth distribution have already become extreme.

2009 was a great buying opportunity, even though the market was never historically cheap, but these disconnects only adjusted slightly. It will be interesting to see if the next bear market has more of a stabilising effect in realigning this distortion than the last one.