Strategy Thoughts

February 2021

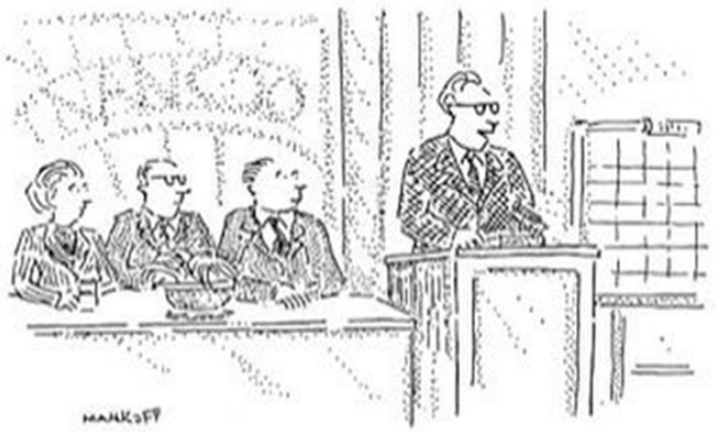
Has the Eye of a Very Major Storm just passed?

Introduction

Welcome back to Strategy Thoughts, and thank you to all the readers who contacted me wondering whether I was ever going to publish again. It was almost nine months ago that I last put out an edition of Strategy Thoughts, at that time markets had enjoyed a rebound from the pandemic stricken lows and hope, at least in investing circles, had rebounded dramatically with a New York Fed survey showing that a majority of Americans believed that the stock market would rise even if the real economy continued to sink. Well, they certainly got what they were hoping for and what I had felt was nothing more than a 'Dead Cat Bounce' turned into something quite historic.

Throughout the second half of last year, I felt writing a new Strategy Thoughts, just to reiterate the same message of caution and capital preservation, was pointless. I still believed that the 2020 rally would eventually be looked back upon as the end of a move, rather than the beginning of something meaningful, but did not feel that this view needed to be published again and again each month. However, now, with a number of vaccines being rolled out across much of the world, hope, and with it, expectations, have risen to historically dangerous levels and the need for caution once again needs to be reemphasised.

Those extreme expectations, the absurd idea that low interest rates guarantee higher stock prices and with them the idea that the dangerous levels of valuation seen currently are seemingly easy to brush aside, and the idea that somehow disasters such as the pandemic are in fact an economic positive due to the fiscal and monetary stimulus they pull out, will all be explored in this latest edition of Strategy Thoughts. There will be no change in my overriding conclusion, but hopefully these thoughts will prevent readers from getting swept up in the nonsense captured in this New Yorker cartoon from around 2001.

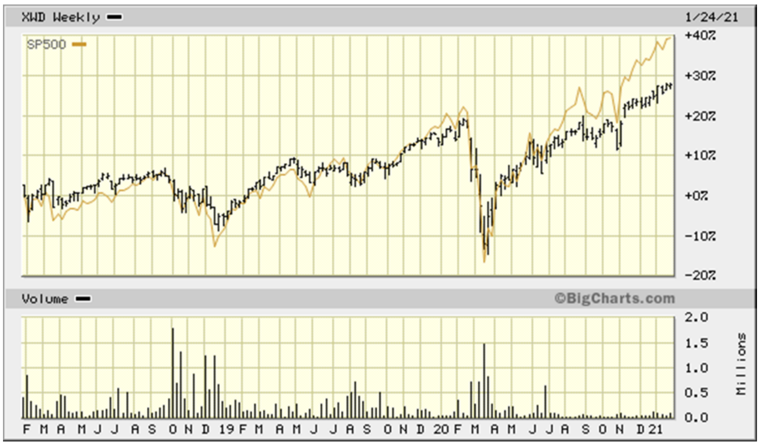


"And so, while the end-of-the-world scenario will be rife with unimaginable horrors, we believe that the pre-end period will be filled with unprecedented opportunities for profit."

When the eye of a storm passes over it feels like the worst may be over as a calm settles in only for this seeming return of normalcy to be abruptly turned upside down when the other side of the storm rolls in with just as high winds, only from the opposite direction. The relative calm and normalcy of the second half of 2020 may be looked back upon as such a 'calm', and when the other 'side' of the storm hits it will be from a different direction. It is quite likely that the next downdraught in asset prices has already begun but it may well turn out to be quite different from that endured in the first quarter of last year.

Where are we now? The broken window fallacy!

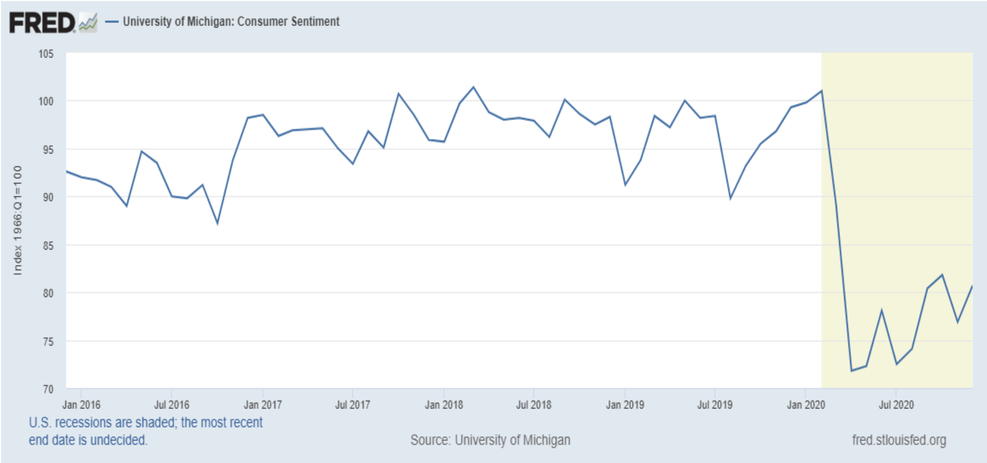
What is the global stock market appearing to tell us now that the end of the pandemic may be in sight? The chart below shows the MSCI index and the S&P500 over the last three years, the collapse associated with the emergence of the pandemic and lockdowns is very obvious, but what is perhaps more remarkable is how much higher markets are now than they were even before the pandemic related collapse. Does that mean that, at least from a stock market perspective, global pandemics are a good thing? Superficially the answer seems to be yes!



It is fair to say that before the pandemic collapse began, I believed that expectations on the part of investors were at historically dangerous levels. I concluded Strategy Thoughts late in 2019 with;

> Preservation of capital ahead of the next great buying opportunity still remains my preferred strategy.

The pandemic induced selloff, clearly with the benefit of hindsight, did produce a buying opportunity but I never believed that it was a great long term buying opportunity and that what followed I anticipated to be a 'dead cat' bounce. Again, with hindsight it has clearly been something more than that, but, some measures, such as consumer confidence, may be evidencing something closer to the proverbial 'dead cat bouncing';



Both the German and US measures of consumer confidence have failed to bounce back to pre pandemic levels, and both have started to roll over.

From an economic stand point it is interesting is to compare where things are now with where they were a year ago.

Back in January 2020 the IMF were forecasting that global GDP would expand 3.3% in 2020 and 3.4% in 2021. This would result in a global economy 6.8% larger by the end of 2021. In their latest forecast, after 2020 actually suffered a 3.5% contraction, the IMF are now forecasting a 5.5% increase in 2021. Even if this were to eventuate the global economy would still be 5% smaller at the end of 2021 than was expected one year ago. Despite this the market does seem to see things as being even better than they were a year ago. Somehow it sees all the unprecedented stimulus efforts that have been seen as being enough to wipe out all the damage and loss of life that has been endured.

This thought process reminded me of 'the broken window fallacy'. Now I am no economist, as long time readers will be very familiar, but economicshelp.org does a great job of describing this famous fallacy;

> The broken window fallacy was introduced by a French liberal economist Claude-Frédéric Bastiat (1801 – 1850). In 1850 he wrote a short article**:** "Ce qu'on voit et ce qu'on ne voit pas" ("What is Seen and What is Unseen") In the article, a boy breaks a window. However, the local people decide that the boy has helped the local economy. Their reasoning is:
>
> - Shop owners employ a glazier to repair the window, who gains extra income.
> - The glazier sees an increase in income which he then uses to spend in other shops – benefitting other shop-keepers. (This increase in spending creates a 'local multiplier effect')
> - Overall, it seems that the local economy has benefited from a flurry of economic activity – even though it came from mending the broken window.
>
> **The unseen effects**
>
> However, Bastiat doesn't stop there. He considers the 'unseen' effects. If the shop owner spends 50 Francs on repairing a window, then isn't able to spend these 50 Francs on a new outfit or new equipment for his business. Therefore, while a glazier benefits, the tailor loses out. The broken window has not increased the stock of good and services. Repairing the broken window has merely replaced what was already there.

Furthermore, if the window hadn't been broken, the shop-owner could have used the time and money to invest in a more efficient production process. This would have led to a rise in net investment – rather than just gross investment to replace the depreciation (broken window)

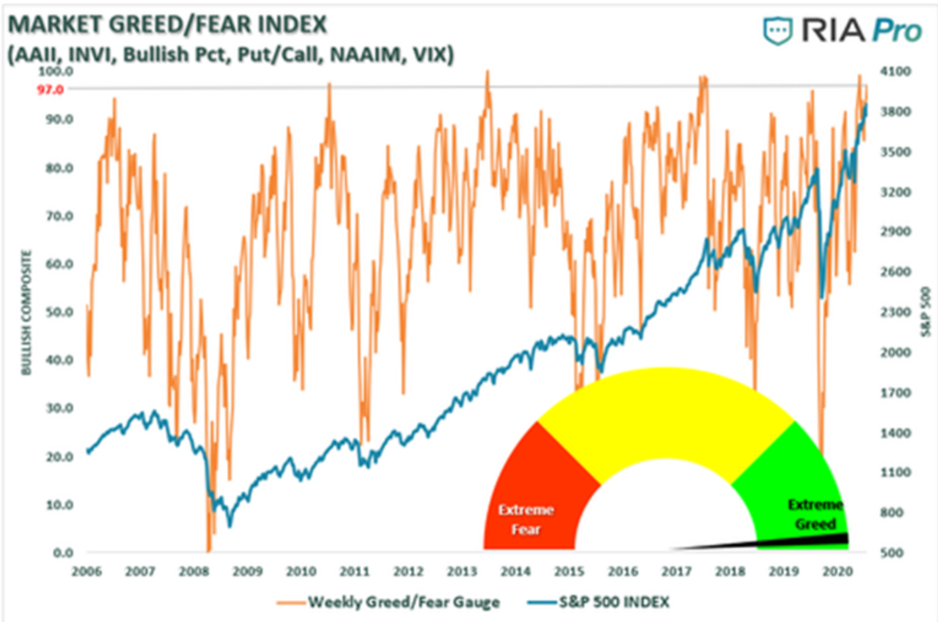
Breaking a window and repairing it, leads to an inferior outcome to a possible alternative, which is investing in increasing the stock of new capital. However, the missed capital is less visible than the more visible signs of giving the glazier work.

It seems obvious, when described like this, that breaking windows cannot, in the long run, be a net positive to the economy, otherwise one could take things to an absurd extreme and just be continually breaking and replacing windows in the hope of growing the economy. Similarly, arguing that somehow the pandemic has been a positive, due to the massive stimulus that has been let loose, is just as absurd, yet that is what the markets are seemingly telling us and reflects just how stretched aggregate expectations currently are.

Expectations

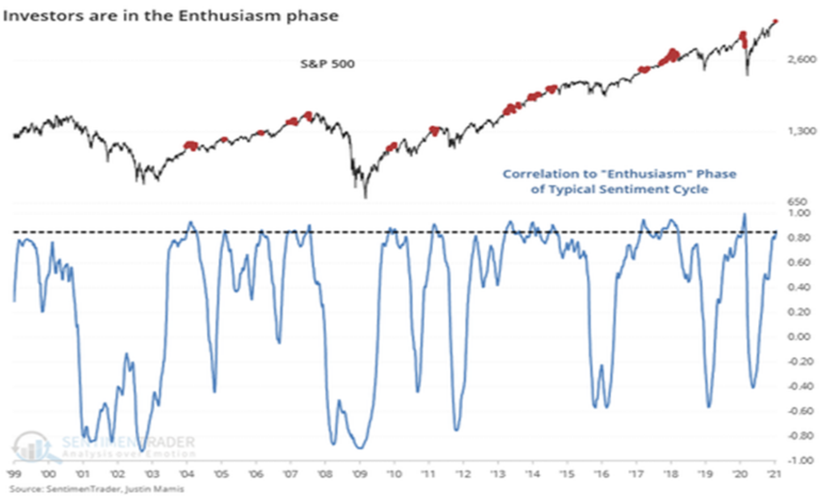
"Sentiment is horrifically extreme and almost all signs are present, screaming at us that we're seeing the kinds of behavior that are almost solely and universally seen at medium-term peaks in stocks."
Sentiment trader

The next four charts, from a variety of sources and over varying time frames, clearly illustrate that expectations on the part of investors were at historic extremes one year ago, leaving the markets vulnerable to any disappointment, and by some measures have attained an even greater degree of 'extremeness' at the recent peak

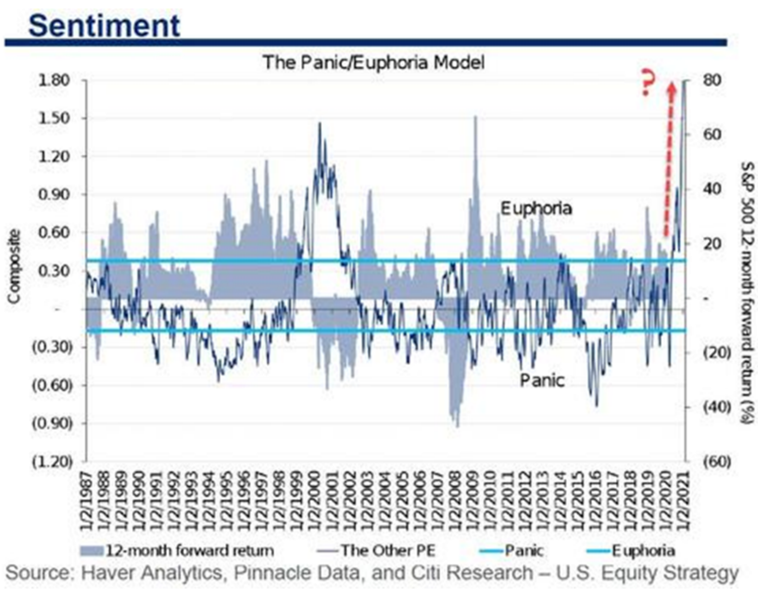


The fear and greed index above remains at an extremely elevated level.

The next two measures, whilst high, are not quite as those levels seen one year ago.



But perhaps most worrying is the record extreme seen the panic/euphoria model, where the only period that comes close was the tech mania at the end of the last century.



Given these extremely stretched expectations, markets are once again vulnerable to any disappointment, and it is important to remember, disappointments at peaks in markets are usually seen in the form of what superficially appears to be very good news but unfortunately fails to meet or exceed what by then have become dramatically stretched expectations.

Some evidence of this has been seen in the latest quarterly earnings reports on Wall Street. A large percentage of companies are beating analysts forecasts for earnings yet the stocks are not responding the way one would expect, in fact they are declining. This was most recently seen when Apple reported what superficially appeared to be a phenomenal fourth quarter, blowing past analysts' expectations, and yet the stock barely budged. This seemingly odd reaction was well explained by Bloomberg;

> Expectations had been sky high for the company on suggestions of a new iPhone "super cycle," spurring a stock surge in recent months.

The risks of disappointment when expectations are this extended are not limited to corporate earnings, as the IMF recently warned;

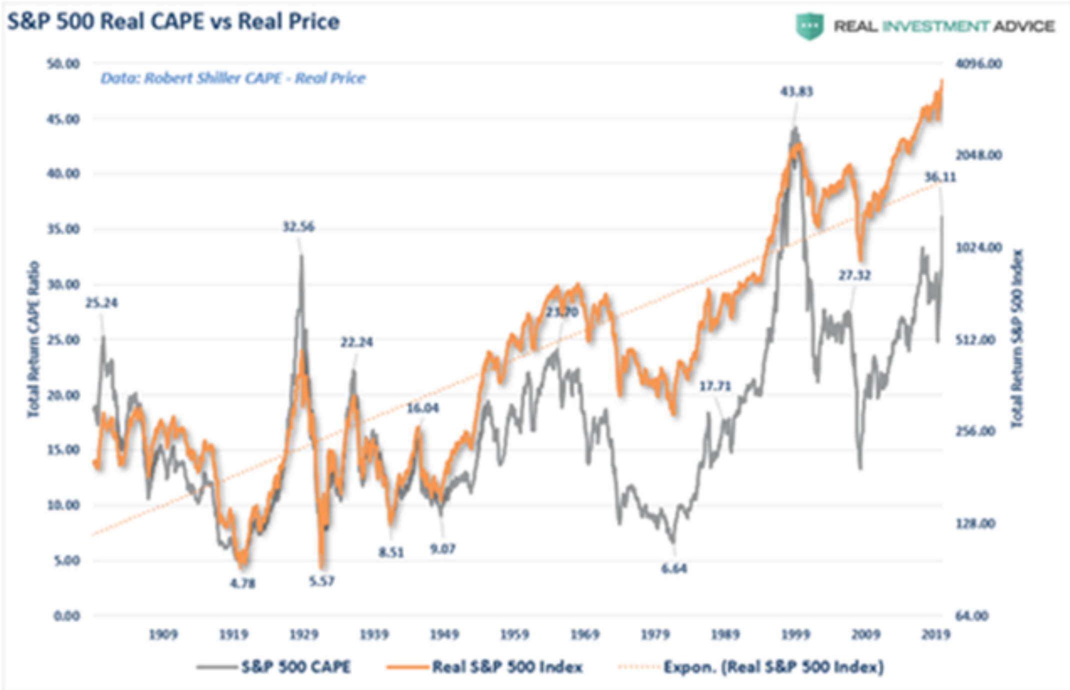
> **'Complacency' permeating markets on continued monetary support -IMF**
>
> A "sense of complacency" is permeating markets as investors, betting on continued accommodative monetary policy, are stretching asset prices, risking a sudden market correction, the International Monetary Fund (IMF) warned on Wednesday.
>
> The rollout of COVID-19 vaccines has boosted expectations of a global recovery and helped prompt a surge in asset prices, despite rising infections and persistent uncertainties surrounding the economic outlook, the world's largest multilateral lender said in its Global Financial Stability Report.
>
> Stretched asset valuations in some areas are largely contingent on government lifelines. Policymakers should be prepared for the risk of a market correction, which could exacerbate financial vulnerabilities that have so far remained at bay, such as rising corporate debt and weakness in nonbank financial institutions, the IMF said. Reuters 28th January

A neat summary of how I feel about the current situation was written some months ago by a Wall Street Strategist, who may or may not still feel this way;

> *We see no easy way out. Again, we wouldn't start from here. This is not a good place to be in for the global economy and **it is getting worse with every shock, despite the market euphoria in the meantime.** An already bad situation before the pandemic has now become worse. **We are not sure how and when we will see the end-game, but in our view this is not a sustainable situation in the long term.*** Wall Street strategist

Things that are not sustainable tend to eventually stop, and one very long term measure of the sustainability of any market move, is valuation. Valuation is not a useful market timer, however, long term investors that buy historically expensive markets will always have a lower long term return than those that buy historically cheap markets. They are also more likely to endure a painful journey from expensive to cheap during which they may decide that they are no longer long term investors.

The chart below of the cyclically adjusted p/e ratio of the US market is currently at levels only ever seen before, like the panic/euphoria indicator earlier, during arguably the biggest speculative boom ever at the turn of the millennium.



The useful table below also highlights just how extreme the current situation is;

S&P 500 Valuations

Model Factors	Most Recent Value	Historical Percentile
Median EV to Sales (Ex-Financials)	4.0	100%
US Total Market Cap to GDP	170%	100%
EV to Free Cash Flow Margin-Adjusted (Ex-Financials)	48.8	100%
Median Price to Sales	2.8	100%
Median Price to Book	3.9	100%
Median EV to EBITDA (Ex-Financials)	15.0	100%
Aggregate EV To Sales	3.0	100%
Aggregate EV to Trailing 12M EBITDA	17.5	100%
Aggregate EV to 2021 EBITDA Estimate	15.9	100%
Aggregate Price to 2021 Book Value Estimate	3.8	100%
Aggregate Price to Tangible Book Value	12.8	100%
Aggregate Price to Earnings	27.9	98%
Cyclically Adjusted P/E (CAPE)	32.9	97%
Aggregate Price to 2021 Earnings Estimate	25.6	97%
Aggregate Price to Book	3.9	91%

Source: Bloomberg, Yale/Robert Shiller, John Hussman — *Numbers as of November of 2020 — ©2020 Crescat Capital LLC

By most measures the current US market is in the 100th percentile of historic expensiveness!

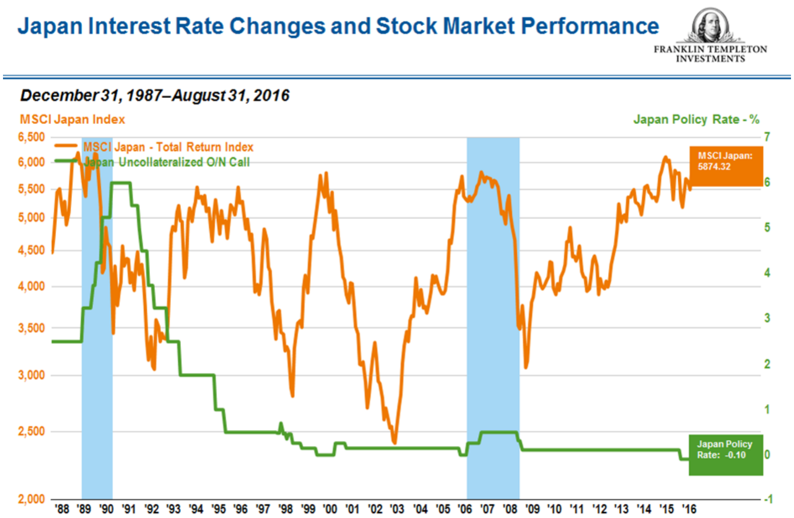
Valuation and Interest Rates

One of the most frequently heard rationalisations as to why the current ‘situation’ may in fact be ‘sustainable’ and why investors should not be concerned about current stock market valuations is that interest rates are so low and somehow these law rates justify higher valuations. In December last year the chairman of the Federal Reserve Board used this rationalisation to down play overvaluation fears;

Powell says stock prices are not necessarily high considering the low level of interest rates CNBC headline 16th December

This may have provided some comfort to the growing army of investors who’s only source of return, given record low interest rates, is the stock market. But history shows that such comfort is probably misplaced.

The chart below shows the total return of the Japanese stock market from 1987 through to 2016. Over that period Japanese interest rates initially rose to 6% and then plunged to less than 0.5% or lower. Throughout that period, even with falling and historically low cash rates, investors suffered a series four major bear markets interspersed with four bull markets and on balance, over two decades, made no money.



Sources: FactSet. MSCI. Indexes are unmanaged and one cannot directly invest in an index. They do not reflect any fees, expenses or sales charges. See www.franklintempletondatasources.com for additional data provider information. Past performance is not an indicator or a guarantee of future performance.

Interestingly, six weeks after his justification of high valuations by low interest rates, the Fed chairman back tracked somewhat;

“The connection between low interest rates and asset values is probably something that’s not as tight as people think.” Chairman Powell 27th January 2021

As the Japanese experience showed, this relationship is absolutely not as tight as some think, or hope!

The other question this rationalisation raises is why haven’t markets, with even lower rates than the US, not one better than the US?

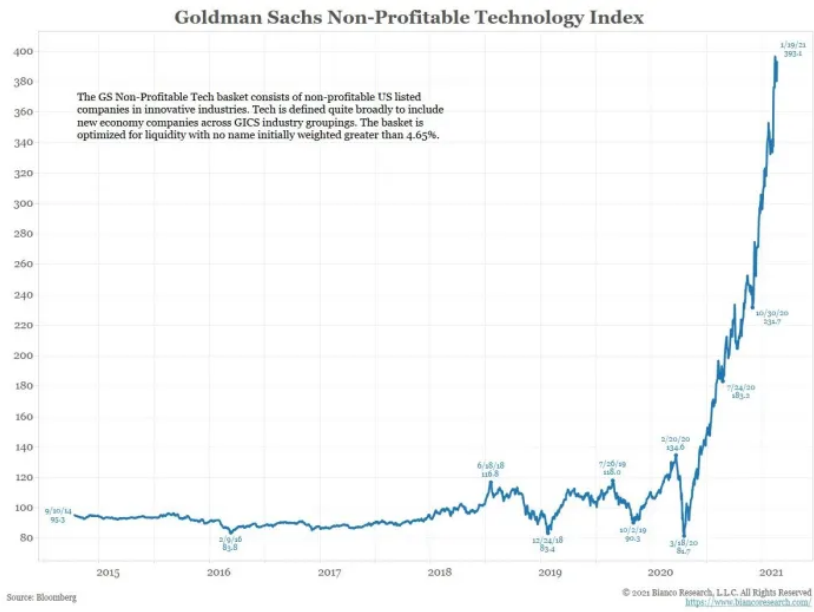
About five years ago the Fed Funds rate in the US rose above the Bank of England’s base lending rate and continued to diverge higher, yet, as can be seen in the chart below UK equities have consistently underperformed the ‘higher interest rate’ US market.

It would be nice if there were some mechanistic relationship between interest rates and equities, but there isn't as the failed so-called Fed Model proved. It is understandable that low interest rates pushes investors into equities as an alternative, the so called TINA rationalisation (There Is No Alternative). And it is understandable that this hope grows into the expectations described earlier, but sadly there is no long term justification for these expectations, leaving markets very vulnerable to disappointments.

Speculation

Historically extremes in speculation are found at the peaks of major bull markets, not at great long term buying opportunities. One only has to think about the rampant speculation seen in housing, and then in derivative products related to home prices and mortgages, ahead of the global financial crisis, and earlier in the dotcom boom. Then no one cared about earnings or fundamentals, in fact a company only had to add 'dotcom' to its name and its stock price would surge.

Something eerily similar to the dotcom boom has been witnessed over the last year;



This chart appeared in the Financial Times on the 21st January under the headline "This is Nuts, where are the profits?"

On top of this, over the last few weeks, the US market has witnessed the most remarkable bout of speculation in a handful of stocks, some of which have rocketed thousands of percent higher

Many column inches have been, and will be, devoted to this incredible bout of speculation currently taking place, but I felt Leon Cooperman summed it up well in a recent CNBC interview

Leon Cooperman on GameStop Reddit speculators: 'I'm not damning them' but it will 'end in tears' JAN 28 2021

He went on to comment;

> "I've been through cycles like this in the past. This is extreme, more so, but this too shall pass," the hedge-fund pioneer said Thursday. For example, he noted that shares of Cisco Systems reached valuations during the dot-com boom that far outpaced the company's sales and have yet to return to the peak of that era even roughly two decades later.
>
> "At the end of the day, the stock market reflects economic progress or the lack thereof," he said, while adding that "water seeks its own level."

Conclusions

It is important that investors see what is happening now for what it is, it is rampant speculation at the peak of a speculative binge that has stretched what should have been a bear market rally, or even a 'dead cat bounce', far further than I would have ever expected.

With valuations and expectations at historic extremes now is the time for extreme caution, as Leon Cooperman said 'water seeks its own level' and that level will likely be substantially below where markets are now. When that occurs markets will be historically cheap, they will reflect dramatically diminished expectations, and finally then a long term buying opportunity be at hand. In the meantime, preservation of capital should be all investors primary objective.

Kevin Armstrong

1st February 2021

Disclaimer