Strategy Thoughts

March 2021

The Music may already have stopped!

And long term interest rates have bottomed

Introduction

Last month I concluded with; "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." It now seems that a reversal may have been seen or is very imminent. In this month's Strategy Thoughts I will examine; just how more extreme things have become, what the inevitable end game of such extremes will be, and some of the reversals that have already been seen, most notably in fixed income markets.

Sentiment, Speculation and Expectations

The most recent bubble and its aftermath that many of todays market participants had to deal with was the speculative build up, largely in housing related assets and their associated derivative products, that when burst resulted in what became known as the Global Financial Crisis and resulted in the largest stock market falls and economic collapses since the 1930s. Although, reflecting upon what I have just written it is probably reasonable to assume that many of those now involved in financial markets were still at university or even school when the GFC was unfolding more than a decade ago, and this sadly means the likelihood of history being repeated is substantially increased.

Back then, before the bubble burst, there was a now famous interview published in the Financial Times with the then CEO of Citgroup Charles Prince. In July of 2007, just ahead of the start of the GFC collapse the FT quoted Prince as saying;

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing,"

At the time the 'music' was still playing and Citigroup's share price was over $500. The 'music' then stopped and markets, particularly those for financial institutions like Citigroup, began to collapse.

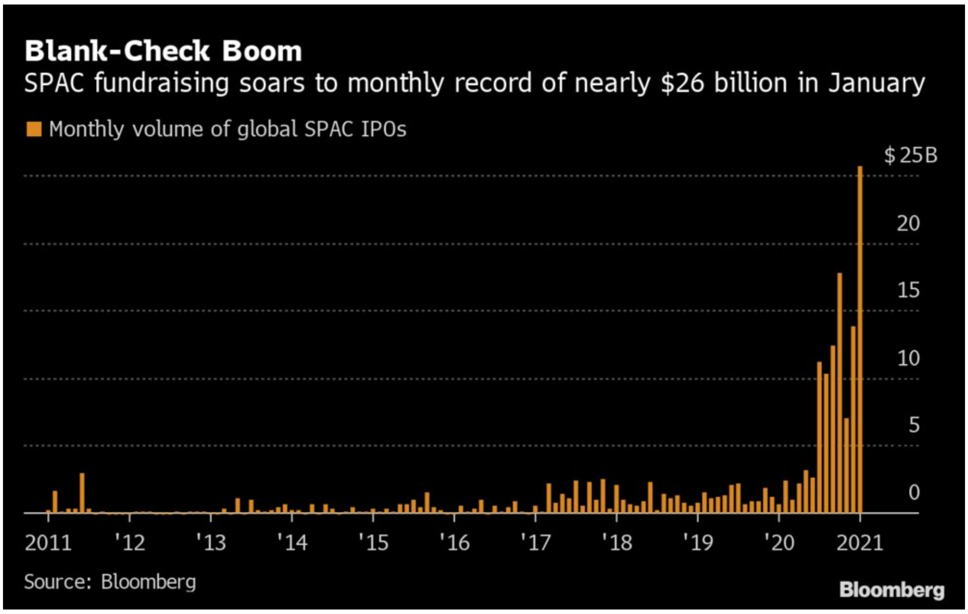
It is quite easy to believe that Prince could see that what his firm was involved in was an ever increasing, unsustainable and deeply speculative bubble, but he could also see that the downside for his firm not taking part was enormous. He may also have believed that he and his team would be smart enough to get out either just before or soon after the inevitable bust occurred. These are the sentiments typically seen at all major speculative peaks; bubble talk abounds but not taking part seems to offer nothing but substantial career risk, and the hope always persists that I can just get out when the burst begins! In every bubble it is always highly alluring and easy to believe that one will be able to get out before the bubble bursts, very few ever do! True to history, Prince, and the vast majority of his mainstream banker colleagues failed to even slightly mitigate the enormity of the GFC associated bust. Less than two years after his FT interview was published Prince's $500 Citigroup shares were languishing below $20, a fall of more than 95%. Even now, fourteen years after the interview Citigroup trades at $65, still down 87%!

In January the legendary investor, and founder of GMO, wrote a quite brilliant market commentary that neatly both reflected Prince's 'dancing' analogy and the inevitability of the bust that will surely come. It was titled 'Waiting for the Last Dance' and I would strongly recommend that all investors read it with some care. The full article can be found at; https://www.gmo.com/australia/research-library/waiting-for-the-last-dance/

It is worthwhile including a few of Grantham's sage comments;

- it is highly probable that we are in a major bubble event in the U.S. market, of the type we typically have every several decades and last had in the late 1990s. It will very probably end badly, although nothing is certain. I will also tell you my definition of success for a bear market call. It is simply that sooner or later there will come a time when an investor is pleased to have been out of the market.
- For the first 10 years of this bull market, which is the longest in history, we lacked such wild speculation. But now we have it. In record amounts.
- I am not at all surprised that since the summer the market has advanced at an accelerating rate and with increasing speculative excesses. It is precisely what you should expect from a late-stage bubble: an accelerating, nearly vertical stage of unknowable length – but typically short. Even if it is short, this stage at the end of a bubble is shockingly painful and full of career risk for bears.
- The great bull markets typically turn down when the market conditions are very favorable, just subtly less favorable than they were yesterday. And that is why they are always missed.
- However, for any manager willing to take on that career risk – or more likely for the individual investor – requiring that you get the timing right is overreach. If the hurdle for calling a bubble is set too high, so that you must call the top precisely, you will never try. And that condemns you to ride over the cliff every cycle, along with the great majority of investors and managers.

The following charts serve to illustrate some of the points that Grantham makes as to just how historically stretched things are. The first chart below reveals the exponential expansion that has been seen in the world of 'blank check' (as Bloomberg described it) money raising.



In the article that accompanied this chart at the end of January Bloomberg not only outlined the flood of money investors the world over are throwing at what are effectively blind pools, but also the 'frenzy' that is being seen in the regular issuance market for listed IPOs, where numbers are even surpassing those seen at the peak of the dotcom frenzy at the beginning of 2000. Naturally it is possible the investment world is simply doing a favour to investors and allowing them in to get a bit of the action, but more likely Charlie Munger got it right recently when he was asked about the explosion in SPACs' he bluntly stated;

> "The world would be better off without them. This kind of crazy speculation in enterprises not even found or picked out yet is a sign of an irritating bubble. It's just that the investment banking profession will sell shit as long as shit can be sold."

At the same time he went on to comment about the similarity in speculation now and that seen during the dotcom bubble;

> "Yes, I think it must end badly, but I don't know when."

Speculation, and the involvement of new retail investors is also apparent in the broader market, both in the explosion of accounts in the Reddit driven Robin Hood facilitated world, and the associated booms and busts that have been seen, and in penny stock trading generally, as the chart below illustrates

None of these activities are what one would expect to see at the beginning of a great opportunity.

However, such behaviour has always been seen, albeit in different forms for the different times, at historic speculative peaks.

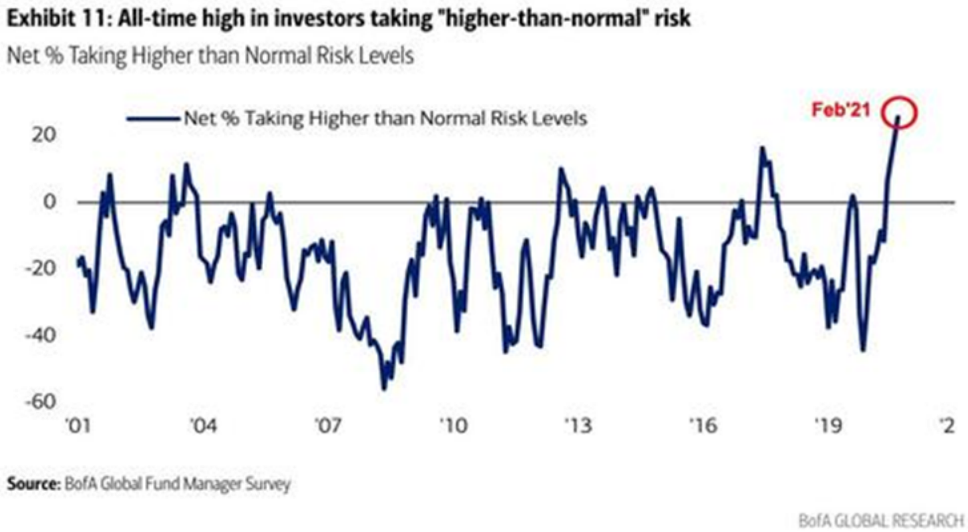
This appetite for speculation and risk has obviously been fuelled by; fear of missing out (FOMO), there apparently being now alternative (TINA), and rampant expectations on the back of a misplaced hope that money printing and perpetually low cash rates will ensure that nothing bad can ever happen again. Similar hopes and expectations have been seen many times over the last forty years, from the 'Plunge Protection Team' **after** the 1987 crash, through to 'The Committee to Save The World' ahead of a more than 80% plunge in the NASDAQ, through the dotcom bust, and to the belief in the Bernanke put ahead of the GFC. It should be remembered that it was Ben Bernanke that said in mid

2007;

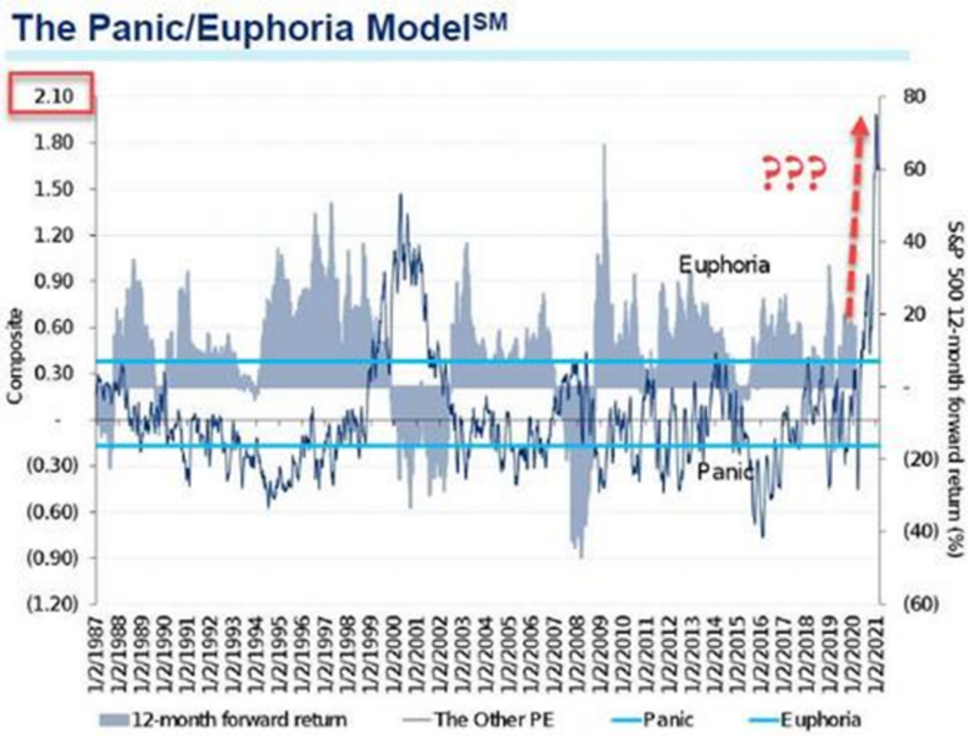
> "we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system"

Central bankers are far from omnipotent.

Risk taking is currently at the highest level ever seen, again not a healthy sign, and the polar opposite of it being at a historic low in 2009 at the beginning of this now very aged, if not already dead, bull market.



And finally, the panic euphoria model that I highlighted last month, has just become even more historically extreme.



Finally, it should be no surprise that the current sell off is being seen as nothing more than another 'healthy correction' by so many in the investment mainstream. Grantham gives an excellent description of why this should be the case;

> So, don't wait for the Goldman's and Morgan Stanley's to become bearish: it can never happen. For them it is a horribly non-commercial bet. Perhaps it is for anyone. Profitable and risk-reducing for the clients, yes, but commercially impractical for advisors. Their best policy is clear and simple: always be extremely bullish. It is good for business and intellectually undemanding. It is appealing to most investors who much prefer optimism to realistic appraisal, as witnessed so vividly with COVID. And when it all ends, you will as a persistent bull have overwhelming company. This is why you have always had bullish advice in a bubble and always will.

This vividly reminds me of the mantra I heard so often in my early career in the 1980s as an institution broker with Merrill Lynch, "there really is no mileage in being bearish!" It was therefore not surprising to read the following rationalisation recently from the head of a major asset management firm;

> **"The reflation trade still has a lot of room to go. Central banks are printing more money every day and that money finds its way into the market. This is not going to stop anytime soon."**

Can it really be that simple? Well, it is…. Until it stops being that simple!

Valuation

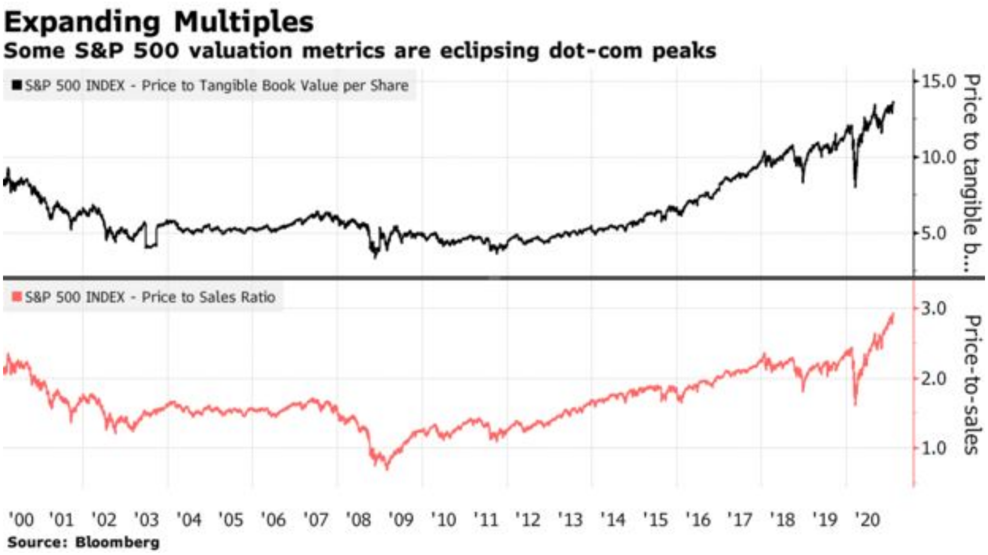
I have long maintained that valuation tools are of very little use in timing turning points in markets, however, at historic extremes they are useful as they vividly portray, in real time, extremes of expectation. The only reason any asset, at any time, trades at an historically extreme valuation is because a large, and probably growing, number of investors expect that trend to continue and even accelerate as it already has been. This is true both at peaks and troughs. At important troughs in markets assets are always priced historically cheaply, there is little interest in them as an investment asset as they have been performing poorly for a long time and this is expected to continue. Aggregate expectations are exceptionally bleak. It is because of this that valuations become historically cheap. At important peaks extreme valuations are dismissed as something not to be worried about, it may be that 'this time it is different' or it may be faith in a central banker or other financial wizard who will ensure that nothing can go wrong, or it may just be fear of missing out and there being no alternative. Whatever the justification may be, high valuations are always accompanied by extreme valuations, and have always, subsequently, been followed by miserable long term returns.

The following headline should therefore be of major concern to any long term investor;

> **Warren Buffett's Favorite Valuation Metric Is Ringing an Alarm** Bloomberg 13th Feb

It accompanied this chart of the total value of the US stock market compared to US GDP over the last three decades. There have been three historic extremes, the speculative peak in 2000, the depressed trough in 2009 and now

Other measures of valuation are also at extreme surpassing those seen in 2000.



The US stock market is now more expensive than it was when arguably the largest speculative bubble in history burst at the turn of the millennium. The same can be said of many other markets in the developed world.

Have markets turned?

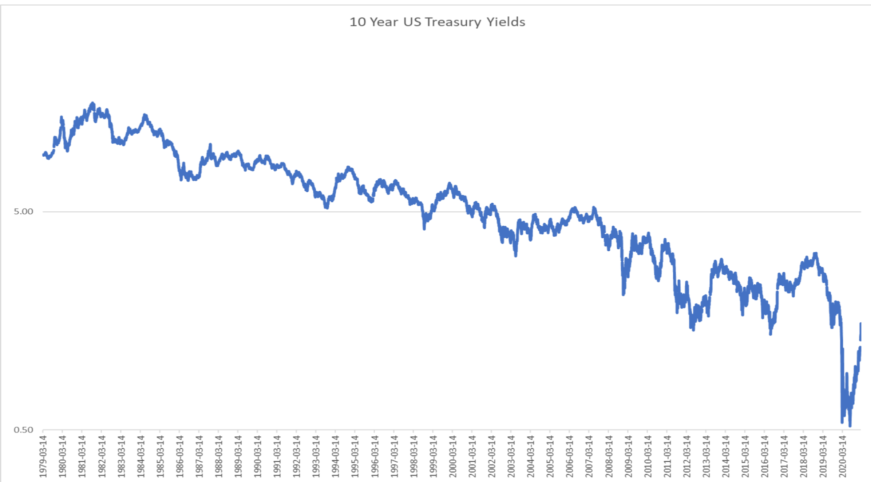
One of the undoubted favourites of the current bull market has certainly been Tesla, with the chart below showing its incredible eighteen fold increase in value over about eighteen months. However, so far this year the story has been a little different with the stock falling 30% at its recent low.

Other market darlings of last year have also struggled so far this year. Some may rationalise this as a natural rotation in an otherwise healthy market, but similar arguments were heard in the early stages of the dotcom bust in 2000. The posterchild then was Cisco, which at its peaks was briefly the largest company in the world by market capitalisation, from late March to late May 2000 Cisco's share price fell 35%. It did then bounce over the next couple of months and recovered about two thirds of its fall. But then it fell again, and again, and again. It ultimately bottomed out two and a half years after the peak at just 11% of its former value.

Whilst the argument in favour of a peak having been seen in stocks and stock markets is far from clear as some new highs are still being recorded, the picture does seem a lot clearer in fixed income markets.

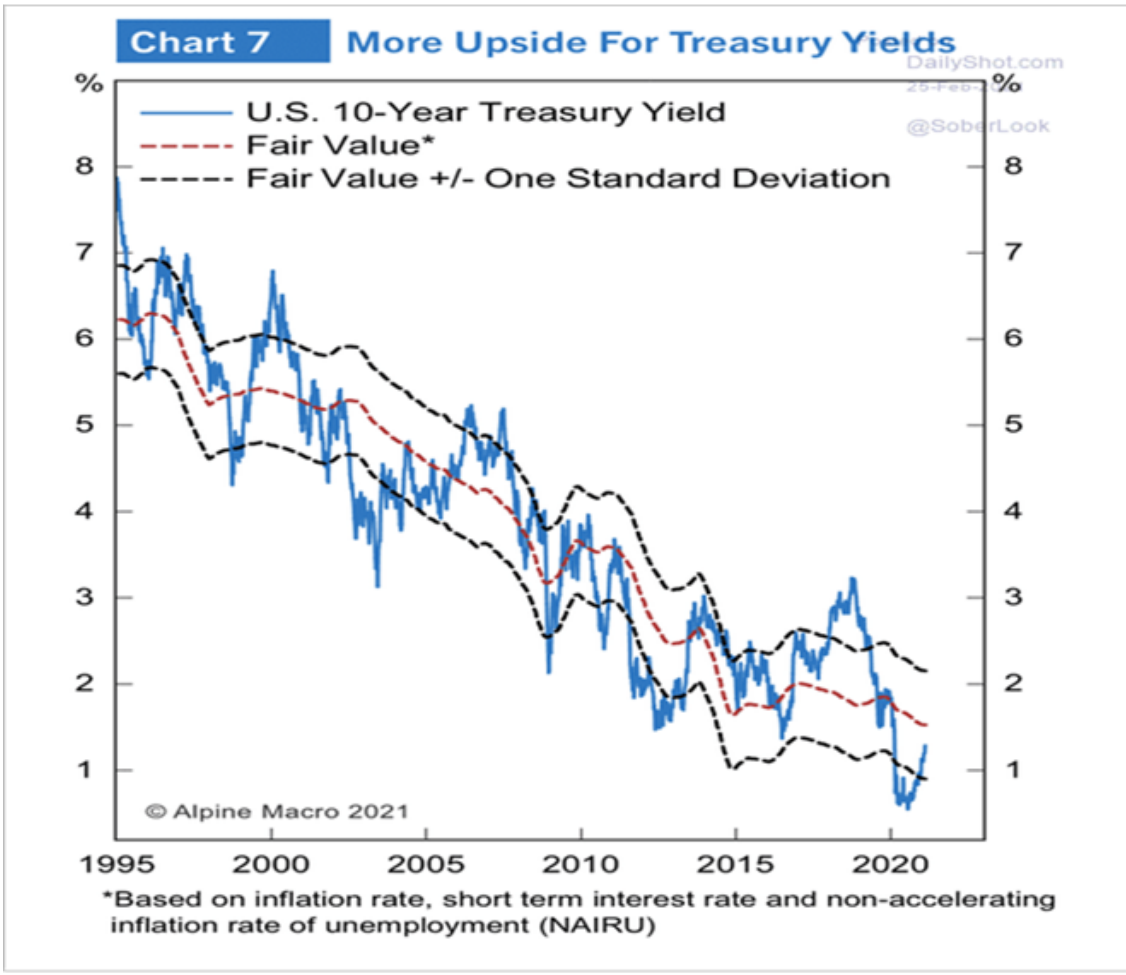
Long Term Treasury Yields

The chart below shows the very long term history of ten year US Treasury bond yields from their peak at just below 16% in late September 1981 to their recent historic low in August of last year at just 0.52%. This thirty-nine year long bull market in bonds has been a wonder to behold, however, it does now look like it has ended.



The graph is shown in logarithmic form so that the magnitude of each smaller bull and bear market can be easily compared. What is clear is that the recent rise in longer term interest rates has been both historic and the largest percentage rise in rates that has been seen in more than four decades, with yields almost tripling, over such a short period of time. Something has clearly changed and the bond bubble may now finally have burst. Obviously, any further rise in rates is unlikely to be as dramatic as that which has already been seen, and certainly the majority will continue to believe that central banks will ensure that nothing too bad will happen. Unfortunately, such faith will likely prove as misplaced as that seen after the dotcom bust and the GFC peak.

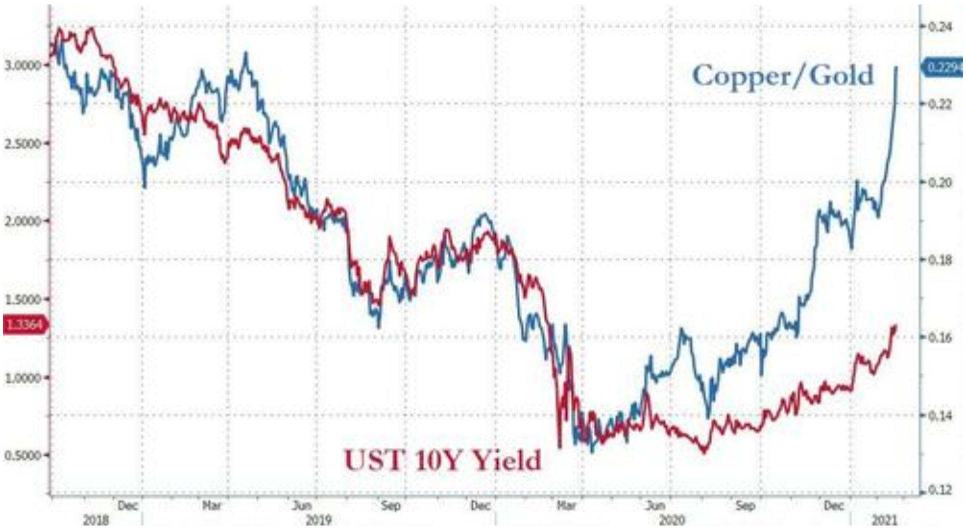
Despite the rise in yields that has already been seen it is clear that there is still room for rates to rise



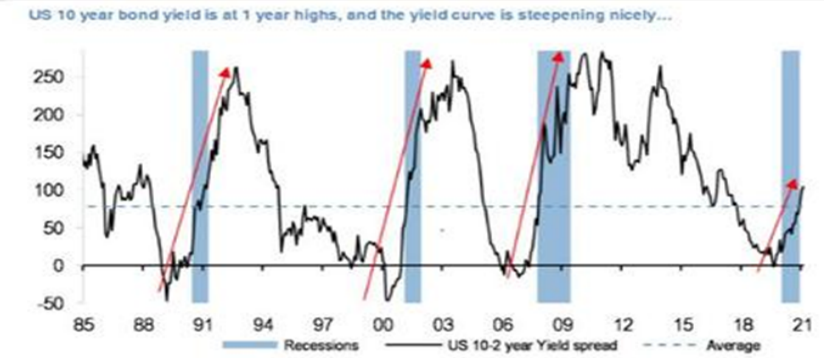
further as the chart below shows.

Further indication that yields may still have further to rise was described by Bloomberg columnist Liz Capo McCormick recently, she wrote;

> There's a clear market signal backing the view that the Fed is ominously behind the curve: as Capo McCormick writes, the sharp rise in the ratio between the prices of copper and gold, which has a solid track record predicting yields. The relationship typically works because copper is a cyclical commodity, and gold is a haven that's sensitive to inflation and rates. **A quick look at the chart below suggests that 10Y yields should be at whopping 3.0%!**



If the bond bubble has indeed burst, and rates do continue to rise even without a marked uptick in inflation, and in the face of expected central bank control, the outlook for stocks is not great. The chart below shows that the last three major bear markets and recessions have been accompanied by markedly steepening yield curves.



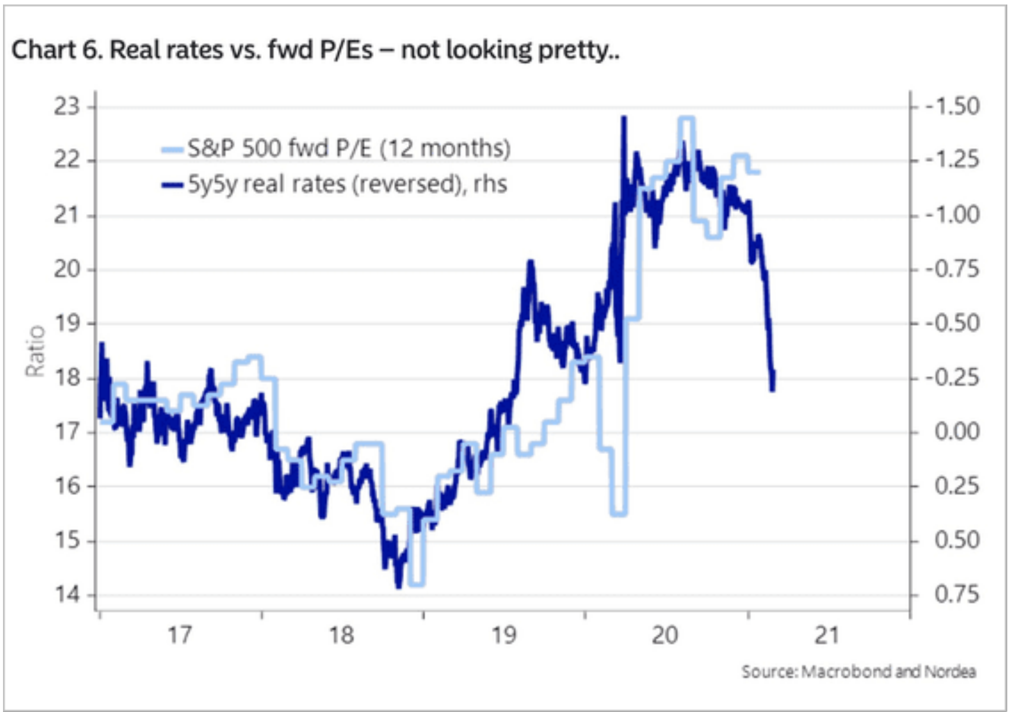
Source: JP Morgan Strategy

...short term stocks-bonds correlation remains clear; since last March, stocks were up when yields were up, and vice versa ... this is consistent with the long term relationship, as well

	Daily SPX Performance since 23rd March '20	
	Bond Yield up	Bond Yield down
Average	0.7%	-0.2%
Median	0.6%	-0.1%
	Daily SPX Performance since '00	
	Bond Yield up	Bond Yield down
Average	0.4%	-0.3%
Median	0.3%	-0.1%

Source: JP Morgan Strategy

The chart below shows that even without any further rise in bond yields investors should expect valuation corrections in form of price earnings multiples.



Naturally this gap could be closed by earnings surging, more ominously it could be closed by stock prices falling.

Conclusions

Extreme expectations on the part of investors are clearly obvious in everything from the rampant speculation in retail accounts, through the number of SPACs and IPOs that are flooding the market, and the record high levels recorded in measures such as the panic euphoria indicators. All of this, along with record high expectations as manifested in record high valuations and longer term interest rates continuing to rise, does not bode well for risk taking in general and equity markets in particular. The turns that have already been seen in previous bull market darlings such as Tesla may one day be looked back upon as having been the canary in coal mine before a major financial disaster.

Preservation of capital while waiting for substantially more favourable long term entry points, whilst highly unlikely to ever be the central recommendation from the investment industry, continues to be the most prudent investment strategy.

Kevin Armstrong

3rd March 2021