Strategy Thoughts

January 2023

Are we there yet?

Introduction

Over the last few weeks, I have been encouraged to write an updated version of Strategy Thoughts by a number of long time readers. The last Strategy Thoughts came out in March 2021 and a lot has happened since then; the pandemic has largely passed, lockdowns, generally, have become a thing of history, inflation has soared, as have interest rates, and equity markets have clearly corrected or begun bear markets and economic forecasts have been, and continue to be, ratcheted down almost daily. This has understandably raised the question as to whether or not a sustainable bottom has been seen and whether a new bull market may soon be at hand. Those long time readers mentioned earlier have kindly reminded me of the remarkable timing Strategy Thoughts showed back in early 2009 in identifying what we then described as likely being the best buying opportunity since 2003. It certainly was, and it turned out to be a far better opportunity than I ever imagined possible. I had expected a cyclical bull market, much like that from 2003 to 2007, what we got was obviously substantially greater than that. This edition of Strategy Thoughts will focus on the question of whether or not we have seen, or are soon approaching, a bottom like that of 2009, and it will conclude with a very emphatic NO!

How Expectations have changed

In thinking about the potential for another historic buying opportunity it is instructive to look back at how expectations have evolved from the last important peak in late 2007, to the next important market bottom in early 2009, and into the peak early last year. In the September 2007 edition of Strategy Thoughts I wrote the following;

> *If a cyclical bear market is at hand and recession risks are elevated it is worthwhile considering how this, less comfortable, indigestion ridden, period will also pass. In the December 2002 edition of A Private View, in an article titled "Should International Shares be Bought Yet?", I attempted to describe what market bottoms, and so great buying opportunities, felt like. I reviewed a number of the great lows of the last century and concluded;*
>
> *"All of these market lows were different, some presented long term buying opportunities while others preceded somewhat shorter term bull markets. However, 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 overcome, markets had been falling dramatically for in some cases years and shares were generally considered a high risk option."*
>
> *Whenever the next great buying opportunity is presented it is likely that many of these characteristics will be present. Excitement about the markets action and volatility will not be the dominant characteristics, a recession will probably have been confirmed and the reason why risk taking is not a good idea will be obvious to everyone; generally expectations will be low.*

In February 2009, after markets had been falling for a year and a half I illustrated the growing gloom with a number of then current headlines, three of which were;

> "**Cult** of **Equity**' Is Under Attack" (Bloomberg story based upon Citi research)

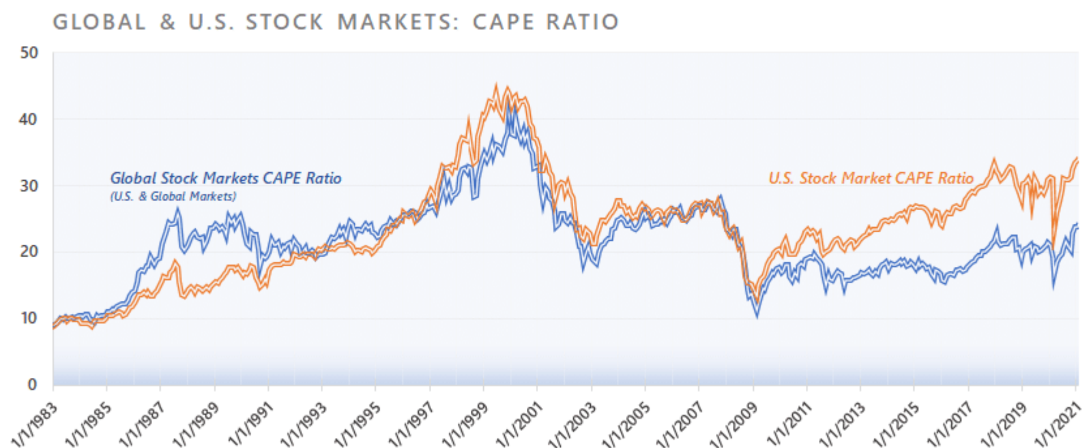
Market's 'Hope Balloon' Loses Air

Tepid Upturns Haven't Stopped the Slide; 'Hard to Make a Cheery Story' WSJ 17th February 2009

One month later, at the time of the March 2009 low, equites had generated zero excess return versus treasuries for four decades, prompting serious investors and commentators to wonder whether the previously longstanding conventional wisdom of preferring equities for the long term was valid. Then, after the low had been put in, conventional wisdom was strongly on the side of any rally being seen as not to be trusted given the then pervasive and obvious economic and market gloom (extrapolation of the previous trend way into the future is true of bear markets just as much of bull markets). Incredibly, but not surprisingly, this distrust lasted well into the next bull market.

To sum up what was seen at the last major equity market buying opportunity;

- Expectations were bleak to say the least, what had already been suffered (a greater than 50% decline in most markets of the world) was generally seen as being the prelude of even worse that was still to come.
- A recession was obvious and looked set to last and get deeper.
- The idea that equities should be the preferred investment for the long term was being abandoned.
- US and Global equity valuations were the lowest they had been for three decades.



- Any rallies were to seen as the last opportunity to get out before things got really bad, they were certainly not to be bought into.

All of this was a world away from where expectations rose to over the next almost thirteen years. From that low point in early 2009 the world index quadrupled and the S&P500 rose more than seven fold, and both measures doubled or more from the initial pandemic scare lows in early 2000 to their peaks at the end of 2021. The following quotes from major Wall Street firms exemplifies the level of optimism, hope and expectation that was present as 2021 drew to a close

- With the S&P 500 reaching a third straight year of double-digit gains, the odds are good for a fourth year of 10%-plus growth. That's because when the S&P 500 makes three-year strings of double-digit years, the next year sees an average return of 8.4%
- Next year, we expect S&P 500 to reach 5050 on continued robust earnings growth as labor market recovery continues, consumers remain flush with cash, supply chain issues ease, and inventory cycle accelerates off historic lows

In December 2021 Yahoo Finance surveyed a selection of leading strategists for their market outlooks for 2022, their average forecast was a year end figure of just under 5000 with a general theme of the bull market of the previous almost two years continuing. The S&P500 actual closed last year just above 3800, 23% below the average forecast. A selection of their comments included;

> "The equity bull market will continue"
>
> "Our view for risk assets is simply, it should be another good year in 2022"
>
> "Profit growth has accounted for the entire S&P 500 return in 2021 and will continue to drive gains in 2022"

Clearly 2022 did not pan out as the majority expected or hoped, but despite missing the start of what has been one of the worst years for 'risk assets' in a long time expectations and hope still remain elevated.

- The 'Cult of equities' is far from dead! As one commentator put it recently;

    > "And even if 2023 ends up being another tough year for investors, it likely sets up a stronger rebound for the following year, meaning **now is the perfect time to get even more invested** at lower prices in anticipation of the bounce back". (emphasis added)

- Valuations are naturally more attractive than they were at the peak, but at the recent low CAPE valuations were only back to where they had been two and half years earlier, after the initial COVID associated bear market and were double what they had been at the 2009 bottom.
- Admittedly recession fears do abound, but the majority seem to see it as a passing phenomenon. As a result of this increased recession outlook Wall Street firms are calling for 2023 being relatively flat with a sell off somewhere during the year of about 20%. Not a great outlook, but a long way from the doom and gloom that was seen in early 2009.

- Meanwhile, despite increased evidence of anxiety investors, when surveyed, are still expecting healthy returns;

    > "Interestingly, despite evidence of increased investor anxiety, UK investors are still anticipating annual returns over the next five years of 11.26%, up slightly from 10.78% in 2021. This is a 0.48% percentage point rise compared to the global increase of only 0.06% percentage points. Expectations across Europe were widely revealed to be lower than the UK, with France expecting returns of 9.20% and Italy 9.80% over the same period. Only Sweden and Greece expected marginally better results at 11.45% and 11.39% respectively. Worldwide, Japan was found to anticipate the lowest returns at 8.19%."
    > Schroders global investor survey 14/12/22

Hope for a 'pivot'

Perhaps the most prevalent source of hope, and so elevated expectations, is that the Fed will pause their interest hikes, or even 'pivot'. Many strategists are calling for a new bull market to begin once the Fed does pause;

> **US stocks will rebound 24% in 2023 as Fed tightening will no longer 'crush the market', Fundstrat's Tom Lee says** Markets Insider Jan 4 2023

Much of this sadly misplaced 'hope' is based upon the prospect of inflation generally peaking (which it may have) and then the US Federal Reserve pausing or even'pivoting' resulting in a reversal in the markets current downtrend.

Sadly, the actual history of what markets do after a Fed pivot should not be employed by those looking for a reason for hope.

Source: www.macrotrends.net/2015/fed-funds-rate-historical-chart'

The chart above shows the US Fed Funds rate going back more than sixty years, the peaks in Fed Funds rates can clearly be seen to have occurred prior to the onset of a recession (shaded areas), and also, unfortunately for those banking on a pivot, well before the bottom of the bear market. The only exception to this was 1974 when the first cut in rates did coincide with the middle of the recession and the bottom of the bear market. The other seven of the last eight pivots, going back to 1969, resulted in the market falling for an average of another twelve months and by more than 25% before a meaningful bottom, and an end to the bear market was seen. Two of the most recent pivots should be particularly chilling to those hoping for one this year.

- After the pivot in late December 2000 the S&P500 fell for another twenty months and by a further 41%, after that same pivot the NASDAQ fell for twenty one months and, after already having fallen 53%, fell by a remarkable further 52%.
- After the pivot in early August 2007 the S&P500 fell by 55% over the next nineteen months.

Finally on this issue of pivoting, all the numbers above are from when the Fed actually started cutting rates, not from their first pause, which seems to be what the majority of bullish commentators are looking for. If merely pausing the hikes was the historic trigger to become bullish then the outcomes would have been even worse.

The Fed and other central banks may very well, contrary to their current comments, pause or pivot and start to cut rates later this year as inflation subsides and economies crack, but history clearly shows that this should not be seen as a reason for hope or bullishness.

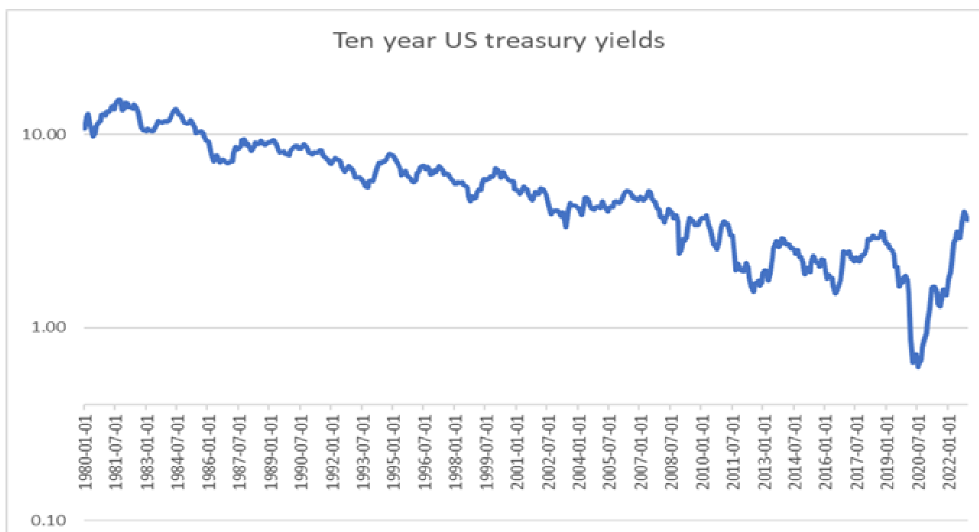
Long term Treasury Yields

Twenty two months ago, in the last edition of Strategy Thoughts, I wrote;

> 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.

Since then yields have continued to rise, further confirming that the historic thirty eight year bull market in bonds did end in August 2020.

An update of the chart above further clarifies the importance of that low point.



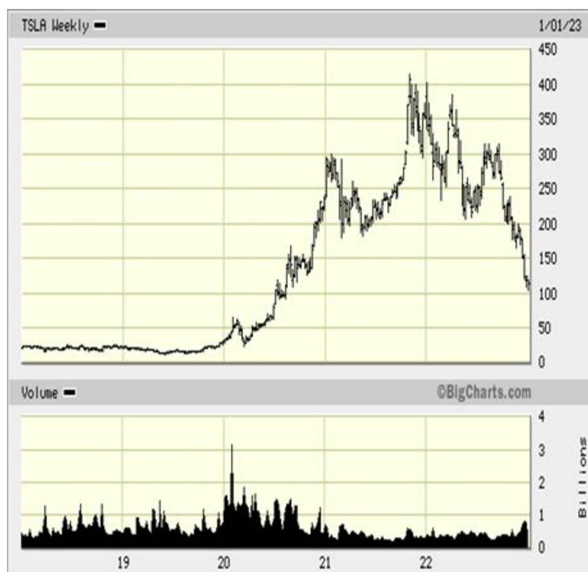
Whilst it is unlikely that the new 'bull market' in yields, bear market in prices, will continue quite at the pace that has been seen so far it does seem clear that the era of historically low and falling long term interest rates is indeed a thing of the past.

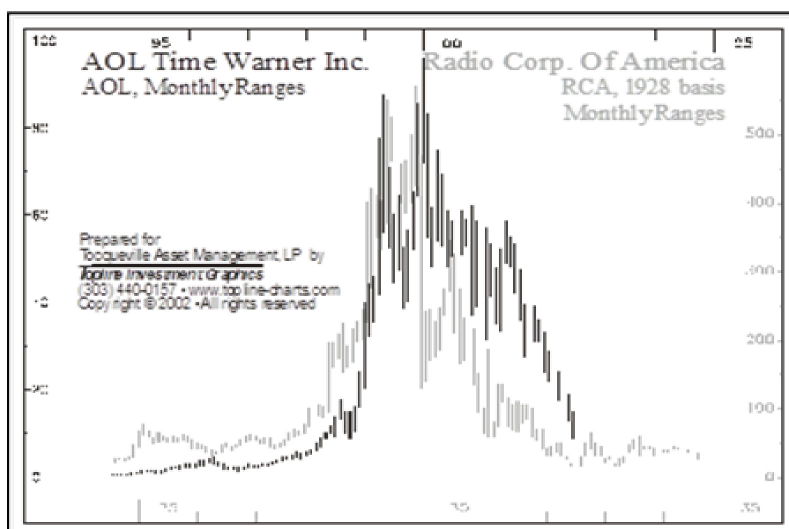
Tesla

Another topic I touched on in the last edition was the leadership that Tesla had, up until then, been providing for the market. I wrote;

> One of the undoubted favourites of the current bull market has certainly been Tesla, with 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.

After that Tesla did double once more over the next six months before peaking at the end of October 2021. From there it has fallen more than seventy percent in value in just fourteen months.





It has always been entertaining to compare historic market bubbles and their leading companies. So often many characteristics recur but for whatever reason the majority seem blind to these echoes until long after the bubble has burst. The chart above compares one of the darlings of the internet bubble, AOL Time Warner Inc, to the undoubted darling of the previous tech boom in the Roaring Twenties, RCA. Both achieved incredible price appreciation in the three years leading up to their, and the market's, peaks, and both ultimately fell all the way back to where they had started. While the fundamental belief behind each company was valid, radios did become ubiquitous, as did the internet, the valuations placed on both of them at their highs were preposterous in the extreme. The same could easily be said of Tesla now. Its peak valuation was preposterous and even now remains absurd. Even though one day electric cars may become as dominant as radios did ninety years ago it is certain that all electric cars will not be Teslas, just as not all radios were made by RCA. If the historic echo' continues then Tesla could easily continue to fall, along with the market, back to its pre parabolic lows of around $13 (another 90%). Ironically such a fall would bring Tesla's valuation down to one comparable to all other major auto makers.

What might the next bottom 'feel' like?

It has long been said that bull markets climb a 'wall of worry' and that bear markets slide down a 'slope of hope'. Since markets globally peaked about a year ago they have been sliding down a clear 'slope of hope', this was the phrase that I used repeatedly throughout the last major bear market, it served us well then and should do again. In March of 2009 I wrote;

> It is likely at the bottom of the current 'slope of hope', and so the start of the next 'wall of worry', that the environment for investing will feel bleak to say the least, but that is the nature of market bottoms. Markets don't bottom and start recovering because the news backdrop suddenly improves, markets bottom because hope gives way to fear and worry. The news is always miserable at a market bottom, but if all hope has gone then markets recover because things aren't quite as bad as the majority had feared.

Given that the current bear market will be correcting an even broader and possibly larger bubble, across even more assets, than was seen from 2007 to 2009 it is likely that even more extreme sentiment may also be seen at the ultimate low.

At that low some of the characteristics that may be present include;

- Extremely downbeat economic forecasts and an expectation that the then lengthy recession may ultimately be seen as having been another depression.
- Valuations comparable with those seen in 2009 or even cheaper, this may mean that stocks trade on multiples that have not been seen since the early 1980s or even the mid 1970s.
- Zero interest in speculative activities, the IPO market will have long ago dried up, day trading in penny stocks will be a thing of the distant past and new fangled structures that always abound at market peaks will not be seen.
- Any dramatic rallies will be dismissed as nothing more than 'sucker' rallies or 'dead cat' bounces. This is certainly not the case now as this Friday's 700 point rally is being rationalised as a sign of 'hope' that inflation is easing and therefore the Fed will 'pivot'.
- Geopolitical tensions will likely be even more extreme than now and domestic tensions that are increasingly present across the globe will probably be even more extreme.
- 'Experts' may once again question the previously held belief in equities for the long term and the supposed benefits of a balanced and diversified portfolio.

- Climate change may well slip from being the biggest global concern as shorter term and more immediately pressing economic issues rise in the collective consciousness.
- Tesla will no longer be one of the most valuable companies in the world and may well not even be the most valuable auto maker.

Conclusions

It has been a fascinating, and frustrating last couple of years, but finally what some have termed the ‘everything bubble’ seems to have finally burst, and for the last year markets have been starting to slide down the ‘slope of hope’. Some much faster than others, such as crypto currencies, Tesla, tech stocks and the previously widely touted ‘meme’ stocks. However, the question that I used for this editions title, “are we there yet?” is one that many investors who have been waiting on the sidelines in a disciplined fashion for a better buying opportunity no doubt are asking. Unfortunately, the mere fact that so many are hopefully asking this question highlights that the answer has to be no. By the time a bottom like that described above is reached very few will be looking for a bottom and the majority will be extrapolating more of what has already been endured way into the future.

Hope still abounds, hope that inflation will subside, hope that interest rates will fall and hope that growth will continue or resume. This is not the backdrop seen at major long term buying opportunities. One will come, and it may even be later this year, but we are not there yet. In the meantime capital preservation with a focus on cash remains an increasingly rewarding investment strategy.

Kevin Armstrong

9th January 2023

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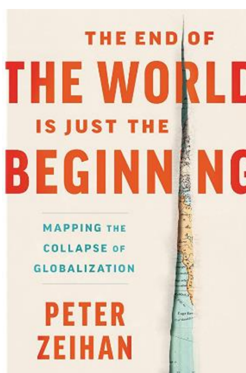
Recommendation

Over the last year I have read many books, however, one stands out as having been the most original, potentially useful, and fascinating. It was released last year and was named as one of the Financial Times Reader’s best books of 2022.



Amazon writes about “The End of the World is Just the Beginning”;

A New York Times Bestseller!
2019 was the last great year for the world economy.
For generations, everything has been getting faster, better, and cheaper. Finally, we reached the point that almost anything you could ever want could be sent to your home within days - even hours - of when you decided you wanted it.
America made that happen, but now America has lost interest in keeping it going.
Globe-spanning supply chains are only possible with the protection of the U.S. Navy. The American dollar underpins internationalized energy and financial markets. Complex, innovative industries were created to satisfy American consumers. American security policy forced warring nations to lay down their arms. *Billions* of people have been fed and educated as the American-led trade system spread across the globe.
All of this was artificial. All this was temporary. All this is ending.
In *The End of the World is Just the Beginning,* author and geopolitical strategist Peter Zeihan maps out the *next* world: a world where countries or regions will have no choice but to make their own goods, grow their own food, secure their own energy, fight their own battles, and do it all with populations that are both shrinking and aging.
The list of countries that make it all work is smaller than you think. Which means everything about our interconnected world - from how we manufacture products, to how we grow food, to how we keep the lights on, to how we shuttle stuff about, to how we pay for it all - is about to change.
In customary Zeihan fashion, rather than yelling fire in the geoeconomic theatre, he narrates the accumulation of matchsticks, gasoline, and dynamite in the hands of the oblivious audience, suggesting we might want to call the fire department.
A world ending. A world beginning. Zeihan brings readers along for an illuminating (and a bit terrifying) ride packed with foresight, wit, and his trademark irreverence.

The Expectations Game

While reorganising our home ahead of numerous overseas visitors for Christmas I came across one last box of my 2017 book, Investing-The Expectations game. I thought I had sold all my copies long ago, if any readers do not have a copy and would like greater insight into what really drives markets, please contact me directly at; kevin@strategythoughts.com