Strategy Thoughts

May 2023

Is HOPE still alive and well?

The danger of Underestimation!

Introduction

I concluded last month's Strategy Thoughts with, "There currently exists a lot of 'hope'. Hope that central banks will continue to buy gold, hope that the Fed will pivot or pause, hope that authorities will contain the current banking crisis, and hope that all of this will continue to justify still very high valuations. None of this presents the kind of back drop typically seen at a long term bottom or buying opportunity". Perhaps the single most important question now is encapsulated in this month's title, is hope still alive and well, and it seems it certainly is with markets having held up despite there being so much investors could choose to worry, or even panic, about. Adding to the list of 'hopes' covered last month is the 'hope' that the US will not default on its obligations and that the debt ceiling will once again be raised, as it always has in the past. This month's edition will once again review the many signs of hope and also explore the very real danger of forecaster underestimation. But first it probably makes sense to quickly review the old adages of bull markets climbing a wall of worry and bear markets sliding down a slope of hope, from an expectational point of view.

The wall of worry and the slope of hope!

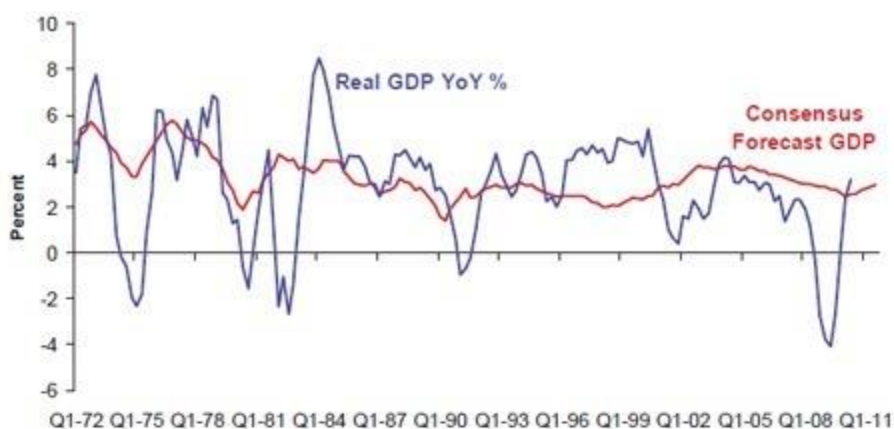
Over the years I have frequently described how bull markets climb a wall of worry and that the subsequent bear markets slide down a slope of hope. These adages do provide a useful perspective; however, they do have to be looked at from an expectational, rather than literal, point of view. It is not correct to think that as long as there are things to worry about then markets can simply continue to rise, this is nonsense, as there will always be something that investors could choose to worry about. What is important is what investors choose to do. If they continually choose to worry about whatever is happening economically or geopolitically or fundamentally with business, then it is much more likely that their expectations are modest and whatever does actually happen will be a positive surprise. So long as investors continue to worry and have modest expectations then bull markets can continue to rise as a result of continued modest positive surprises. However, the more positive surprises are delivered investors gradually shift and start expecting better outcomes, they become less worried and the scope for disappointment increases. This is how bull markets end, naturally there will still be many things that investors could worry about, but if the majority of investors choose not to then expectations become stretched, and when they are not met then markets roll over. From there the slide down the slope of hope begins.

In the early stages of a bear market hope abounds. Initially the hope is along the lines of whatever has been suffered so far is just a correction and that the previous bull market will reassert itself, then each subsequent bounce is accompanied by hope that any problems will be fixed or challenges overcome. As the slide continues, and each bounce gets weaker and weaker, eventually hope evaporates and expectations become dire. When that point is reached the chance of things being not quite as bad as the majority fear increases and so the possibility of a positive surprise rises. It must be remembered that the positive surprise is unlikely to be outright good news, just not the end of the world that by then so many fear. From that point, of dire expectations and zero hope, a new bull market can begin.

Currently we are still in the 'hopeful' stage, meaning that the chance of any positive surprise is low and the risk of disappointment high. We will examine more of these hopes later, but first it is worth examining some of the factors that may feed these swings of hope and worry, economic forecasters.

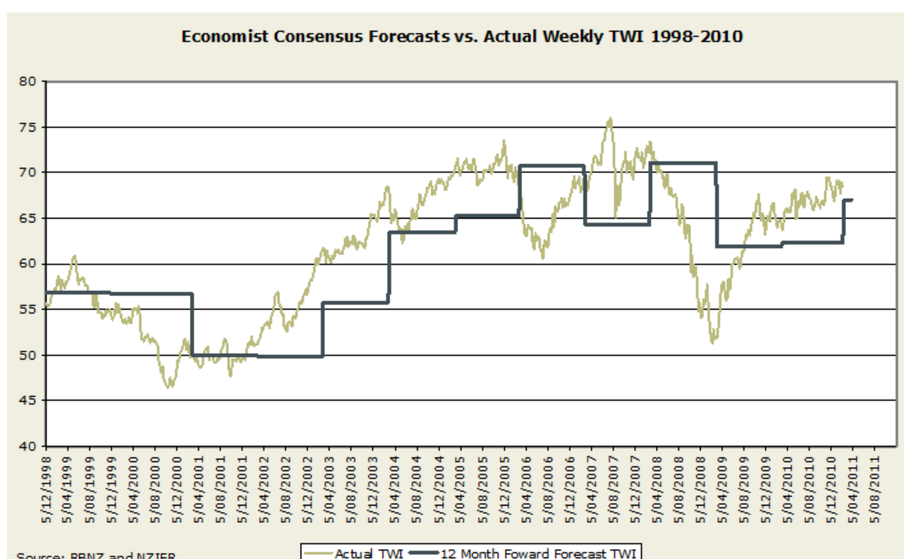
Hope, and Underestimation

Economic forecasters have a tremendous track record of underestimating the prevailing trend, both up and down, most of the time. The chart below that was originally produced by James Montier and was included in 'Investing – The Expectations Game'. It shows how little help economic forecasters have been over many decades of economic expansions and contractions. They have consistently underestimated the magnitude of moves in economic growth. Only when the actual GDP growth rate begins to roll over they eventually start to reduce their forecasts, but seemingly never enough and not in time. The same is true with recoveries.



This consistent underestimation means that during expansions investors are being positively surprised on the upside, allowing a bull market to continue. However, and this is not clear in the chart above, what forecasters actually tend to do is become increasingly optimistic as an expansion progresses until finally they become far to optimistic as the economy rolls over, and so investors are disappointed.

This tendency for underestimation, and lagging the actual move, can more clearly be seen in another chart that was included in 'Investing – The Expectations Game'.



The chart above shows the consensus forecast for the trade weighted New Zealand dollar compared to the actual level of the New Zealand dollar for the twelve years from 1998. In 'Investing' I wrote;

> What is clear from the chart is that over the period shown, which may have been a little more volatile than others but it is through such periods that investors look for help and comfort, economists and their forecasts were severely whipsawed several times. In early 2001 their forecast was slashed, but only after the dollar had actually been falling for about two years. In a cruel twist, and with the benefit of hindsight it is clear that by the time they finally cut their forecast the dollar had already bottomed and begun a more than five year rise that they would never, despite raising their forecasts many times, actually catch up to, that is until the dollar's rise had actually peaked. What followed was a see sawing dollar that resulted in a very frustrating three or four year period where forecasts were continually being reversed, just at the wrong time.

Not only did the consensus forecast consistently underestimate the size of the New Zealand dollar's moves, it consistently lagged the actual move in the currency by up to two years. Perhaps not surprisingly the currency's actual moves were a far better forecast of what economists' forecasts would be than the other way around!

A similar tendency is found in strategist's forecasts for what markets are likely to do over the next twelve months. Thirteen years ago, I highlighted this in a 'Thoughts and Observations' piece that examined the consensus forecasts, as polled by Barron's magazine, from 2001 through 2008. In all but one of those years the consensus either underestimated the magnitude of the move or, during bear markets, got the direction totally wrong. The only year that they were close in their forecast was calendar 2005 when the market moved less than a handful of percent.

Hopeful underestimations, and continuing to extrapolate the previous move, even after it has reversed, are very dangerous for investors and breeds the kind of hope that is currently being seen, but it has regularly happened before.

The great recession, or GFC, from December 2007 to June 2009, (the official dates of its beginning and ending as determined by the National Bureau of Economic Research) may have 'officially begun in December 2007, however, this date was not officially declared until a year later in December 2008. So, for twelve months a recession had started yet it was not declared an official recession. Throughout that period hope abounded and even six months into that recession, in June 2008, with the market down more than 15% there continued to be many unfortunate, hopeful, and dangerous forecasts being made by economists;

One chief economist wrote in June 2008; "A funny thing happened on the way to the most predicted recession in US history: it didn't happen."

Unfortunately, it did happen, and had already started six months earlier when that hopeful assertion was made, and would ultimately become the worst economic contraction in seventy years.

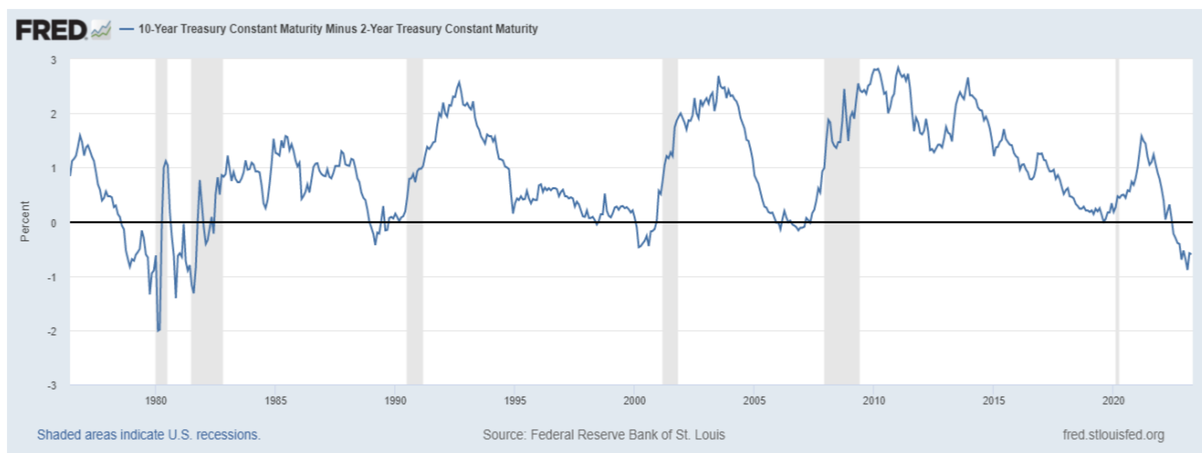
Coincidently, that same month, June 2008, a paper was published by the Federal Reserve Bank of San Francisco. The paper in June of 2008 further acknowledged the poor performance of economic forecasters in predicting recessions;

> As witnessed by the public attention to recent pronouncements of probabilities of recession, there is a great deal of interest in predicting recessions. Nonetheless, **economists have a very spotty track record of predicting downturns.** (emphasis added)

However, the paper went on to point out that there was an indicator that had delivered an outstanding record of predicting recessions. The paper stated that the yield curve does have significant ability in doing so. Their paper concluded;

One possible explanation is that recessions are simply unpredictable. But, this view is contradicted by evidence that the yield curve provides useful information for forecasting future periods of expansion and contraction. In this paper, we show that the yield curve has significant real-time predictive power for distinguishing between expansions and contractions several quarters out relative to the predictions of professional macroeconomic forecasters. Indeed, we find that a simple model for predicting recessions that uses only real-time yield curve information would have produced better forecasts of recessions at horizons beyond two quarters than the professional forecasters provided. This conclusion remains true during the past 20 years, despite the fact that the yield curve model's usefulness has been widely known since the late 1980s.

A simple version of their model is shown below;



The chart shows that whenever the ten year minus the two year yield spread has gone negative, or inverted, and then recovered, a recession has either begun or been imminent. That recovery from inversion has not yet happened, but this can occur very quickly as was seen in the early 1980s. Despite this the majority continue to hope that a recession will be avoided, or that if one occurs it will be mild. History shows that whilst this hope is understandable, it should not be relied upon or used as a basis for investment.

Hopeium 'A clinging to unreasonable or unfounded hopes' Wiktionary

Last month I suggested that there were then some similarities with the prevailing conditions in May 2008. If that analogy were to continue then now, we must be in June 2008, when the aforementioned economist stated that the most predicted recession in history had been effectively cancelled.

A similar 'HOPE' can indeed be seen now;

> **The recession with a small r.** In a recent poll of economists, the World Economic Forum found that nearly two-thirds of the respondents believe there will be a recession in 2023.
>
> But here's the good news: Many analysts expect a relatively mild and short recession, or what is sometimes referred to as recession with a small r. NPR 24/1/23
>
> **Recession, Yes. But Markets Cling to Hope Crisis Will Be Avoided** Bloomberg 18/3/23
>
> Maybe a mild recession wouldn't be so bad at this point Philadelphia enquirer 15/2/23

Economists at the Federal Reserve said they expect a "mild" recession later this year, an escalation from their previous assessment. ABC News 13/4/23

Sixty-five percent of economists expect a recession within the next year, according to a Bloomberg survey last month. Still, many stock investors hold out hope that the economy could avert a downturn or expect that a mild recession would cause little economic upheaval. ABC7 21/4/23

In fact, it seems that in some quarters hope is actually growing;

Citigroup hikes 2023 global growth forecast, sees US recession only in Q4 Reuters 19/4/23

And it is not just economic hope;

Big Tech Earnings Spark Hope That Worst Is Over
Shares rise on better-than-expected results, but growth lags behind what Microsoft, Amazon and Google did in past WSJ 29th April

There are also very clear signs of Hope when it comes to the unfolding banking crisis and to the US debt ceiling, apparently the worst is already behind us!

Jamie Dimon says 'this part of the crisis is over' after JPMorgan Chase buys First Republic CNBC 1st May 23

The crisis that led to the downfall of three regional U.S. banks in recent weeks is largely over after the resolution of First Republic, according to JPMorgan Chase CEO Jamie Dimon.

In an Unsteady Banking Industry, First Republic's Problems Stood Out The bank's rivals appear on firmer footing this time, in contrast with the widespread panic after the failures of Silicon Valley Bank and Signature Bank in March. NYT 1st May

The worst of the banking crisis is over, says Moody's Mark Zandi CNBC 2nd May

Banking crisis is over but its effects will last, Powell says Federal Reserve Chairman Jerome Powell indicated Wednesday that the period of bank failures that have rattled markets and the economy has come to an end. Speaking to reporters after the Fed pushed ahead with its 10th rate hike since last March, Powell sought to reassure the public that **the worst of the banking crisis is behind the U.S.** The Hill 3rd May (emphasis added)

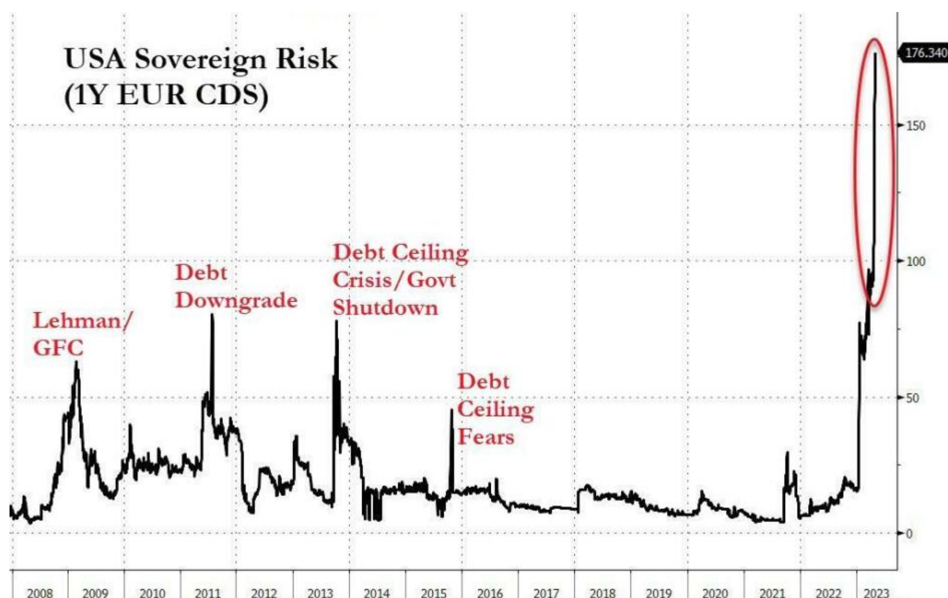
White house spokesman Karine Jean-Pierre says they are "very confident" no more banks will fail 1st May

There is now a worrying standoff between Democrats and Republicans regarding the debt ceiling. Rabobank summed the situation up well recently;

The game of chicken between Democrats and Republicans has really kicked off after the House of Representatives voted for the Limit, Save, Grow Act, Treasury Secretary Yellen sent a letter indicating that the X-date could arrive as soon as June 1, and

Biden's repeated dismissal of any conditions attached to a raise in the debt limit. **Either this game is over within a few weeks or we are going to see a delay until later this year. In both cases, we are not likely to see any solution until financial markets start to panic.** Rabobank 2nd May

Markets are demonstrating some concern regarding the impending breach of the debt ceiling as the chart below illustrates;



This spike is obviously enormous and has resulted in US Treasury notes now costing more to insure against the risk of default than those of Mexico!

The odd thing about this debt ceiling crisis is that there is an overwhelming feeling being presented by commentators, and the stock market, that it is nothing more than a storm in a tea cup, a game of chicken between the two political sides in the US. In trying to assess exactly where expectations currently are it is interesting to see what other markets were doing during prior spikes in the Sovereign Risk index shown above.

Building up to the Lehman / GFC crisis the stock market was plunging and the VIX, or Fear index, was surging up to its highest level ever. Three years later as the debt ceiling was approaching the stock market sold off about 15% and again the VIX rocketed higher, approaching 50, its highest level post the GFC. Whilst the 2013 spike was not accompanied by anything as dramatic in the stock or VIX markets, the last spike, in 2015, was. Then the market once again sold off about 15% in fairly short order and the VIX surged above 50. What should be cause for some concern is what hasn't happened this time around.

Complacency

Despite the US Sovereign Risk index having surged to record highs over recent weeks the same cannot be said of the volatility index, VIX, nor has there been any accompanying rapid sell off in stock markets in response. In early May the VIX was at 15.5, down from 34 seven month earlier, and at its lowest level since November of 2022, at the same time the US stock market was near the top of its year to date trading range. These were clear signs that few were choosing to worry about all the various things they could choose to worry about; from Bank failures, to the debt ceiling or an imminent recession. Hope, and complacency, it seems, are very much alive and well.

Pushing the 2008 analogy mentioned earlier a little further it is interesting to note that in May of 2008 the same VIX index was at 15.8, down from 37 earlier that year. In both cases recession risks were growing, in fact as mentioned earlier one had already started in 2008, but hope kept the fear index depressed. A recession may or may not have begun yet but the complacency currently evident in the VIX is eerily reminiscent of June 2008.

Over the next six month, from that May low in 2008, the VIX rocketed higher to its all time high reading as what would later become known as the GFC unfolded along with the worst bear market in seven decades. Just as pride comes before a fall, so too do hope, and complacency, precede a bear market.

Conclusions, and Dealing with Hopeium

Shiny Object Syndrome

Whilst it would be nice if such a pill as shown in the cartoon above existed, it doesn't. The only solution to avoid getting swept up in hope, at just the wrong time, or getting panicked with worry at

just the wrong time, is to appreciate what it is that drives markets. It is not the economy, interest rates, or earnings, or any other such so called fundamentals. It is expectations.

The reason we pay whatever price we do for anything is based upon our expectations for what that thing will deliver. The same is true collectively. Any broad market is a real time indicator of the collective expectations of all market participants. If those expectations are exceeded then people will be prepared to pay a higher price and expectations will grow and prices will rise. Unfortunately, as humans, our expectations tend to get ahead of themselves and eventually, after a series of surprises, we start to expect positive surprises (which is obviously an oxymoron, you can't expect a surprise). This lays the foundation for disappointment and a market peak. The same is true in reverse, and at market bottoms the collective expectation is grim indeed, this leaves open the real possibility of a positive surprise.

Currently hope continues to be very evident: hope that the banking crisis is over, hope that the debt ceiling will simply be raised without a hiccup, and hope that any recession will be one with a small r. As I wrote last month, this is not the set up for an important market bottom and so buying opportunity. More likely this is still just the early stages of the slide down the slope of hope.

Kevin Armstrong

5th May 2023

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The Expectations Game

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