Strategy Thoughts

January 2024

Things may not be as rosy as they appear!

Introduction

It has been six months since the last edition of Strategy Thoughts. In that time markets as a whole have sold off a little and then rallied, some, especially those with greater exposure to the so called FAANG stocks, to new all time highs. Not surprisingly this very narrow strength has spurred investors to become increasingly hopeful and aggressive in their investing behaviour. In this edition of Strategy Thoughts, I question whether such behaviour is sensible and look at the motivations of those offering ever more aggressive investment options. I also revisit the prospect of an imminent Fed Pivot, something I discussed at length earlier this year, and what it has historically meant for the stock market. Finally I will touch on a couple of investment themes that I have personally been taking a far greater interest in than the overall stock market over recent months, Uranium and Gold.

Investor demand rarely implies superior returns.

In Investing: The Expectations Game I warn readers of the danger of buying whatever the hot new sector may be. Unfortunately, the manufacturers of investment products do not launch the funds that they truly believe are going to deliver the best returns, they launch the funds that are easiest to sell. In Investing: The Expectations Game I wrote;

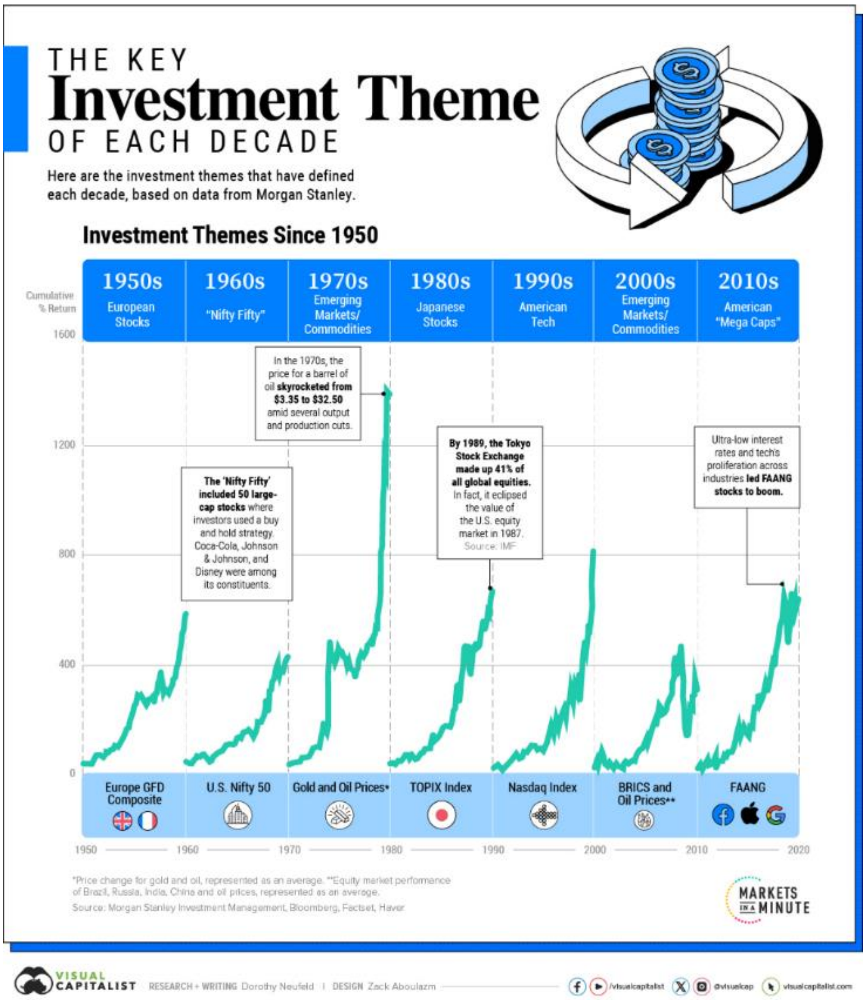
> It is important to remember that most fund management organisations are primarily focussed upon growing their assets under management. As a result the new funds they sell are by definition those that they think they can most easily sell the most of, not what they genuinely think will deliver returns. Sadly, when it comes to investing, the funds that are easiest to sell are those that would have given the best performance had they been available over the prior few years. But of course, before that performance occurred, very few would have invested at that time.

Investor demand is almost always driven by careful consideration of what has done well followed by an ever growing herd like extrapolation of that trend. The result being that most of the money that enters a particular trend or theme does so very close to the end and contributes to the crescendo that inevitably precedes a major peak. A few examples of this behaviour are;

> In the late nineties everyone and their brother was launching tech funds or starting their own .com incubator. Fund managers rapidly jumped on the band wagon as the NASDAQ soared eager to get their share of that particular run away train. And they did with most of the investment coming right at the end ahead of a massive collapse.
>
> A similar pattern was seen in the eighties. At the beginning of that decade most Americans were still very wary of Japan and the Japanese, however, as the Nikkei rocketed every higher and shrugged of the 87 Crash faster than any market in the world, the world took more and more notice. As a result fund manufacturers were more than happy to meet the growing demand.

In the late 2000s, on the back of what was increasingly being called a ‘commodity supercycle’ the number of commodity related funds available rocketed to meet the seemingly insatiable demand, ironically just ahead of the supercycle’s bust.

In fact each of the decadal themes illustrated below produced, and in the latter stages were caused by, the proliferation of investment vehicles encouraging all to climb upon each ‘runaway train’.



These few examples highlight an understandable motivation on the part of fund management organisations. The easiest way to grow assets under management is to offer whatever it is that investors appear to want more and more of. Unfortunately, the very nature of markets is that what ever everyone wants more and more of is likely to have already been doing very well for some time, probably at an accelerating rate, and that acceleration is only fuelling even more demand. These trends have always come to an abrupt end despite ever growing participation and expectations. The results are always a disaster for the investor whereas the fund manager, who may eventually suffer from a shrinking asset base, has already enjoyed a bonanza in new sales.

I was therefore more than intrigued by these recent stories in New Zealand.

ASB launches new Aggressive Investment Funds 22 November 2023

The funds have been launched in response to strong customer demand for more aggressive investment options.

BNZ expands investment offering by launching High Growth Funds for the BNZ KiwiSaver Scheme and YouWealth

Perhaps the most interesting comment is from ASB, who claim that they are merely pandering to customer demand.

It is worthwhile looking back at the opposite periods in market histories, when it truly would have been a great time to invest.

In April 1942, in the depths of World War II, major US corporations were paying dividend yields in excess of 10% and the average price earnings multiple was about 5x. The reason was that expectations were at rock bottom and no one wanted to take on any risk, in fact many corporations with investment portfolios were specifically barred from owing equities. It would have been a phenomenal time to launch a US equity fund, arguably the most opportune time in the last century, but whist performance would have been fantastic it would have made little money as no one would have bought into it.

The same would have been true in gold in the late nineties. It had collapsed over the previous two decades and central banks were dumping the supposed investment relic. With hindsight it was exactly the time to launch a fund, but no one did, as no one apparently in their right mind would have bought it. From there gold rocketed higher, rising more than seven times in value over the next decade.

The commodities boom of the 2000s witnessed a similar reversal from total disinterest before the boom began (when of course it would have been a great time to invest) to a myriad of issuance of new funds as the theme became obvious to everyone and the super cycle was extrapolated way into the future. Thus, ensuring that the majority of money came into the sector at or very near the peak.

A contrarian approach to investing does not and cannot work all the time, however, at extremes of expectation, be they optimism or pessimism, it is the only way to invest in a disciplined fashion. Investing in a sector or market because funds are being offered because that is what everyone wants is unlikely to be a successful strategy for very long.

A Fed Pivot?

Over the last few days there has been a marked increase in bullish expectation on the part of many commentators, apparently driven by the hope that the current rising interest rate cycle is over and that a Fed Pivot is inevitable.

Fed’s Pivot Is Forcing Stock-Market Skeptics to Become Believers Bloomberg December 19

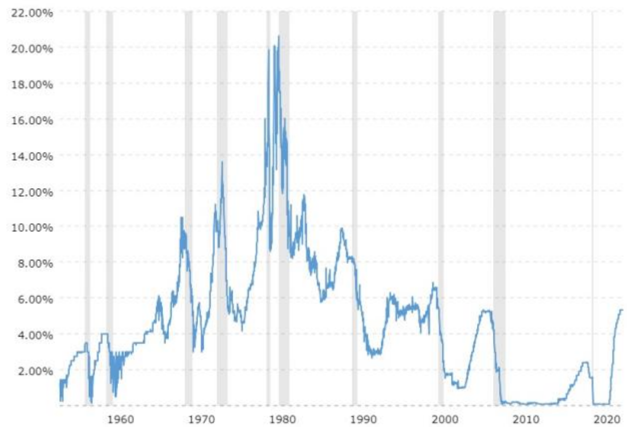
Investors cheer Fed's dovish pivot, as focus shifts to 2024 risks Reuters December 15

A Fed Pivot Could Spur “Animal Spirits” & Investor Confidence Schwab Network December 19

Dow hits a record high following Fed's nearly pivot rhetoric CMC Markets December 14

It would be nice if investing really were as simple as these headlines seem to explain, and that such neat cause and effect characteristics really did play out in markets as so many expect. However, the truth is actually quite different as I went to some length to illustrate through the first few months of this year when a Fed Pause and then a Fed Pivot were so widely anticipated.

I have updated the chart below which I included in the January 2023 edition of Strategy Thoughts and have included the comments that accompanied the original chart eleven months ago.



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

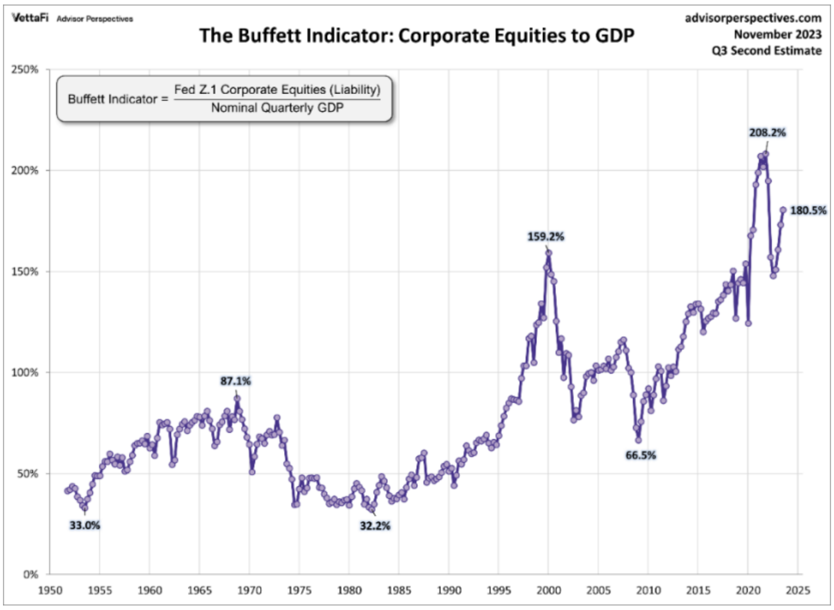
The chart above shows the US Fed Funds rate going back more than sixty years, the peaks in Fed Funds rates can clearly be seen to have occurred prior to the onset of a recession (shaded areas), and also, unfortunately for those banking on a pivot, well before the bottom of the bear market. The only exception 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.

As a follow up to these comments it is certainly worthy of note that the two pivots that I highlighted as being particularly worrisome, those of December 2000 and August 2007, share one characteristic with the currently hoped for and expected pivot, extreme overvaluation. The chart below shows Warren Buffett's favourite indicator of valuation, a measure of the stock market compared to GDP. To date the 2000 and 2007 pivots were accompanied by the highest valuations ever seen at a pivot, until now that is.



A Fed pivot with a backdrop of heightened expectations for stock markets despite near record valuations is unlikely to deliver what so many hope.

A note on expectations

Russell Investments summed up current expectations well in their recent year ahead article;

"Over pessimism for 2023 has become over optimism for 2024"

Over the years I have written many times about the tendency for market commentators' year ahead forecasts to be nothing more than simple extrapolations of the previous years returns. After one or more good years in the market the expectation widely held is that the trend will continue. Similarly, after more difficult years commentators general find such enthusiasm hard to muster.

This tendency is summed up well in the quote from Russell above. As 2023 began forecasts generally were modest at best, fearing a recession and interest rate hikes and extrapolating the poor performance of the previous year into the next. We now know that interest rates were indeed hiked, so far, a recession has been avoided but stock markets have delivered far better than expected returns, particularly in the US.

So, what has this strong 2023 done to expectations? Not surprisingly, again as summed up by Russell, expectations have become more, and perhaps dangerously, optimistic, with healthy stock market gains expected next year. This optimism can be seen in the American Association of individual investors survey that in late December indicated a similar peak in bullishness to that seen at previous stock market peaks. Not the backdrop that generally accompanies launch pads for yet another great year of returns. Similar levels of enthusiasm can be seen in measures of both investment advisor and fund manager optimism in the US.

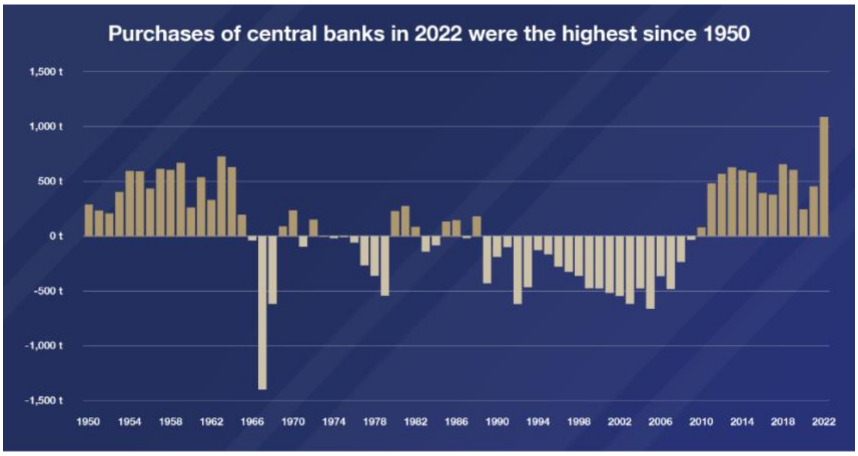
Optimism is also prevalent globally. Natixis, in their 2023 survey of more than 8,500 investors across 23 countries found that the average expectation for future returns was 12.8% above inflation. Obviously, this would be nice, but it is not the kind of expectation seen ahead of great returns, rather it is born out of great returns that have already been had.

Uranium and Gold

Seven months ago, I expressed some scepticism regarding relying on central banks continuing to buy gold to push the price higher. I concluded an article in April with;

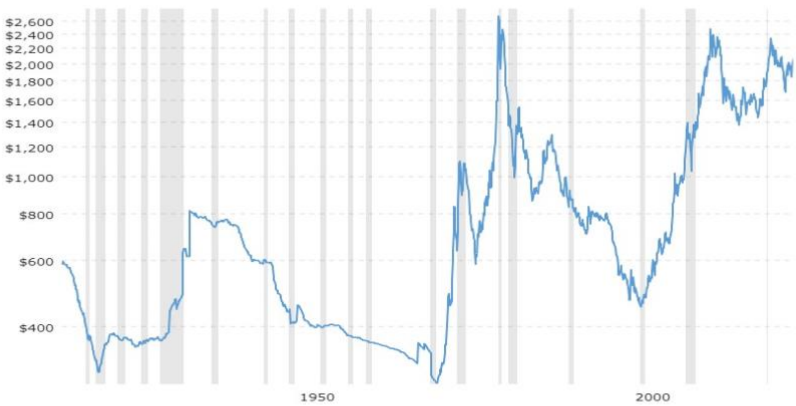
> It may be a little unkind to say that central banks are contrary indicators of the gold price, even though Gordon Brown so famously demonstrated they can be. However, it is very difficult to say that they are in any way a leading indicator. Taking comfort in central bank buying continuing and using that as a reason to buy more gold as it approaches a record high may not be the soundest strategy.

What is remarkable is just how strong that central bank demand has continued to be.



And now gold is looking like it may be finally breaking out above $2,000.

Whilst it may be entertaining to reflect upon Gordon Brown's timing, selling the UK's gold reserves so disastrously at the metals historic trough in the early 2000s, it is also clear that there is no causal relationship between central bank buying or selling and the price of the underlying metal.



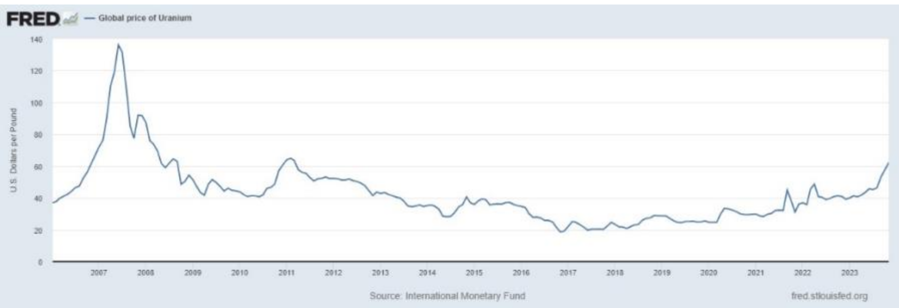
www.macrotrends.net/1333/historical-gold-prices-100-year-chart'>Gold Prices - 100 Year Historical Chart

Peak selling may occur near or soon after a trough in the price, similarly peak buying will likely occur near or after the peak in the price, unfortunately one never knows when a peak in buying has been seen until after it has!

The chart above shows an inflation adjusted price history for gold. What it reveals is that over the very long term gold has performed poorly, still well below its inflation adjusted peak more than forty years ago. However, over the medium term, since the central bank selling accompanied lows in the early 2000s, gold has performed well. More recently gold has struggled in inflation adjusted terms and it is therefore not surprising that at the recent low last October sentiment towards the metal was as bearish as it had been for five years. Since then gold has rallied and, as mentioned earlier, may be about to enjoy another breakout. With that set up I have begun to buy gold through the etf GLD for the first time in many years.

The other metal that I have become particularly attracted to over the last three years is uranium. The chart below shows the long term history of the Global X Uranium etf that attempts to mirror the Solactive Global Uranium & Nuclear Components total return index.

Not surprisingly, this etf also reflects the long term trends of prices for uranium, as shown in the second graph below.



The attraction of uranium as a potential investment was first highlighted to me when I read 'Apocalypse Never, why environmental activism hurts us all' by Michael Shellenberger. This book, published in 2020, was the first time post the Fukushima nuclear accident in March 2011 that I had heard anyone highlighting nuclear energy as being part of a solution, rather than a totally separate and much larger problem.

The collapse in the price of uranium and uranium related investments post that disaster is understandable and can clearly be seen in the two charts above. Particularly the chart of the etf URA which fell more than 90% in value from 2011 to its 2020 low (coincidentally when Shellenberg's book was published).

The bullish case for uranium and uranium related investments were summarised recently by themarketbull.com.au;

> **Growing Demand for Uranium** The increasing need for fresh uranium sources is intricately linked to the volatility of fossil fuel prices and global pushes for decarbonisation, prompting substantial investments in nuclear power. The recent Cop28 climate conference emphasized the transition away from fossil fuels and the acceleration of low-emission technologies, including nuclear energy. With nations committing to this transition, nuclear power was recognised for one of the first times as playing a fundamental role in combating climate change. This year, 21 countries worldwide have committed to bolstering their nuclear power capabilities, sparking forecasts that anticipate a threefold increase in demand and production by 2050. However, this surging demand for nuclear energy is met by a myriad of risks to supply.
>
> **Supply Risks** Western utilities have continued to turn away from Russian uranium imports due to its on going conflict and invasion of Ukraine. In December, the US House of Representatives took a decisive step by passing a bill to outright ban imports from Russia, the world's leading producer of nuclear fuel. Supply was also under a crunch through pressures asserted from the military coup in Niger and troubles in Canadian mines.
> Miners and explorers of Uranium are also feeling the pressure, with a recent Wall Street Journal article outlining miners are struggling to get enough uranium out of the ground. However, this appeared to have little sway over price and demand, with China ramping up nuclear production building 22 of the 58 global reactors, Europe's opening its first new facility in 16 years with a new reactor in Finland, and Japan lifting the operational ban on the Tokyo Electric Powers Kashiwazaki-Karia plant, the world's biggest nuclear plant.
> While grappling with limited material availability and the need for government and private sector funding support, the global backing for nuclear power suggests a promising outlook for sustained uranium demand in the years to come.

Not only might gold be about to breakout to the upside, so too might URA, from a much longer base.

Conclusions, and dealing with runaway expectations

Markets are undoubtedly a reflection of the aggregate expectations of all market participants, therefore at market peaks expectations are elevated and at troughs, or great buying opportunities, they are very depressed. It is also true, and understandable, that the hottest markets or sectors attract the most attention from investors and so spur investment product manufacturers to come up with even more ways for investors jump on the band wagon. A proliferation of similar investment opportunities in the latest hottest sector should be seen as a cautionary sign, not as a green light to get in at any cost.

Therefore, the current trend to become even more aggressive should also be seen as a sign that caution is warranted. Finally, if hope for even better returns is based upon the expectation that the Fed will cut interest rates then history should be revisited. Cutting interest rates because the economy is slowing with stock markets near record valuations has rarely been a constructive set up in the past.

Kevin Armstrong

7th January 2024

The Expectations Game

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