Strategy Thoughts

February 2024

The Generals may have made their last stand!

Introduction

Thirteen years ago I wrote an article titled 'The San Juan Hill Theory', in it I discussed the deteriorating breadth that was being experienced across global equity markets and likened it to what had been seen four years earlier in 2007, just nine months prior to the onset of the GFC. In last month's introduction I again referenced the narrowness that was being seen in the US market. In this month's Strategy Thoughts I revisit the San Juan Hill Theory and again broaden the review out from the US to look at all major regions of the world. I will also look at the marked divergence that has been seen between the two global rivals, China and the US, and also update on the two positions I mentioned last month; gold and uranium.

The San Juan Hill Theory

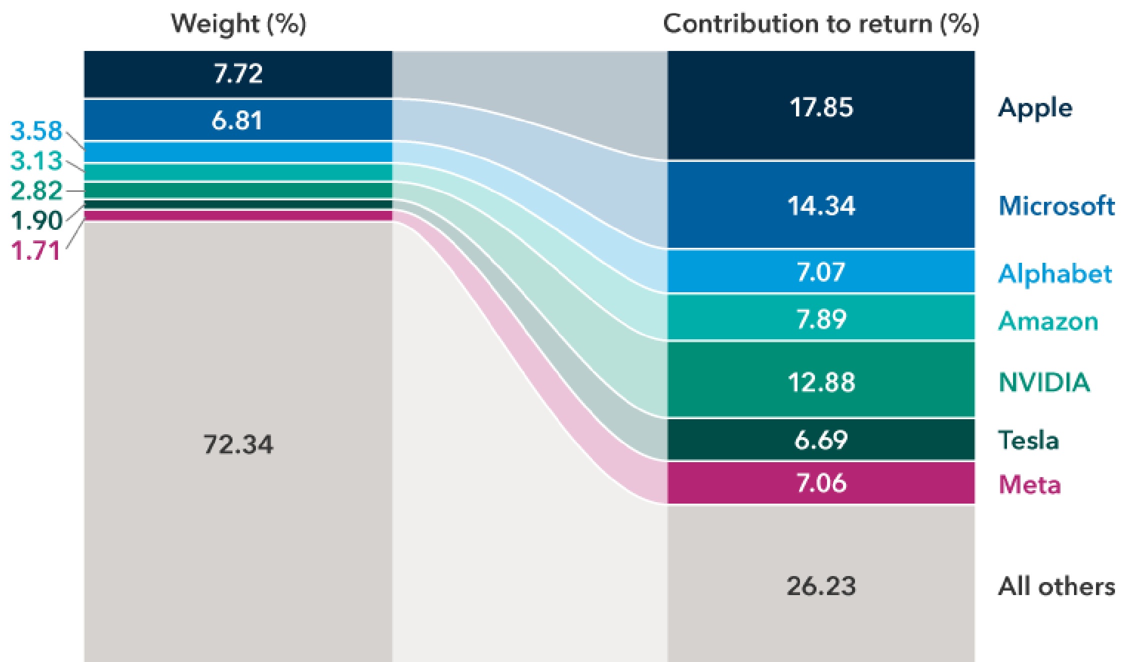
In 2011 I wrote;

> In 1998 John Rothchild wrote 'The Bear Book' that described why the, up until then, incredible bull market of the nineties would end. He was obviously about two years early but anyone heeding the book's advice avoided a dreadful last decade of secular bear market whipsawing. In part II of the book he writes a section on 'Early Warning Systems' one of which is the 'San Juan Hill Theory';
>
> *"Hong Kong pundit Marc Faber says stocks reach the top when the generals (large stocks) are charging up the hill while the troops (small stocks) lag behind. It is not uncommon, says Faber, for the generals to plant the flag nine months after the troops have retreated."*
>
> Of course looking for this breakdown in leadership of any market is far from infallible, and currently the US market is not yet displaying such a breakdown, however, the world as a whole may be beginning to send such a signal with many markets now beginning to struggle.
>
> Almost four years ago in the March 2007 Strategy Thoughts I highlighted the potential for a similar breakdown in the up until then great performing emerging markets:
>
> *"In reviewing the twenty five markets in the MSCI Emerging Markets index it is clear that the individual markets are far from synchronised, however, when the most money is being lost in the sector virtually all markets are falling and similarly when the most money is being made, like the last five years, all markets are rising, albeit to differing degrees. It seems it is at the important turning points, and there have been many of those over the last quarter of a century, that divergent performance from country to country is seen."*
>
> *"This characteristic is quite understandable and consistent with the behaviour of individual markets. During rampant bull phases most individual stocks rise, however, it is most unusual for the majority of stocks in an index to all peak at the same time as the market. Typically, as a bull market ages fewer and fewer stocks rise with the market or make new highs as the market does. This aspect of market behaviour, known as the breadth of the market, has*

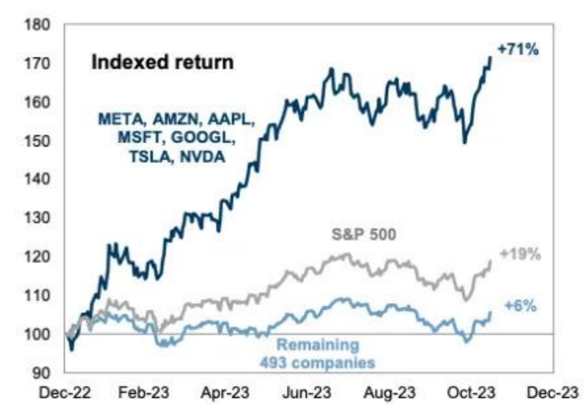
become a valuable and much used tool in market analysis and deteriorating breadth has frequently highlighted the risk of a market reversal."

Within about nine months of that 2007 warning virtually every market in the world had joined the reversal and begun their worst bear markets for decades. The 2011 warning was not as prescient, however, within eight or nine months both the S&P500 and the MSCI world index had suffered close to 20% declines.

The 'Generals' now are undoubtedly the so called Magnificent Seven technology stock that have delivered so much of the return that the market has so far delivered. This dominance and weighting can be seen in the illustration below from mid last year.



A more up to date illustration of the dominance of the Magnificent Seven can be seen below;



Never before have seven companies become such a dominant part of the market, and whenever markets have been dominated by just a few stocks bear markets have followed. Examples were the so called ‘nifty fifty in the early seventies, TMT in the nineties and now we have the Magnificent Seven.

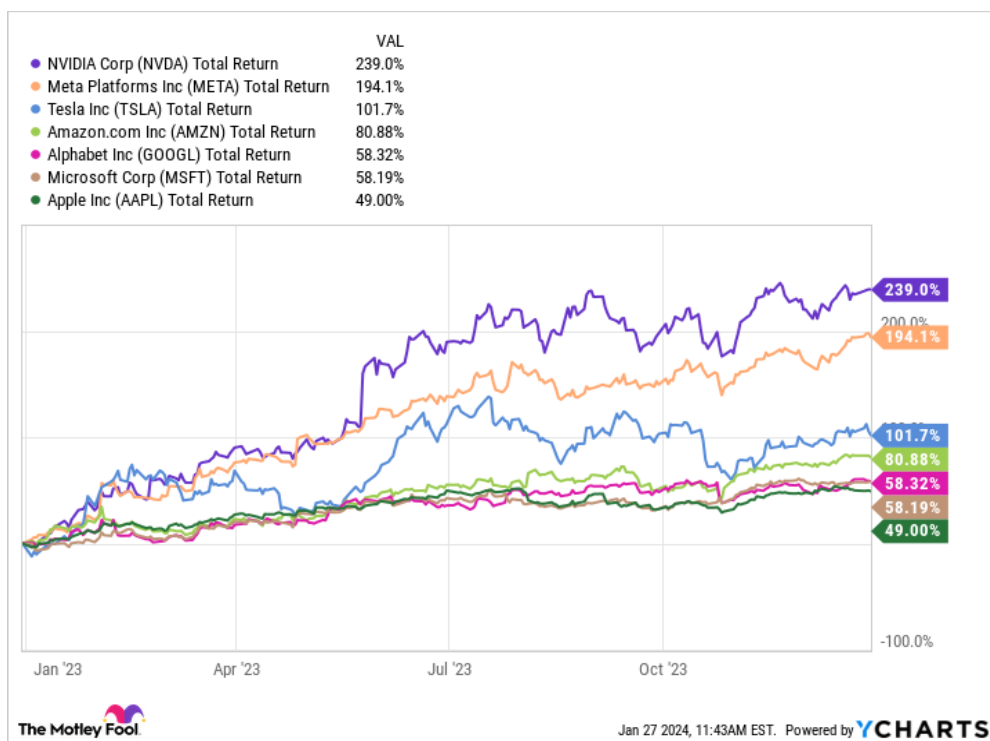
In a remarkable echo of the comments I wrote last month regarding the caution that investors should feel when new funds are launched to capture the continuation of an already very stretched trend, I saw the following recently on Reuters;

> New US ETF targets 'Magnificent Seven' mega-cap technology stocks
>
> Tidal Financial Group and ZEGA Financial launched a new exchange-traded fund (ETF) designed to profit from future growth in the "Magnificent Seven" growth and technology companies that have come to dominate U.S. market indexes and returns.

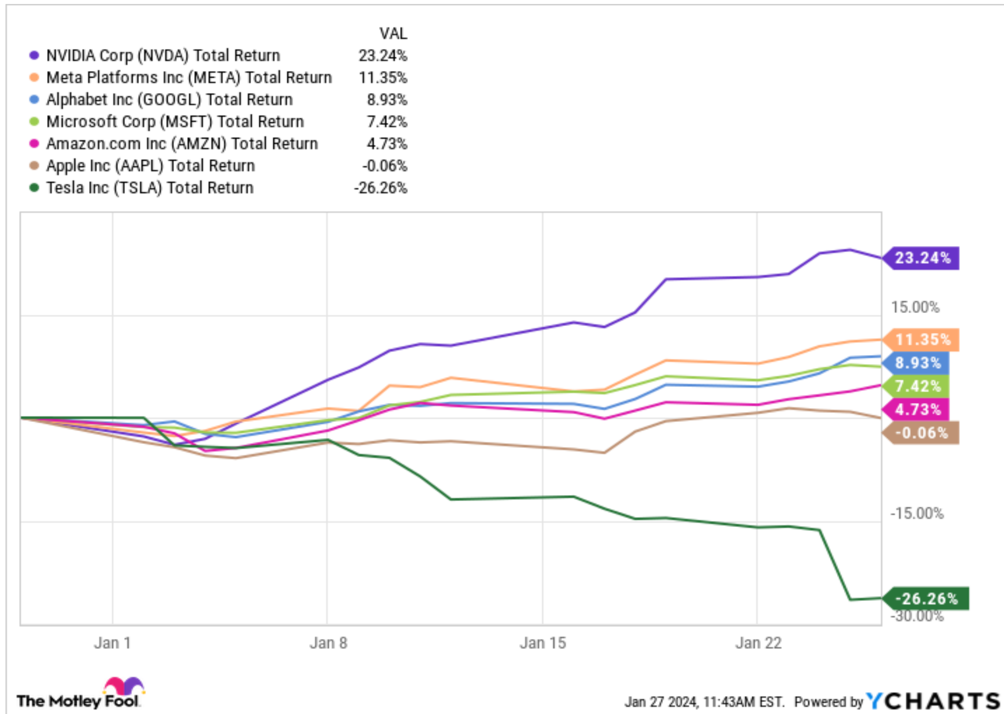
A proliferation of newly created opportunities to invest in already established and very extended trends has always been as a result of an understandable opportunism on the part of fund managers to exploit dangerously extended investor expectations rather than the start of a great investment.

Another sign that this current bull market may be aging or even over is illustrated by the narrowing breadth even with the seven stocks themselves. The Motley Fool recently ran an article raising the possibility that the Magnificent Seven had become the Sweet Six. The Article quoted CNBC’s Jim Cramer saying that Tesla no longer belongs with Nvidia, Meta Platforms, Amazon, Alphabet (Google), Microsoft, and Apple. Cramer’s comments do seem valid as the Motley Fools charts below show.

Through 2023 all seven contributed handsomely.

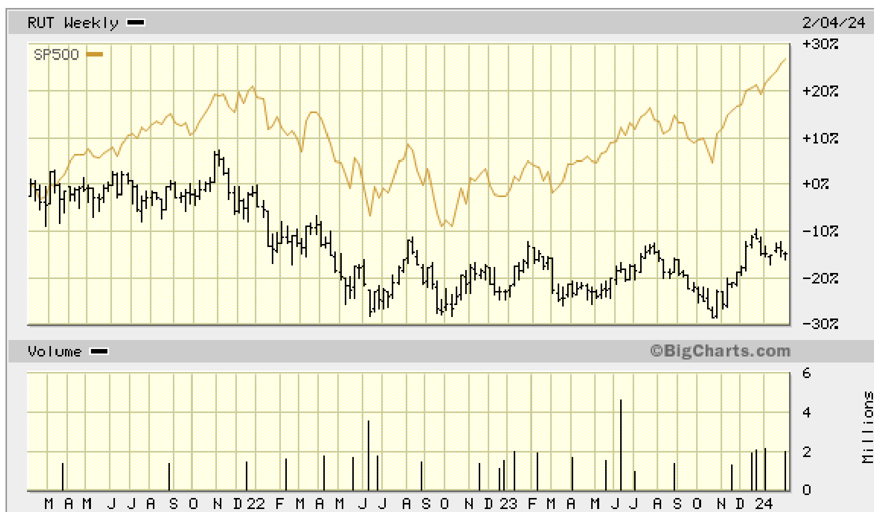


The same cannot be said so far this year as the chart below for January shows just how much Tesla has underperformed the ‘sweet six’ and also the market that it was supposedly leading!



The fact that new ways to invest in the most extended names in the market are appearing, at the same time as the US market is dominated by fewer names than ever before, and that the breadth of that concentrated leadership group is itself breaking down should all be warning signs to investors, and certainly not green lights to finally get on board a runaway train for fear of missing out.

This concentration, or lack of breadth, can also be seen in the broader indices in the US. The chart below shows the large cap S&P500 over the last three years compared to the small cap Russell 2000 index;



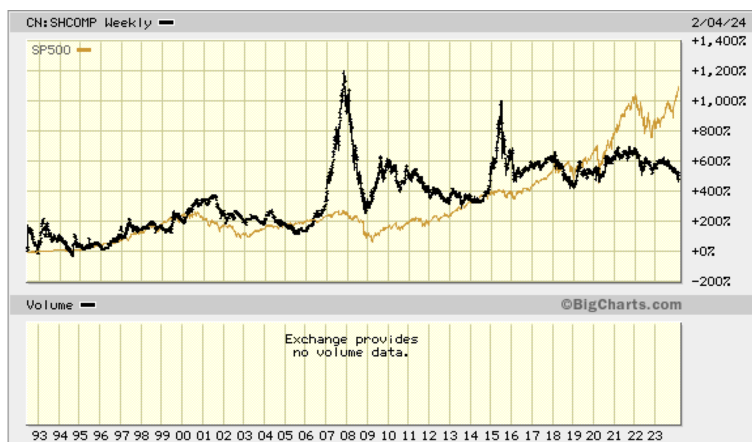
The S&P500, admittedly helped mightily by the Magnificent Seven, has this year broken above its late 2021 highs whilst the small cap Russell index is still close to 20% below its 2021 high.

A similar divergence between small cap stocks and the large cap ‘Generals’ can be seen in the world indices where the MSCI world small cap index is still 10% below where it was in late 2021 whilst the overall world index has recently been recording new highs.

A quick review of world markets reveals that with the exception of the US, India and Japan (although Japan is still below its peak recorded in late 1989), most markets are not currently recording major new highs; Korea is down 25% since its 2021 high, Australia is flat over the last 27 months, Singapore is 15% below its 2007 peak, the broad European indices are flat over the last two years, New Zealand is still 11% below its 2021 high and flat over the last four years, Taiwan is flat since 2021 and finally China is down 25% over the last 26 months, down 35% over the last nine years and 50% since 2007.

China versus the US

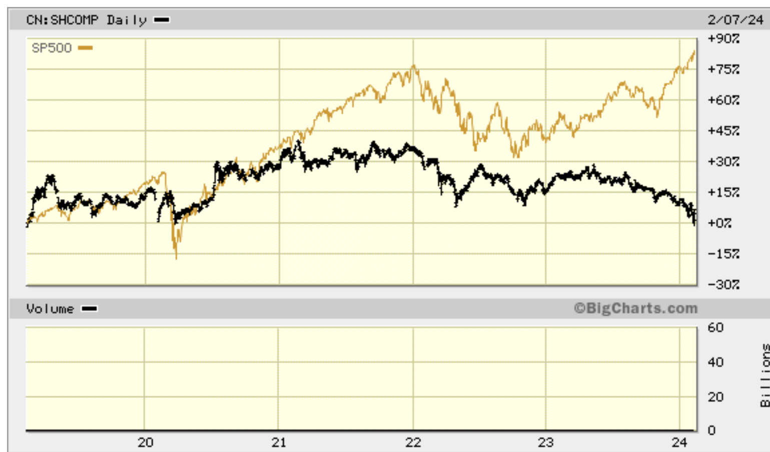
The increasing lack of homogeneity across markets, or increase in divergence, can best be seen in the performance of the broad US market, as shown by the S&P500, compared to the now fourth largest market by market capitalisation, the Shanghai Composite.



The first chart shows the last three decades of comparative performance and whist it is clear that the US has done better it is important to note that this has not always been the case and that for much of the last three decades both markets have at least moved in similar directions, albeit to varying degrees.

Throughout the nineties they rose largely in lockstep, fell in the early 2000s and then rose into 2007 and fell into 2009.

Both markets rose into 2015, fell into 2016, rose into 2018 and then fell into the close of that year. They also both fell together in the COVID bear market of early 2020 and then rose into 2021/2 before falling into late 2022



Since late 2022 the two markets have followed very different paths.

Over the last twelve months the broad US market is up more than 20% at an all time high, while the Chinese market has fallen close to 20% at its recent lows when it was at the same level it had traded at almost fifteen years earlier.

This may be one of the largest divergences ever between two major markets with perhaps the only comparable one being that between Japan and the US when from 1991 the US market powered ahead while the burst Japanese bubble market meandered sideways until 1999/2000. That divergence didn't end well for either market. The US TMT bubble burst and the NASDAQ fell by close to 80% and the S&P500 more than halved. At the same time the Japanese Nikkei, despite halving almost halved since its late 1989 peak, fell another 63% to its 2003 low.

Divergences of any kind are rarely healthy.

Investor demand rarely implies superior returns. Bitcoin ETF

I commented at some length last month on the tendency of fund managers to manufacture whatever may be easiest to sell rather than what may ultimately be most beneficial to an investor. This is understandable as almost by definition they wouldn't sell much of whatever would be most beneficial in the long term as no one would buy it. Conversely it is easy to sell whatever is hot and where expectations are the most rampant. As mentioned earlier this month this behaviour has been seen in the recent opportunity for investors to get direct access via a fund into the oh so hot Magnificent Seven.

A similar ‘new opportunity’ for retail investors is now being seen in Bitcoin. There has long been a desire for investors to be able to buy a securitised version of Bitcoin. One where a fund manager would buy and hold the underlying asset and issue securities represented by those assets, just like any other ETF. This process has been undergoing lengthy scrutiny as the SEC originally rejected any possibility of such securities being produced. However, a court order in August 2023 forced the SEC to reconsider these proposals, and on January 10th, 2024, the Commission approved 11 Bitcoin spot ETFs. It has been interesting to observe how Bitcoin traded immediately after this ruling. On January 10th Bitcoin closed at $46,600 having tripled in price since late 2002 (no wonder manufacturers wanted to get on board), the next day Bitcoin jumped to near $49,000 before closing the day at $46,300, down $300 from the previous day. After that it fell a further $8,000.

Something similar was seen in 2021 when the first official Bitcoin ETF was produced by Proshares, unlike the newer variety these were not backed by actual Bitcoins but Bitcoin futures, nonetheless, there was pent up demand as Bitcoin had risen from $38,000 to $67,000 over the previous four months. After that product’s launch Bitcoin initially sold off a little over $8,000 before rallying to a brief new high close to $69,000. From there it turned down and in a devastating rout to all those new ‘investors’ fell close to 80%, down to $15,500, over the next twelve months.

Time will tell whether anything similar happens after this latest Bitcoin ETF ‘opportunity’.

Uranium and Gold

Last month I mentioned that Uranium may be about to breakout from a very long base and showed the long term chart of the Uranium ETF URA. The shorter term chart below shows that URA Uranium, has started to breakout above its 2021 high.

Accompanying this breakout, which came on the back of news indicating that the supply of Uranium may be getting tighter later this year and next year, is an understandable increase in media coverage. The Australian Financial Review ran an article titled;

> **Uranium’s renaissance brings big opportunities for investors** 8th Feb

The same day NASDAQ reported;

> **Uranium Makes Japan’s Critical Minerals List**

> The receptiveness of countries to nuclear energy will be imperative for growth in uranium-focused mining companies. Japan's inclusion of uranium in its critical minerals list is a step in the right direction.
>
> "Japan's government has added uranium to its list of critical minerals, citing the threat to supply raised by Russia's dominance of the mineral.," confirmed Mining magazine.

In 'nuclear free' New Zealand one of the leading Fund Managers, Milford Asset Management, wrote a very balanced piece on uranium titled Uranium - The Facts and Fallacies.

The whole article can be found at; https://milfordasset.com/insights/uranium-the-facts-and-fallacies

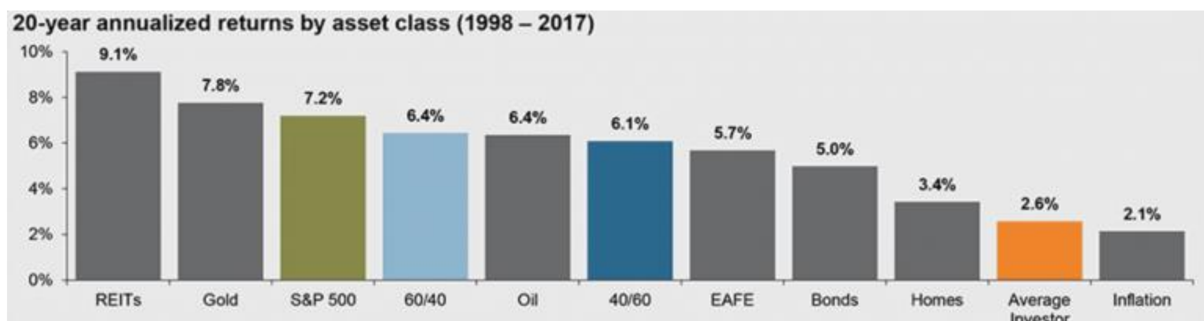
Whilst Uranium is, understandably, beginning to attract greater attention, given the moves that are being seen, I continue to believe that it still has a very long way to go before such attitudes and expectations are common place, or even talked about broadly.

Gold on the other hand has done little over the last month.

The price of the GLD ETF, shown above, is still flirting with the breakout discussed last month.

Conclusions and why the majority don't get market returns

Investor expectations across many asset classes continue to be elevated, much of this is driven by headline grabbing stories about the Magnificent Seven, and on the back of how well many markets did last year. Unfortunately, individual investors rarely achieve the headline returns that the best performing markets do. This is illustrated in the table below of annualised returns across various assets over a twenty year period. It clearly shows that the average investor only just beat inflation and did substantially worse than a balanced 60/40 portfolio



One of the main reasons for this is that individuals tend to be attracted into whatever HAS been the best performing asset by fund managers eager to gather funds, for all the reasons outlined both this month and last.

In 'The Expectations Game' I described at length the three main attributes investors needed for success, they were, discipline, patience and humility. The first two of these are of particular importance now. With the vast majority of the world doing substantially less well than the high flying Magnificent Seven, or maybe now the Sweet Six, and with global and regional divergences growing now is not the time to jump into whatever maybe hot, be it Bitcoin or AI and the Magnificent Seven. Having the discipline and patience not to get swept up in increasingly optimistic expectations will ultimately be rewarded when overly extended expectations run into inevitable disappointments.

Kevin Armstrong

9th February 2024

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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