Strategy Thoughts

March 2024

The problem with 'Liquidity'!

Is a Top in and how long does it take to Forget?

Introduction

There is currently great comfort being taken from ever rising and increasingly speculative markets. Just at a time when warning bells should be ringing the majority appear to be forgetting whatever disciplines they had previously felt were of value. This is not healthy behaviour, but it is a behaviour that is always seen ahead of market turns, both up to down and down to up. In this edition of Strategy Thoughts I explore this tendency and also some of the lessons that have now been forgotten, along with an update on the 'Magnificent Seven' and a look and the long term use of market valuation.

How long does it take to forget?

I have scoured the internet and my past writings for a quote that I thought captured this question beautifully. I know I have used it in the past but I just can't find it. I believe it was Jermey Grantham of GMO who, after the GFC wrote something like, 'Over the short term we will all learn a great deal through this experience, over the medium term we will learn a little, but over the long term we won't learn a damn thing.'

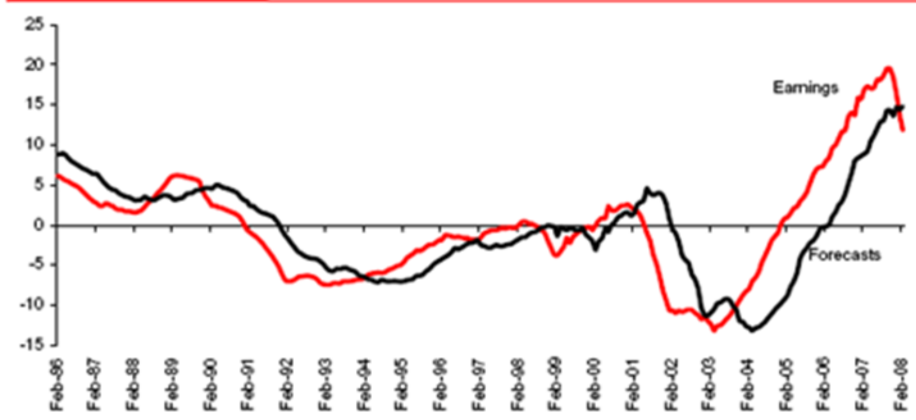
Boy has he been proved right.

More recently, in January 2022, Jeremy Grantham did write;

> With the clear dangers of an equity bubble revealed in 2000 to 2002, the even greater dangers of a housing bubble in 2006 to 2010, and the extra risk of doing two asset bubbles together in Japan in the late 1980s and in the U.S. in 2007, **what has the Fed learned? Absolutely nothing**, or so it would appear. In fact the only "lesson" that the economic establishment appears to have learned from the rubble of 2009 is that we didn't address it with enough stimulus. That we should actually have taken precautions to avoid the crisis in the first place seems to be a lesson not learned, in fact not even taught. So we settle for more lifeboats rather than iceberg avoidance. And we forgive and forget incompetence and fail to punish even outright malfeasance. (Iceland, pop 300,000, sent 26 bankers to prison; the U.S., pop 300,000,000, sent zero. Zero!) (emphasis added)

One of investors biggest enemies is forgetfulness. As Grantham sums up so well, we do all learn from our recent experiences but as markets progress it becomes increasingly comfortable to extrapolate whatever is currently being experienced, and the longer that trend continues the easier it is to ride that trend and forget any disciplines we had earlier determined were long term sound behaviours.

One only has to look at the general level of confidence and comfort that strategists have with their current broadly bullish outlook, and the fact that the majority are playing leapfrog with their own year end forecasts for where the S&P will close this year, as their earlier forecasts keep getting taken out by the rising market. This behaviour reminded me of a chart I included in 'Investing - The Expectations Game'. This chart showed analysts estimates for S&P earnings compared to actual earnings. There is a clear close correlation between the two, however, it is not particularly useful.



The more earnings rise the more analysts raise their estimates, and they don't stop raising them until after the actual earnings have rolled over. The same is true with their cuts in forecast following the actual falling earnings and then the estimates don't start rising again until after the actual earnings have begun to rise. Actual earnings movements are a great forecaster of what analysts' forecasts are likely to be! Similarly, what the broad market does is a great indicator of strategist's forecasts of where the market will go. This optimism is in stark contrast to the pervasive gloom that was seen fifteen years ago at the depths of the GFC. Then lessons were being learned, but they have now all been long forgotten.

Regarding the question of how long it takes to forget, the only answer I can come up with is, it varies, and the variation seems to relate to how long and large the previous move had been. One thing I am sure of is that whatever lessons have been previously learned through painful experience, they will be finally forgotten by all but the most disciplined investors just when they would become of most value.

Liquidity

There is a broad consensus that the current bull market has been driven by ample liquidity, it doesn't appear to matter that this liquidity has materialised as a result of an ever expanding universe of debt. The simplistic narrative appears to be that there is, and has been, plenty of liquidity and it has to go somewhere so stocks can easily continue to climb and valuations don't really matter. What has been forgotten here is that a similar view has prevailed before!

Ahead of the Global Financial Crisis that began in 2007 any concerns regarding lofty valuations were dismissed as there was apparently an 'ocean of liquidity' that had to go somewhere and so the only path for stocks was up. A not dissimilar attitude was seen ahead of the tech wreck in 2000. Then historically high valuations were overlooked as baby boomers looking to retire were going to continue to funnel more and more liquidity into the only asset class that had delivered the historic level of return required in order for them to retire, stocks.

Many articles supporting this notion that liquidity will drive markets higher have appeared recently;

> "Liquidity is still ample, but leverage is not yet at worrying levels. QT has not resulted in shrinking liquidity in the US so far, as reverse repos (which absorb reserves) declined faster than the balance sheet. In fact, liquidity has been increasing somewhat since the start of last year (there is a risk that 2024 Fed cuts will add to the froth)," she said. CNBC March 7th

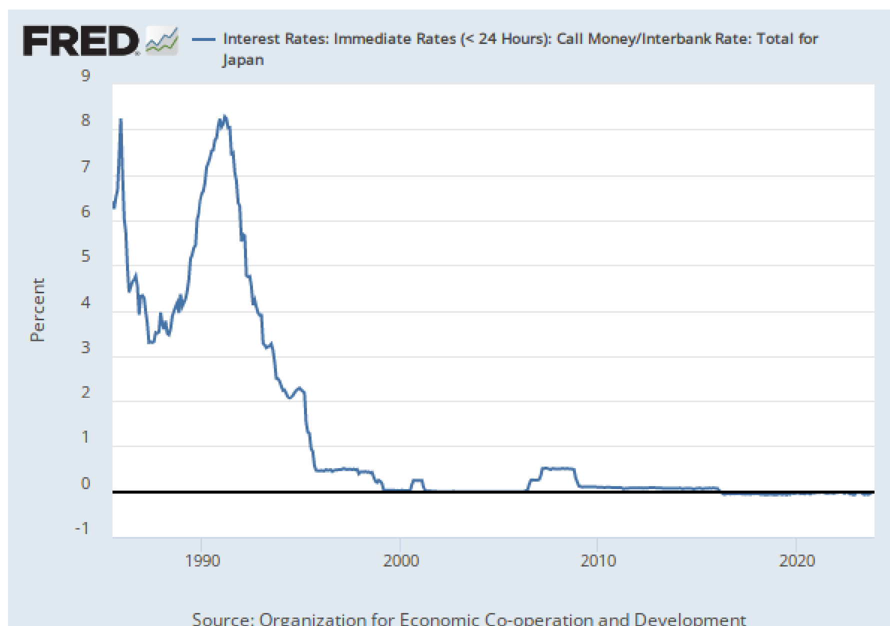
> **Liquidity**: Financial conditions have become looser than they were even before the Fed started raising rates in March 2022. Ample injections of cash into the financial system from banks, money markets and government stimulus programs have more than offset the Fed's tightening of monetary policy. Morgan Stanley March 6th

> Excessive amounts of debt support our economy and asset valuations. Therefore, the Fed has no choice but to keep the liquidity pumps flowing to support the leverage. As in 2019, the Fed will likely take stimulative policy actions to provide liquidity despite an economic and inflation environment where policy should remain tight. Keep a close eye on the excess liquidity gauge RRP and be aware of irregular activity in the money markets. Investing.com March 6th

Simplistically these rationalisations do appear to make some sense, however, unfortunately investing is not a zero sum game where cause and effect always work out neatly. Back in the nineties and into early 2000 investors did continue to pour more and more wealth into ever rising markets, that is until they didn't and the apparently simplistic approach stopped working. The same was true in 2007 when there was apparently an 'ocean of liquidity' but it no longer flowed into stocks once they started going down. And as they fell authorities the world over flooded markets with liquidity through lower interest rates and ever more convoluted acronyms, yet still markets fell.

There is not a simple cause and effect relationship between liquidity increasing and markets rising. As I have long maintained, and outlined at length in 'Investing – The Expectations Game', it is not liquidity that drives markets either up or down, it is what market participants in aggregate choose to do with that liquidity, and that choice is obviously driven by their aggregate expectations. If expectations are super optimistic then liquidity will flow into those assets that reflect the source of that optimism, but once those expectations are disappointed then the flow will go into reverse. This phenomenon was clearly seen in the historic boom and subsequent bust that Japan experienced in the

late eighties and into the early nineties. Once that bubble burst authorities did everything they could to reinflate the bubble as the chart below of Japanese interest rates illustrates.



All to no avail, the lower interest rates got the bleaker expectations became and the more the Nikkei fell. It reached the point where cash could have been dropped from helicopters, a solution once suggested by Ben Bernanke of the Federal Reserve, however, such a policy, especially if it were enacted in Japan, would not have achieved the desired effect. The citizenry would certainly and gladly have collected up the currency, however rather than throwing into the plunging stock market or rushing out and spending it, their collective bleak expectations would have resulted in them storing the helicopter money in shoe boxes under their beds or beneath their mattresses.

It is important to remember that it is not liquidity that drives markets, it the expectations, hopes and fears of those that control the liquidity that drives markets. This conclusion was alluded to by Warren Buffett in his latest letter to shareholders where he pointed out that the stock market has become increasingly casino like over the years, largely due to the ease of access and trading that technology provides. However, he also wrote;

> "Though the stock market is massively larger than it was in our early years, today's active participants are neither more emotionally stable nor better taught than when I was in school."

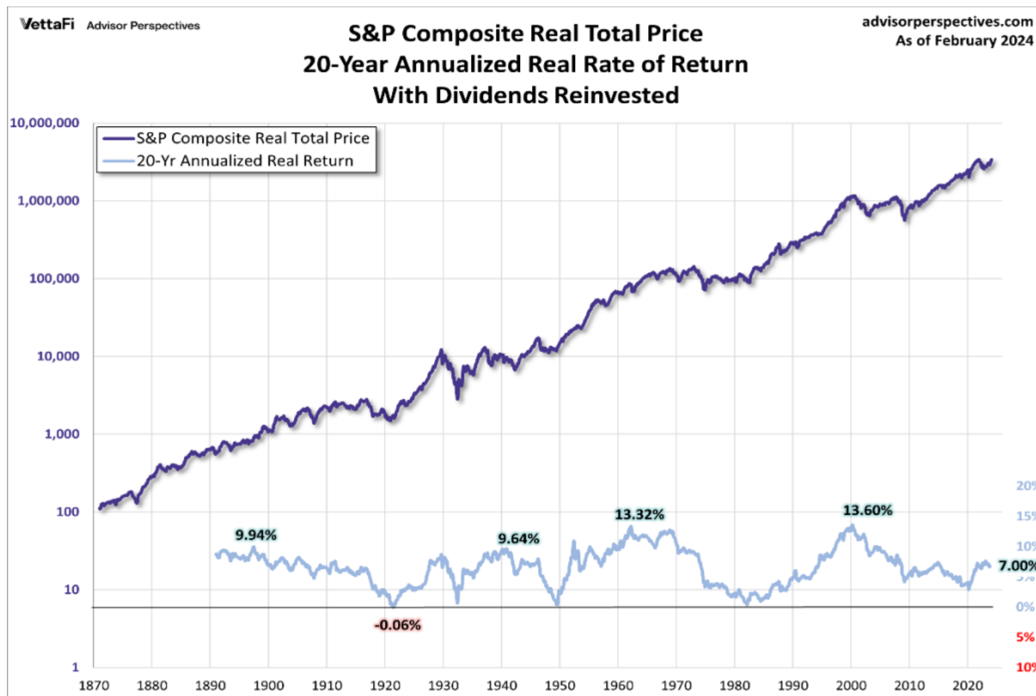
As I first laid out in 'The Expectations Game', it is still the collective expectations of all market participants that are reflected in the price. This is something that no investor should ever forget, even though it is hard. Again, as Buffett famously said, 'investing is simple, it is just not easy'.

Simply Buy and Hold for the Long Term!

This is a frequently heard mantra but it highlights investor's tendency to forget whatever lesson they vowed never to forget and illustrates just why investing should be simple but is hard to do.

Last weekend I heard an interview with a prominent local business editor who has recently written a well intentioned book on economics. One of the questions posed to him was whether investing in the stock market was closer to gambling than a path to wealth accumulation. His around about answer was that it could be for ill informed individuals picking stocks somewhat at random and perhaps on

the back of tips. However, he then went on to point out the sensibility of individual investors simply buying and holding a low cost index tracking fund, echoing the long time recommendation of Warren Buffett. He pointed out that you merely had to look at a very long term chart of the S&P500 to see the sense in this advice, it always recovers and continues to rise over the long term as can be seen below.



Over the very long term the total return of the S&P500 does look like an almost straight line rising from the bottom left of the chart to the top right, who wouldn’t want to achieve such steady long term returns?

The problem is that the chart masks the huge emotional swings that have taken place over the last 150 years, and its those swing in emotion, or expectations, that cause investors to forget. Invariably at just the wrong time!

It is unfortunately true that the majority of investors get involved in an asset AFTER it has already been performing well for some time. This increasing tide of investment into that asset produces something of a self fulfilling prophecy, pushing the asset price higher and culminating in even more investment from even later comers who don’t want to miss out on what by them has been universally acclaimed as the next big thing. Think tech, media and telecoms in 1999 or AI now.

The long term real total return of the S&P500 has been about 10% per year, however, for the twenty year period up until the early 1920s the total return had been zero. Similarly from 1930 to 1950 the annual return was zero and from the early 1960s until 1982 the total return had also been zero. More recently the ten years from 1999 to 2009 delivered an annualised real return of minus 6%. At the depths of bear markets no one is urging investors to buy and hold for the long term. In fact, the opposite is usually the case, despite all the well meaning and comforting literature and research that emerges usually in the second half bull markets. Such urging usually continues through the early stages of bear markets, when any downdraft is dismissed as just another ‘healthy correction’, but by the time of the bottom, when the long forgotten wisdom would be of most value, such convictions are nowhere to be found. One only has to think back to the low point of early 2009. Then, after the worst

bear market in seventy years, the conviction that stocks always outperform bonds over the long term was evaporating. Describing this period in 'Investing -The Expectations Game' I wrote;

> Headlines at that time were truly bleak;
>
> **Market's 'Hope Balloon' Loses Air**
>
> And there was a new cottage industry in town. No longer were pundits making the case for capitulation having been seen, now the growth industry was in academic papers and research articles claiming that everything that so many had previously believed in during the bull market, particularly the primacy of equities over the long run, was in fact incorrect. Equities hadn't delivered a better return than bonds for years, even decades. Citibank published a widely read piece on this topic and Bloomberg ran the story;
>
> "**Cult** of **Equity**' Is Under Attack"

Near the peak of a bull market, with returns having been very healthy for close to fifteen years, it is both easy and comfortable to trot out simplistic assessments such as investors should simply buy and hold for the long term. This totally overlooks the gut wrenching fear and discomfort that all but the most disciplined feel during what may turn out to be, but never feels like it at the time, the latter stages of a bear market. Given the emotional cauldron that stock markets are it is no wonder that investors always forget the lesson that in more comfortable time they swore they never would.

It's not the economy!

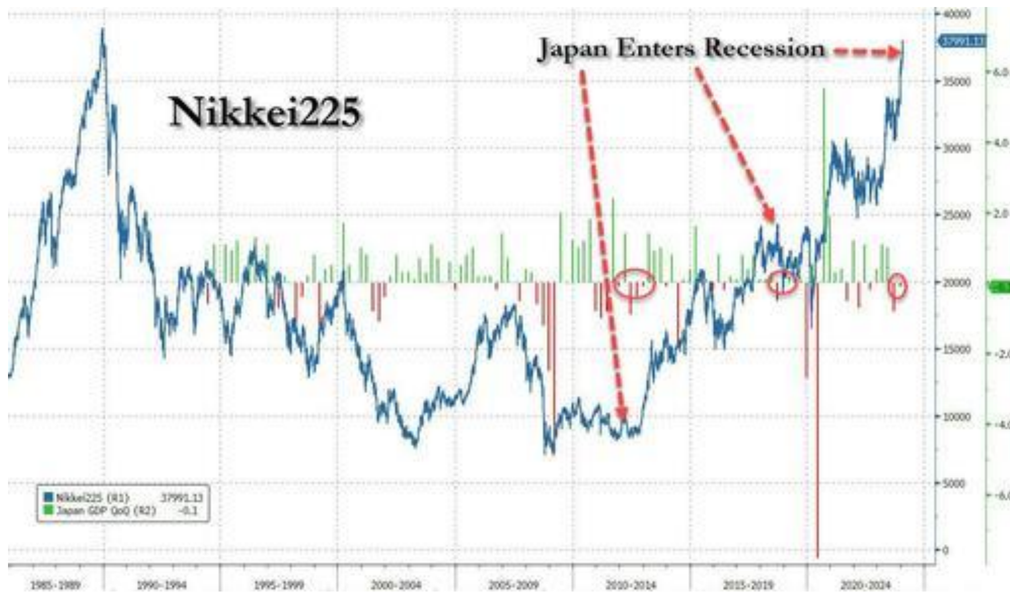
I have long maintained that attempting to forecast where markets are going to go by forecasting where the economy may go is foolish, it really reflects a misunderstanding of cause and effect and is certainly a case of putting the cart before the horse. The stock market is an excellent reflection of real time aggregate expectations of investors. The economy, on the other hand, is a cumbersome thing that takes ages to reflect changes in grass root activity and then the collection and aggregation of data to put out an economic data point takes even longer, and will probably be revised. By the time a clear understanding of where any economy was six months or more ago has been determined and settled upon stock markets have already well and truly moved. It is for this reason that the performance of the stock market is included as one of the constituents of the Index of leading Economic Indicators.

Wikipedia writes that the Conference Boards US Index of Leading Economic Indicators includes;

> **Stock prices of 500 common stocks** — Equity market returns are considered a leading indicator because changes in stock prices reflect investors' expectations for the future of the economy and interest rates.

It clearly begs the question, why try to forecast the economy to come up with a forecast for the stock market?

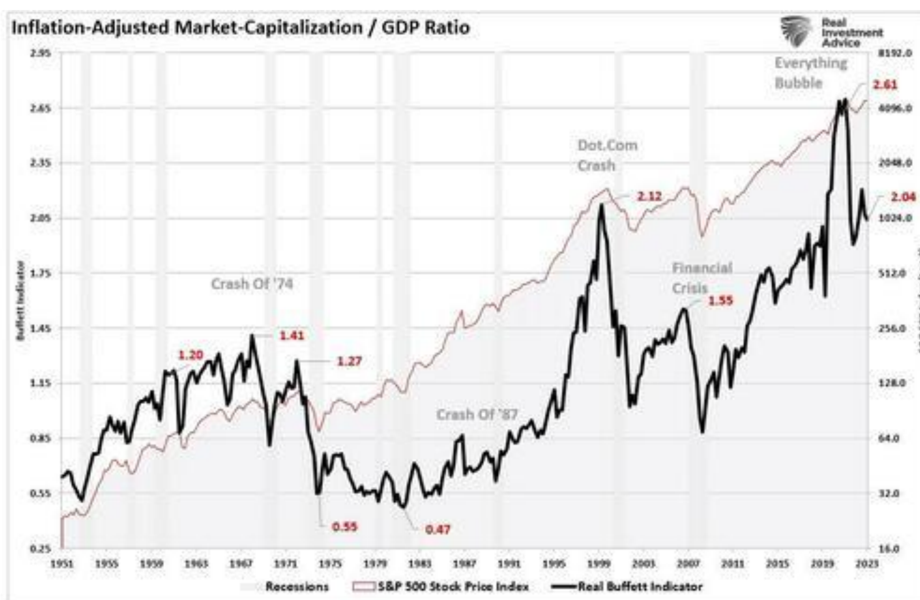
I have included these comments this month because I was struck by the following chart on Zerohedge. It shows the Japanese Nikkei Index, which really should be discussed in the section on 'buy and hold for the long term' as the long term has now been almost thirty five years. That is how long the house wives who were buying shares from door to door salesmen at the manic peak in late 1989 have had to wait to break even. The real message of the chart though is that at least for the last dozen or so years having a perfect forecast of the Japanese economy would not have helped an equity investor. The chart shows that whenever Japan has entered a recession would actually have been a very opportune time to jump into the market.



Valuation

It is often said that it is valuation that drives markets. Certainly it is the case that long term returns are better when markets are bought at historically cheap levels, and obviously the reverse is also true. However, it is not that levels of valuation are doing any ‘driving’. Valuations are just a reflection of aggregate expectations. When markets are historically cheap it is because there is little investor appetite for them because expectations are dire or bleak. Similarly expensive valuations are an indication of extended and optimistic expectations.

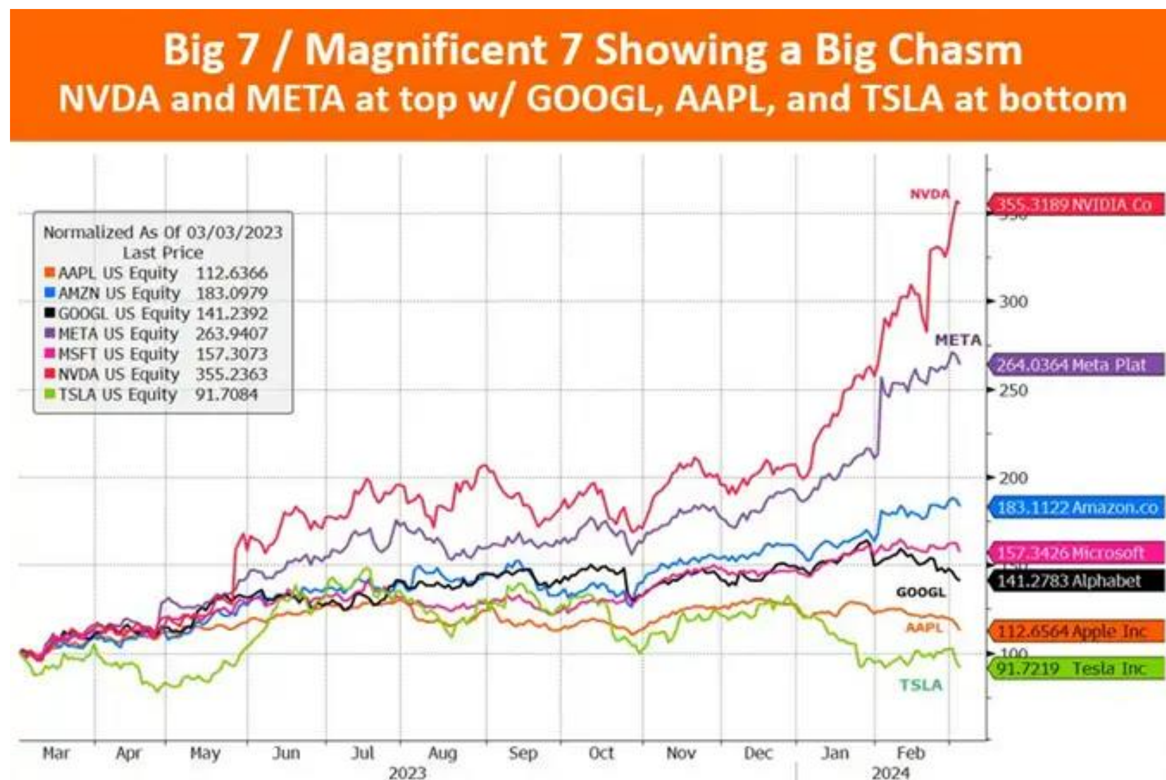
Whilst there is no short term correlation between valuations and subsequent returns, as a cheap market can always get cheaper and expensive valuation can always get richer, over the very long term there is a strong relationship between valuations and returns. It has always been the case that the best long term returns have been when markets were historically cheap, think 1920, 1932, 1942, 1974, 1982 and maybe 2009 (although markets were cheap in March 2009 they were not historically cheap as the chart below illustrates).



The chart above shows Warren Buffett's favourite measure of US stock market valuation. Clearly it is not now as expensive as it was a couple of years ago, but that should not provide too much comfort as it is still about as expensive as it was in 2000 ahead of the Tech Wreck and 80% collapse in the NASDAQ.

The Magnificent Seven

Last month I described the danger of an ever more concentrated and narrowing market and highlighted the danger of the growing enthusiasm for the so called Magnificent Seven and commented that even within the seven there was a growing divergence in performance and that perhaps they should be the 'sweet six' as Tesla maybe no longer belonged there. An updated chart of their performance further highlights the concentration in ever fewer leading names.



Nvidia and Meta clearly continue to the way, and Amazon and Microsoft are still just hanging on, but the other three; Alphabet, Apple and Tesla do appear to have rolled over. As I wrote last month, ever narrowing markets are not healthy.

Conclusions

Last month I concluded with;

> 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.

This remains my strong conviction. Markets remain historically expensive, which almost guarantees poor long term returns, the Magnificent Seven are themselves breaking down, and important lessons and disciplines from the past are being forgotten. At the same time investors are relying on comfortable, but ultimately not useful, approaches, such as buying and holding or the importance of liquidity. Whether the weakness of some of the former leaders is indicative that a top has been seen will only be known with hindsight but it may be useful to start thinking about what the next great

buying opportunity might feel like, and to keep it in mind, so that when it comes it has not been long forgotten. I found this quote from Justin Mamis, the late and highly respected market analyst and author of the Mamis Letter. I had included it in some market commentary during the latter stages of the 2007 to 2009 bear market.

> *"A bear market can't end -- never has -- until denial turns into realization. . . . This is a long process, because the light bulb doesn't come on collectively but gradually. Some are quicker to catch on, or less dumb, than others."*

A good memory and a disciplined investment approach will be essential whenever this point is reached.

Kevin Armstrong

20th March2024

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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