The End of an Era

6th September 2018

I have been writing this market commentary since 2010 and it is with mixed emotions that I put pen to paper for the last time under the RMG name. I am moving on to pastures new from where I will continue to write, albeit on a slightly less frequent basis. I truly hope that readers have enjoyed my weekly ramblings.

The post Global Financial Crisis has been an extraordinary period in which to be writing a regular market commentary. Some of my market calls have been good, and some bad. By way of a final sign off from RMG, I thought I would start by 1) articulating what I am trying to learn from past mistakes, 2) share some thoughts on what I see as the current big picture fundamental landscape and 3) what this may mean for future market returns and how to position in what could be a very interesting few years ahead.

First lesson to be learned must be to not fight the trend. No matter what an investor's fundamental view of a particular market, sector or individual security, do NOT fight the dominant trend. For most of the post 2009 period, non-US markets were trending broadly sideways as can be seen in chart 1 below. However, 2017 was a strong year to say the least, and my shift to a more cautious stance in April 2017 was wrong, or at best 9 months early.

Chart 1 – MSCI World Equity Index excluding the United States (price only) in US$

Although I don't feel too stupid for being cautious on non-US markets up until 2017, the US market is a different argument altogether. As I write, the post 2009 bull market in the US has become the longest in history, and my ofttimes cautious fundamental view here has been wrong.

Chart 2 – S&P 500 Index (price only)

So, I have been spending quite a bit of time in looking at momentum studies and other technical strategies in an attempt to keep me on the right side of the market especially when my fundamental view is opposing these. I very much look forward to sharing these with you in the future.

Building on the theme of do not fight the trend, my second lesson to be learned is to admit mistakes as quickly as possible and move on. Every investor/trader makes mistakes (even the best) but the trick is to recognise the mistake as early as possible and to rectify it. I would also phrase this as do not get married to a fundamental investment view, especially when the price action is different from what you see on the fundamental landscape.

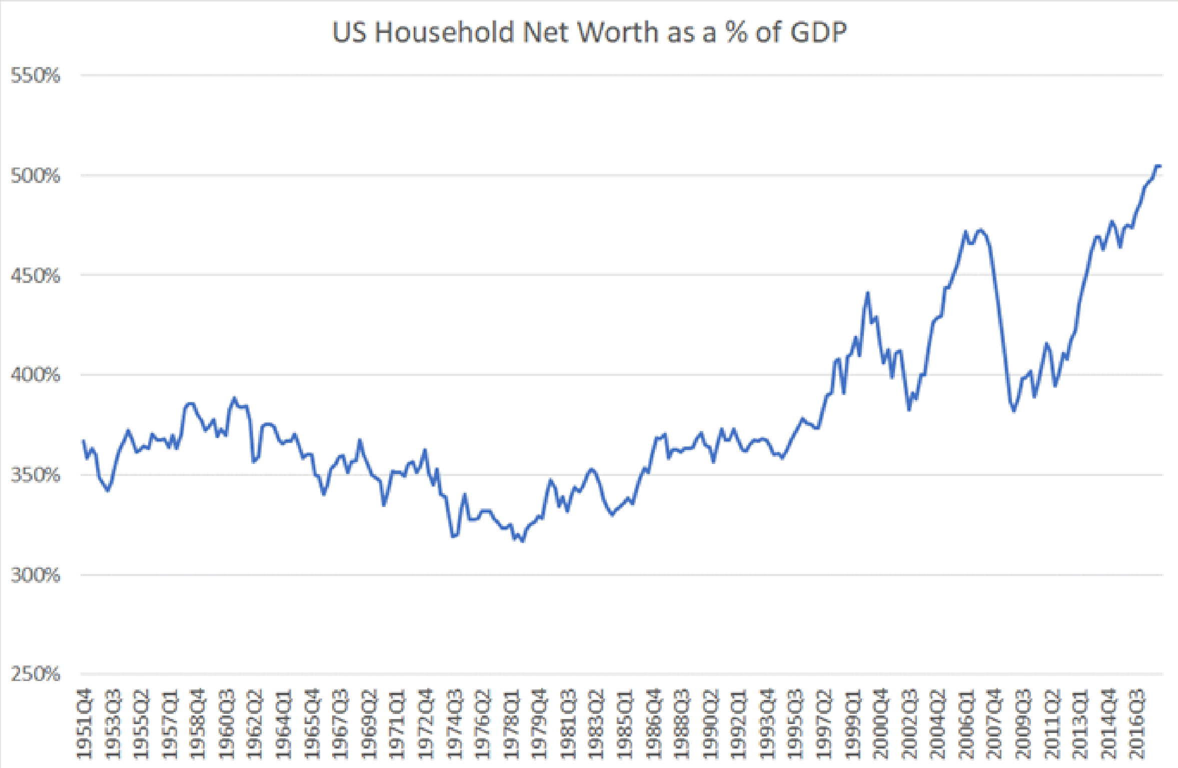
There have been many times in the post GFC period when the fundamental landscape appeared to be very worrisome. But the power of investors to look past such troubles and buy into the political rhetoric of the day coupled by tremendous support from central banks has been truly a feature of markets in recent years. Can this be placed under the “do not fight the Fed” banner? Perhaps. Or put another way, central banks have employed the most extraordinary policy tools in order to do whatever it takes to make sure that markets do not go down. Can there really be no unintended consequences to these experimental policies? Only time will tell, but we would suggest that central bankers have not created new tools in this last cycle that have banished economic and market cycles to the dustbin of history, and probably don’t fully understand all of the long-term costs that such policies may or may not deliver.

So, if I were to try and place the lessons learned into a single sentence, it would be; maintain a flexible mind to all potential outcomes, be agile in terms of changing market views when the circumstances change and simply do not fight the dominant trend, no matter the strength of conviction held on your fundamental view.

As well as learning lessons from past mistakes, investing is also about risk management and making sensible decisions. When I survey the landscape today, although my momentum work suggests a positive view on the US market, I cannot help but think we are late cycle both economically and market wise (as noted above the US is now in the longest bull market of all time). Assuming that economies and markets remain cyclical and that central bankers have not ascended to the arena of holding Godly powers, investors must expect a bear market (and recession) at some point in the future. Simple risk management and an understanding of past cycles surely dictate that investors should be considering a process of reducing risk in the current time frame rather than increasing risk?

Not only are markets and the economy probably quite late in the cycle, asset valuations in the US are very high. Chart 3 below shows the value of assets held by US households as a per cent of US GDP; this ratio has never been higher and at 505% is about 33% above the average since 1951. This record reading is a result of inflated assets rather than high savings rates, and a further worry is that these assets are concentrated in the hands of a small minority. This inequality is bad both economically and socially and was last witnessed in the 1920s. Either GDP has to start outperforming asset prices or asset prices have to start underperforming the economy, as this chart cannot head upwards forever.

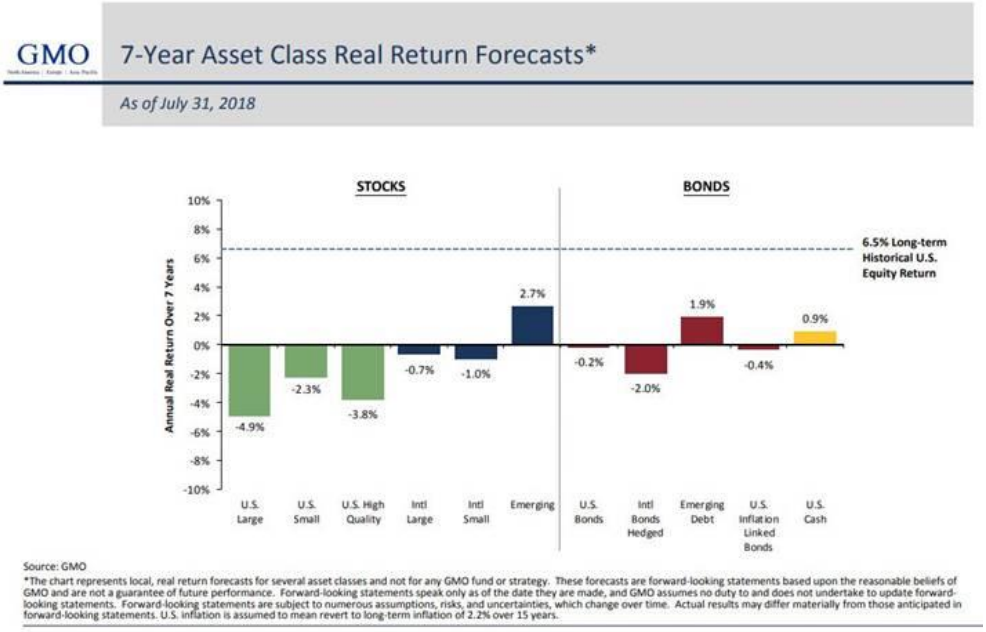
Chart 3 – Value of US Household assets as a % of US GDP



My view is that asset prices will not only begin to underperform the economy at some point, but this process will include a period of falling market values. I have tried to frame this debate since early 2018 as to whether markets are in a multi-month topping phase or not. Regardless of whether we have entered such a topping phase in January or not, surely investors must consider the potential risks here as well as have a view on expected market returns. My personal view is that the potential reward compared to the potential risk is now skewed against an aggressive position in equities (in fact nearly all assets) for buy and hold investors, even though I cannot yet point to my momentum studies showing that risk appetite is rolling over.

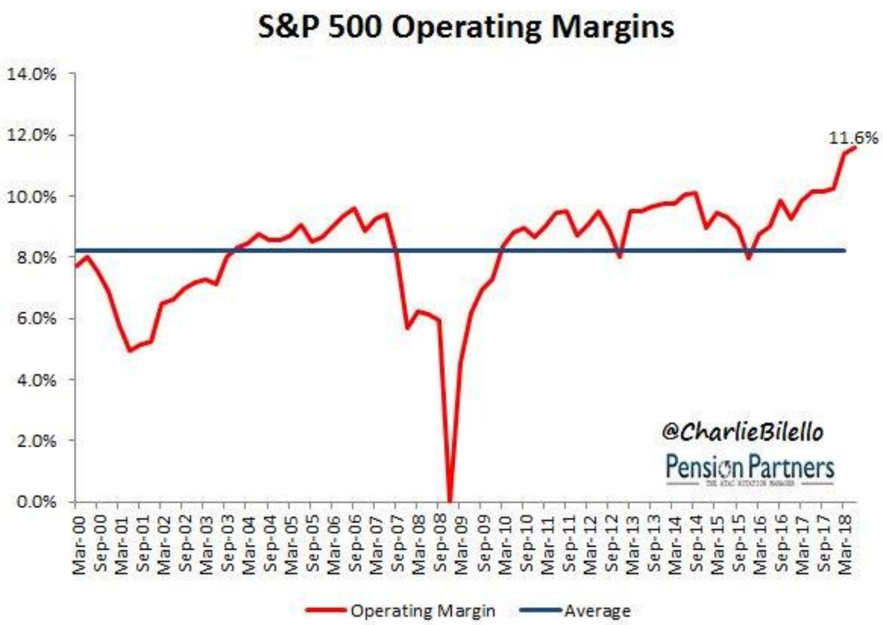
What are reasonable assumptions for market returns at this point in the cycle? Well, most reasonable work suggests modest positive real returns over the next 7 to 10 years in the 0% to 4% annualised range. And perhaps the more negative end of the spectrum suggests negative real returns over the next 7 years of so. The team at GMO, who have called markets well in previous cycles (but been too bearish in recent years) have the following return forecasts. All assets are expected to generate returns significantly below their long term averages, and most developed market assets may well see negative returns over their forecast period.

Chart 4 – Real 7 year annualised return forecasts from GMO



It seems to me that the more bullish argument for equities stands on valuation measures based on current strong earnings with price to earnings not too far above long term averages. This is true, but the potential problem with using current earnings is whether they are a true reflection of the long term stream of earnings that shareholders can reasonably expect. Chart 5 below shows that the operating margins currently enjoyed by US companies are at a record high, and are some 40% above the long term average. At some point, is it not reasonable to believe that margins, which have always been mean reverting, will slip back to the 8% level or so? If so, then the bullish view based on future earnings metrics may well be questioned.

Chart 5 – S&P 500 operating margins at a record high



This high level of operating margins is part of the wider debate on the share of the spoils between shareholders and other stakeholders. At heart, we have a position today where shareholders are benefitting more than ever and arguably at the expense of workers in particular. Another way to illustrate the debate is to look at the recent explosion in share buybacks, as shown by the blue line in chart 6 below. I would also stress that it is not simply the fact that shareholders are receiving more reward than ever before, but that these buybacks are almost by nature designed to boost share prices, benefitting not just shareholders but also management.

It would appear that these buybacks are becoming more and more indiscriminate about the price that shares are bought back for, and that they are designed to boost the remuneration of management. Is this increasingly indiscriminate behaviour really enhancing shareholder value? And is the recent frantic activity really sustainable, especially during the next recession?

Chart 6 – US share buybacks and issuance

Coupled with the de-equitisation shown above is the increase in corporate debt since the GFC, shown in chart 7 below. In aggregate, US corporate balance sheets are more heavily geared than ever before, but that masks a distinct division between those really cash rich generally technology companies and a very large rump. The credit quality of the rump has deteriorated since the GFC and the covenants of corporate bonds is significantly worse. Overall, we believe that the US corporate sector is increasingly vulnerable to both rising interest rates and ultimately a fall in earnings that will occur during the next recession.

Chart 7 – US Total Outstanding Corporate Debt

So, overall I believe there is a strong case to say that the corporate sector is more highly leveraged than ever before, that household wealth is higher than ever before and that future returns from financial assets are arguably set to be worse than nearly all previous points in history. These balance sheet analyses seem to oppose the income statements of corporate USA and many households, but with operating margins at record levels and household savings and unemployment at record low levels, the income side of these sectors is vulnerable in the next recession.

We have tried to explain some of our thoughts about leading economic indicators in recent commentaries, and we hope that we have made it quite clear that the US is not about to fall into recession in the next few months. We also pointed out that the equity market itself is a leading indicator, and as it is trading at all time highs, we should not expect an imminent recession. However, it is also wrong to wait for obvious signs of recession before selling, as the peak in the equity market would then be well behind us.

Chart 8 – US equity market, Index of Leading Indicators and Fed Funds Rate with recessions shown

So, with asset prices demonstrably very elevated, and non-earnings based valuation measures near or even at all time high extremes, we continue to believe strongly that the potential reward at this point in the cycle is quite limited, and the risk of yet another devastating bear market is getting higher. Once momentum turns lower (likely after several more Fed rate hikes), the path to said bear market and most likely another recession will be set. For those that believe central banks have the tools to prevent bear markets and recessions, why did they not prevent the 2008 Global Financial Crisis?

What we have tried to illustrate here is that both the financial system (and by extension the economy) are vulnerable to disappointments. Those disappointments could be seen in a future downturn in corporate profitability, a shift in momentum away from ever rising equity prices, a political shift towards rebalancing obvious signs of inequality, a continued shift towards US isolationism, higher interest rates making safe assets an attractive asset class; or just as likely, something that very few are focusing on today.

The main point perhaps is that regardless of the eventual reason/s for a reversal in fortunes, the dye is cast. Buy and hold investors are likely to be disappointed by the overall outcome of the next 7 to 10 years, and are likely to have to suffer a nasty bear market during that period as well. We also believe that the majority of investors would actually like to try and avoid the worst ravages that may befall markets, and that they are not really buy and hold investors at all.

Central banks have pursued policies that not only have encouraged a reach for yield never seen before (remember when over $10 trillion of global debt carried a negative yield?), but their rapid responses to the first signs of trouble in recent years have taught investors that they should look to buy every dip regardless of true fundamentals and potential long term returns. This reach for yield will have inevitably led to a number of poor investment decisions that will ultimately prove costly; just ask those Japanese investors who have bought Turkish Lira denominated bond in the last couple of years, or those investors that bought 100 year Argentinian bonds last year.

Yet at the same time, central banks are now removing the punch bowl, and will seemingly continue to do so until something breaks. It would appear that the Fed will raise rates to between 3% and 3 ½% next year. Is this high enough to cause stress to vulnerable borrowers? Is this enough to cause economic problems at either home or abroad? Will ongoing quantitative tightening coupled with rate rises prove too much for the system?

So, having painted a cautious fundamental picture, I would stress again that momentum (in US markets more so than other developed and emerging markets) remains positive. Bad things are not likely to happen tomorrow so to speak.

But I do believe that everything is very late cycle and that buy and hold investors will be disappointed. Those that wish to avoid such disappointing returns likely coupled with a bear market need a strategy for the period ahead. Two simple strategies could be to either continue to lower risk as markets move higher (and future expected returns shift lower), or to reduce risk once momentum has shifted to a negative bias.

Of course, for those that either disagree with any bearish thesis, or who can/will truly live through the next bear market without any worries, they should simply remain happy with their current portfolio and do nothing; for as long as possible.

And perhaps to sign off on a couple of upbeat notes. Periods of economic and market dislocation can often provide opportunities for those that are willing to entertain trade ideas slightly outside the normal. For instance, prior to the next recession, it is likely that the US yield curve inverts. The next step will then be for the Fed to cut rates as the economy enters recession, and as in every cycle since at least WWII, the yield curve will steepen as the Fed cuts rates to try and boost the economy. So, with the yield curve still positive by 23 basis points, it is too early to put on trades designed to benefit from a steeper curve. But my guess is that curve steepening trades will work well during the next recession when equity markets will be under pressure for a time, and so will be a nice diversifying strategy to have in the portfolio at that time.

Chart 9 – US yield curve and Fed Funds rate

But of much greater importance for the long term, those that survive a future bear market with their capital intact will have the pick of the bunch in terms of buying cheap assets. Will assets become as cheap as they were in either 2009 or 2002, or even the generational buying opportunity in 1982? Only time will tell. But we must look at market and economic dislocations as ultimately great buying opportunities, and I truly believe that such an opportunity lies ahead, and to be prepared to buy at that time will be as difficult as it was at any market low. However, to have the liquid capital available to buy after a significant market decline requires liquidity to be raised (or capital protected) when prices are high. So, it requires fortitude to sell when nobody else does and at the potential cost of missing out on some further (possibly marginal) market gains. But at this late stage in the cycle, I believe that investors of all stripes need to consider the big picture potential reward versus the risks that seem to be growing.

It has been an absolute pleasure writing a regular market commentary on behalf of RMG. I will be returning to writing at some point during the fourth quarter, and I hope to be able to keep in contact with as many of you as possible so please do let me know whether you wish to receive them in the future (my temporary contact email is stew.rich1968@btinternet.com). I wish all my readers and my colleagues at RMG all the very best for the future regardless of what markets may throw at us. I know that RMG will continue to send fortnightly commentaries on Macro themes, written by Ciaran Mulhall, and on Foreign Exchange markets by Howard Jones. Both are hugely experienced investors in their fields and I would encourage you all to continue reading the RMG market commentaries.

Stewart Richardson

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