July 12, 2013

"Money does not create wealth. Wealth creates money."
-CHARLES GAVE

Wanted: Market strategist, one arm missing. It wasn't just Dr. Richard Kimble, of *The Fugitive* fame, who was frantically seeking answers from a one-armed individual. President Harry Truman, after listening to the equivocations from his team of economists, "On the one hand, but on the other…," famously moaned: "Would someone please find me a one-armed economist?"

For anyone who is following current market commentary, it's abundantly clear that the same could be said about equity strategists these days. Frankly, Evergreen GaveKal is not immune to this conflicted condition. In the guest EVA for May, we shared with you the bullish case espoused by our partner firm GaveKal's Anatole Kaletsky: *Goldilocks and the Ten Bears.*

This month's guest *EVA*, on the other hand (sorry, couldn't resist that one), is from the joint keyboards of Louis and Charles Gave. Its title "Bad Omens" provides a strong hint that Louis and Charles are on the other side of the debate with their close friend and GaveKal co-founder. Being privy to the plethora of daily email exchanges between the various GaveKal team members, I can assure you this is much more than a Charles/Louis vs Anatole debate. From what I can tell, among their top dozen or so analysts and strategists, the bulls and the bears are pretty much divided right down the middle, with a few straddling neutral ground.

Yet, as Louis and Charles point out at the beginning of this essay, the reality is that for most of the world the bears have already been vindicated with, as a jaw-dropping example, Brazil's market crashing nearly 35% this year, in dollar terms. In fact, the formerly hallowed BRICs (remember that once trendy acronym for Brazil, Russia, India, and China?) are down on average 16.5%, trailing the US market by over 30% in 2013 after a major lag last year as well. Further intensifying the pain, bond investors have also been taking their lumps in almost every corner of the planet.

Additionally, those who have sought safety in the "negative correlation" of commodities have once again learned the veracity of Buffett's old adage: the only thing that goes up in a crisis is correlation (even in this relatively mild shakeout). However, there is one very prominent exception to this most recent example that when fear flares up almost everything tends to go down in unison--US stocks.

For most American investors, it is the domestic stock market that is the ultimate focus. In fact, I've been hearing from an increasing number of conservative and income-oriented types who are now comparing their returns to the S&P 500 or the Dow. There's not much I would virtually guarantee in this bizarre world we now live in but one of those is that the next time the market drops 20%, those same individuals will be comparing their returns to cash.   If Louis and Charles are right, as I think they are, that benchmark shift might happen sooner rather than later.

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BAD OMENS
Louis and Charles Gave

In late May we published a debate piece on the near-term outlook for equity markets. Since then, emerging markets have once again lived up to their name by proving themselves hard to emerge from during an emergency (in USD terms, Brazil is down –35% year to date while Chinese valuations are back to

2008-crisis levels); for their part, European and US equity markets have pulled back, while the only salvation has come from Japan (the one market where it's possible to find attractive valuations, accelerating economic activity and liquidity growth feeding off a Tour de France vitamin cocktail). But is this a case of Japan being the best looking horse in the glue factory? In the following paper, we aim to review a number of signs from equity markets that look somewhat ominous. Needless to say, we welcome any feedback on the below.

The question at hand: is this a break-out? The chart over-leaf (on the next page) traces the relative performance of the S&P 500 against long-dated bonds since the Asian Crisis in 1997. Since then, the world has experienced a series of deflationary shocks, each of which has been met by more activism from the Fed and other central banks: i.e.: lower rates and higher monetary base growth. And each time, the excess money allowed for the rise in a few asset classes (TMT in the late 1990s, housing and financial intermediaries in the mid 2000s, commodities, fixed income instruments and emerging markets in the late 2000s…). But each time, the asset price rise was followed by an equity market bust, begging the question of whether the bust that seems to be unfolding in emerging markets is now the third iteration of a movie every investor has seen before (and which few have enjoyed)? Or whether the recent correlation between bonds and equities indicates that the repeated deflationary shocks are a thing of the past and nominal GDP growth will accelerate from now on? Could we be at a structural turning point?

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1– A first bad omen: fewer markets rising. In the chart below (left), we take the top twenty equity markets in the world and compile a diffusion index that shows how many rose in the previous six months, against how many fell. So when the grey bar is at +20, global equity investors have made money in every major market; when the index reads –20 they found nowhere to hide. And when the number is in negative territory, it simply means that more markets have fallen then risen in the previous six months. The red line is the performance of the S&P 500. Since 1992, we have had 14 occurrences in which more stock markets were falling than rising. In 10 of these 14 occurrences, the S&P500 fell by at least –10%. In the other 4, the S&P 500's performance hovered between 0% and –10%. As things stand, the S&P 500 has recorded a double digit rise in the past six months, a major divergence.

2– Another bad omen—collapsing silver prices. Unfortunately, it's not as if, lately, equity markets have been the only place to lose money. Indeed, as every gold bug has rediscovered in recent months, precious metals have again proven that they are anything but a safe-haven. Still, drops of 30% or more in silver prices do not happen that often: looking back at the past 100 years, such drops have only occurred 11 times. And interestingly, each one of these massive declines marked a significant change in the world financial system. (See chart below, right.)

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To cut a long story short, the investment rules after large declines in precious metals were almost always totally different from the rules which prevailed before the fall. More worryingly, each such decline was accompanied by a massive recession/depression somewhere in the world and almost every time by a recession in the US (grey shaded areas in chart above, right), the only exception being 1983-1984 when the Latin American depression did not trigger a US recession but instead a collapse in oil prices.

3– Beyond stocks and precious metals. Let us imagine a pension fund whose assets are invested conservatively with 40% in global fixed income, 40% in global equities, 10% in the world's largest hedge funds (Bridgewater, Man-AHL, AQR…), 5% in gold and 5% in private equity. Leaving aside the private equity illiquid pocket, our pension fund will have basically lost between 5% and 15% of its assets across the board in just a few weeks.

Following these widespread losses, will our pension fund look to a) increase its risk and average down on the more beaten-up asset classes (i.e.: emerging market equities) or b) reduce its risk and use the recent rise in yield to immunize liabilities (or reduce its portfolio's volatility)? In a world directed by VaR* measures, CAPM** models, and CYA*** boards, is that even a question?

4– Falling inflation expectations. Not that the imagined pension fund in question would automatically be wrong in increasing its fixed income allocation. After all, inflation expectations in the US (and almost everywhere) are falling like a stone, implying that fixed income instruments now offer a much higher real yield than the recent rise in nominal interest rates might imply:

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And these collapsing inflation expectations bring us to the chart above for, since the Asian Crisis, each time US inflation expectations fell below 1.5% (i.e.: a deflationary shock), US equities took a beating. That [dotted] line in the sand is approaching fast. Just as worryingly, the collapse in inflation expectations, combined with the rise in nominal rates, means that the recent rise in US Baa real bond yields is the biggest one witnessed since the start of 2009—when bond markets were massively oversold.

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Of course, one could argue that the recent rise in yields is nothing to worry about; that it is just the side effect of the air coming out of the bond market bubble (see our Quarterly Strategy Chart Book 2Q12—The Global Bond Yield Conundrum). Unfortunately, recent weeks have shown that such an attitude may be too carefree as most assets have reacted badly to falling bond prices. Indeed, if the recent global equity market sell-off can be laid at the feet of the 100bp move higher in US bond yields, it is hard to know how another 50bp increase in real rates will be digested? Looking at the bond vs equity trade-off today, it is easy to imagine Woody Allen saying "we have reached a cross-road. One way (rising yields?) leads us to despair and annihilation, the other (falling yields?) to certain death. I hope we choose wisely."

*Value at Risk **Capital Asset Pricing Model ***Cover Your A_ _

Conclusion

So here we are, with:

- China, the single biggest contributor to global growth over the past decade, slowing markedly.
- World trade now flirting with recession.
- OECD (developed countries) industrial production in negative territory Year-over-Year.
- Southern Europe showing renewed signs of political tensions (i.e.: Portugal, Greece, Italy…) as unemployment continues its relentless march higher and tax receipts continue to collapse.
- Short-term interest rates almost everywhere around the world that are unable to go any lower, even as real rates start to creep higher.
- Valuations on most equity markets that are nowhere near distressed (except perhaps for the BRICS?).
- A World MSCI* that has now just dipped below its six month moving average.
- A diffusion index of global equity markets that is flashing dark amber.
- Margins in the US at record highs and likely to come under pressure, if only because of the rising dollar (most of the US margin expansion of the past decade has occurred thanks to foreign earnings—earnings that may now be challenging to sustain in the face of a weaker global trade growth and a stronger dollar).

Lackluster growth? Falling margins (outside of Japan)? Rising real rates? Unappealing valuations (outside of the BRICS)?... Perhaps these make up the wall of worry that global equities will climb successfully. After all, if the British and Irish Lions can win a rugby series in the Southern hemisphere, while a Scotsman wins Wimbledon, then nothing is impossible. Though perhaps the simpler explanation to the above growing list of bad omens was formulated by Claudius who said that "when sorrows come, they come not as single spies, but in battalions".

*Morgan Stanley Capital International, i.e.: world stock index