June 14, 2013

"The great traders that I've known would joke about how their emotions would push them to do the wrong thing. Admitting that part of your brain is working against you is not a sign of weakness—it's the first step towards really doing well in financial markets."
-TERRY BURNHAM, author of Mean Markets and Lizard Brains: How to Profit from the New Science of Irrationality.

In a perfect (investing) world. OK, all you baby boomers out there, be honest. You Generation Xers and Millennials can also 'fess up. You loved the original *Star Trek* series even if you watched it on reruns years later. Although it was made 50 years ago, the producer, Gene Rodenberry, pulled off the illusion of centuries-advanced technology amazingly well. And, of course, computers, just beginning to go mainstream in 1960s America, often played a big role (though not quite as pivotal as in Stanley Kubrick's *Star Trek* imitative 2001: *A Space Odyssey*).

These days, computers are even more ubiquitous than most sci-fi writers envisioned in the sixties and they are increasingly influential in the behavior of financial markets. Yet, as noted in last week's EVA, we all have witnessed over the last 25 years that they don't seem to operate with the cool logic and stoic discipline of *Star Trek's* Mr. Spock.

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If Spock, in his uber-rational way, were to somehow program all the computers that interface with the financial markets, I suspect we'd see radically different price patterns. What if Spock set up two, just two, massive computer networks—one to buy whenever prices deviated excessively below long-term fair value and another to sell whenever they ventured too far above? The idea being to keep the value of a broad index, like the S&P 500, extremely close to its historical mean valuation, or as close to equilibrium as possible.

Besides the fact that it wouldn't be nearly as much fun (my God, what would we all do without Jim Cramer screaming "buy, buy, buy" every business day?), how would Spock determine where the "fair value" line lies? Fortunately, he would have a lot of credible research at his disposal to make a reasonable stab at such a trend line.

First, he would likely note the long-term link between earnings growth and stock prices. The obvious logic to this correlation would no doubt appeal to his Vulcan sensibilities. For decades, US corporate profits, adjusted for inflation—through wars, booms, "normal" recessions, one Great Recession, and, of course, an even greater Depression—have risen at about a 6% annual rate on average. Thus, he would likely deem that a reasonable pace at which stock prices should escalate over time.

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Second, he might also seek to assign a price-to-earnings ratio that has been the average over as long a period of time as possible. A century might please him since that's a nice round number (Vulcans are notoriously fond of round numbers—and pointy ears).

Third, being congenitally brilliant, as is true of his entire race, he would seek to find a realistic earnings number on which to base his P/E ratio, realizing that profits are highly cyclical, just like the economy that drives them. Accordingly, he would avoid the simplistic trap of using earnings at either the top or bottom of an economic cycle; rather, he would use relatively basic calculations to determine an approximate midpoint. Despite his innate Vulcan precision, he would appreciate the wisdom of a celebrated human, John Maynard Keynes, who said it is better to be approximately correct than precisely wrong. He would also be flexible enough to recognize a structural improvement in profit margins that would argue in favor of using a higher P/E ratio now versus 60 years ago. He would easily discover that blending points two and three, the "Spock P/E" would be 16 over the last 100 years and 20 over the last 60.

Fourth, he might look at what stock prices have traded at on average relative to the size of the economy. It's possible his confidence in this approach might be enhanced knowing that Warren Buffett—who, despite being a mere earthling, managed to make himself one of his planet's wealthiest inhabitants—favors this metric to determine whether stocks are cheap or dear.

Let's stop on number four and consider a very simple graph.

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Though this is just a guess on my part, somehow I don't think Mr. Spock would set his fair value price at 150% of GDP, approximately where it is at the present time.

A Vulcanic dialogue.

Why is it that stock prices deviate so frequently and so drastically from their long-term "value line?" Even this casual *Star Trek* fan doesn't believe Spock would hesitate for one nano-second to say: "It's your silly human emotions."

But, wait, I reply, defending my species, "what about extenuating circumstances?" "Yes," he would say in his inimitable flat (and slightly condescending) tone, "there always are—at least if you let your investment decisions be ruled by your emotions—let's consider the present case in point.   Tens of millions of your species are being misled by a handful of specious humans that you call central bankers.   Haven't you suffered enough at their hands already?"

"Well, now that you mention it…," I stammer. "Look," he goes on, exhibiting a rare glimmer of passion as he warms to the subject at hand, "the 'extenuating circumstances,' as you refer to them, right now come down to the fact that your planet's most important central banks are forcing investors to take risks they will eventually regret. The data are unambiguously clear about that."

"Not according to the financial press!" I retort. "Every day on television I hear an almost endless procession of supposed experts saying there are all kinds of reasons why stocks should be this high and will go higher."

"You mean Bubblevison and emphasis on 'supposed,'" he drily notes. "Try to use the rational part of your brain, as hard as that may be for you humans. Last week you wrote that the Japanese market fell 20% in two weeks despite the fact that Japan's central bank is producing money at a rate equivalent to $2.5 trillion in your country. Doesn't that prove anything to you?"

"But the US stock market isn't Japan. We're special."

"You mean because you have such inspired leadership? Have you noticed how your Congress has completely abandoned any effort to address your absurd budget process or reform your utterly irrational tax code? When was the last time your elected representatives actually tried to make it easier for your economy to grow instead of constantly making it harder?"

"They don't have to," I reply, with undisguised disgust in my voice, "as long as the Fed is printing money like Zimbabwe they can do what they do best: Create more rules that no one can possibly comply with."

"Now you are sounding like a Vulcan. Keep that up and go finish your newsletter."

The fadness of crowds. It's hard enough to write a weekly newsletter without having to deal with your inner Spock. Yes, we all have that ultra-rational part of our psyches. However, it is much more developed in some, like Buffett, who don't seem to be wired like mere mortals and routinely exploit the stock market's wild oscillations.

And in the real, non-Vulcan controlled, world we live in, wild they are. Because markets are a place where our emotions collide, they are inherently unstable. The computers we employ to make us less emotional work just fine most of the time, and then, all of a sudden, they interact with our worst emotions, greed and, especially, fear. The net result is that we get a series of events that is mathematically impossible.   Allow me to give you a recent example…

My ultra-cerebral pal, Grant Williams, recently gave a speech to a group of financial pros in Singapore (you can access the YouTube of his excellent presentation here). In it, he points out that the statistical probability of gold having two consecutive down days as severe as occurred in April is equivalent to finding one specially marked dollar bill out of stack of the trillions of dollar bills that represent the US debt stock. In geek speak, this was nearly an eight standard deviation event.

The truly remarkable thing is that, based on recent market history, this wasn't all that remarkable. The crash of 1987, the Long-Term Capital hedge fund debacle in 1998, the tech bubble, the tech collapse, and the 2008 market meltdown were all literally off the charts when it comes to statistical probability. Clearly, something drives asset prices besides rational pricing models, á la Mr. Spock.

Because there are so many new *EVA* readers, I'm going to do something that he would never do, something in strict violation of the Vulcan code. In fact, it's a riff almost worthy of the enormously ego endowed Jeff Gundlach, to whom Barron's refers as "the new King of Bonds"—but with a very un-Gundlach footnote.

Japanese stock and real estate bubble—I called it. Tech stock bubble—called that one, too.

Real estate and lending bubble—yup (click here). Chinese stock bubble in 2007—got that one right almost to the month (click here). Commodity and emerging market bubbles in 2008 (click here)—well, this is getting tiresome, even for me! (Please click on the links above if you would like to view past EVAs on the latter three bubble-trouble predictions; the Japanese and tech manias predated this newsletter.)

Now let me rip myself off my pedestal and munch on some humble pie. With almost all of these I was woefully, painfully early. As the new Bond King himself said in a speech I heard last month, when it comes to investing, being early is a synonym for being WRONG. In the case of the Japan and US tech stock bubbles, I was literally 100% early!

Let me further humble myself (trust me, I've got a lot of material to work with!). Unlike so many of my money management peers, I wasn't trained to be a chief investment officer, a portfolio manager, or even an analyst. Rather, I was educated to be a filmmaker (I can visualize all those new *EVA* readers unsubscribing almost in unison next week).

For most of my 34-year career, I viewed my lack of traditional financial education as a handicap to be overcome. Only very recently has it dawned on me that it might have been an advantage because movies are all about emotions (perhaps they should have been called "emotion pictures"). Not having been inculcated at an early age in the supremacy of "the data" may be one of the reasons I've been able to continually question the collective wisdom of the markets—at least when they've reached extremes that can only be explained by emotions run amok.

But, let me tell you, it's never a fun experience to fight the crowd.

The loneliness of a long distance forecaster. The curse of being a contrarian is that you're almost never happy. When markets are effervescent, and prices are extended, you are continually issuing unwanted words of caution. And because trends tend to overshoot going up, as well as going down, your views are contradicted on almost a daily basis—until the reversal point suddenly is reached.

It's not any easier being bullish when prices are falling. Most investors just want to stop the bleeding. They want to curl up in the fetal position, in the safety of cash, and the last thing they want to hear is why they should be buying instead of selling. Besides my repeated exhortations to buy almost everything except Treasury bonds in late 2008 and 2009, I was also advocating buying during the August massacre of 2011. Those were times I felt just as out of synch as I did warning about the housing bubble back in 2006 and, frankly, as I do right now. (Thankfully, the Evergreen Investment Team has been hugely supportive during all of these episodes.)

It's only when the market is gently rising and staying reasonably close to that 6% long-term trend line that I feel comfortable. (By the way, with dividends factored in, a 6% average price increase is what produces the stock market's long-term return of 9% to 10%.) Yet, as a direct result of those pesky emotions, the market doesn't spend much time hugging that 6% upslope. In fact, years when the stock market produces its "normal" total return of 10% are quite rare (only four between 9% and 11% since 1890!).

One of the most Vulcan-like investors I know is John Hussman. While he is far more quant-driven, he and I seem to go through the same pattern of being out of step with the herd (although he did miss the opportunity to switch to bullish back in 2009, as he has repeatedly admitted). Despite that "miss," his long-term record is admirable and several of his recent essays have pointed out that the most dangerous markets are those that are overbought, overbullish, and overvalued (i.e., like now) and especially when interest rates start rising. You may have noticed that the latter has been occurring rather forcefully of late.

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It may have also come to your attention that a number of asset classes—whether commodities, bonds, or overseas stocks—are behaving in an increasingly wobbly fashion of late. In fact, the US stock market is one of the few that is still behaving as if the Fed's printing press has rendered downside risk extinct.

What are the odds that will continue, given what is unfolding around the planet right now?

And then there were none... Few would confuse the professorial and follically-challenged Ben Bernanke with the dashing William Shatner circa 1965 (the current Priceline version, however, would be much more of a horse race). Yet, there is little doubt that the skipper of the Fed's starship Improvise wants to transport investors light years away from their comfort zones.   His mission, which he's often had to draw up on the fly, has been to force normally risk-averse savers to venture into the outer reaches of the investment universe where the black holes of unquantifiable dangers lurk.

Consequently, and as noted in numerous prior *EVAs,* ~~Captain~~ Chairman Bernanke has eliminated almost all safe harbors. He's basically given investors the choice to travel with him on his exciting voyage to parts unknown or see their principal gradually eaten away by inflation.

Bill Gross, the still-reigning King of Bonds in the minds of most people, has stated that almost everything is inflated as a result. In my view, that's an important point. Unlike in the late 1990s with tech, or six years ago with real estate and lending, there are no extreme bubbles. It's more like a general 20% to 30% overvaluation. Or at least it was…

Two weeks ago, our guest EVA was based on GaveKal founder and partner Anatole Kalestky's clever piece, *Goldilocks and the 10 Little Bears*. In it, he adroitly attempted to debunk the worries of folks like John Hussman, Bill Gross, yours truly, and his longtime partner, Charles Gave. However, based on recent market action around the planet, I would counter Anatole with a slightly different title, *10 Little Indians*.

For those of you who don't remember the Agatha Christie murder mystery by that name, the "Indians," (actually, guests at a remote home) start gradually expiring until…well, I don't want to give away the plot. In the last few weeks, we've been seeing a global financial market reenactment of Dame Christie's wildly successful play, as one market after another succumbs.

Illustrating this trend, on Wednesday of this week, The Wall Street Journal ran the following headline:

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The number of "Indians" still standing is shrinking by the day, but the US stock market is clearly among the survivors. The preeminent question in the minds of most American investors is, or should be, whether our little Indian will escape the slings and arrows of outrageous market misfortune.

Actually, I think what’s been happening recently could be a good thing as long as it doesn’t get out of hand on the downside. Reminding investors that asset prices fall occasionally before valuations get too detached from reality is beneficial. It’s also quite obvious that there is some deleveraging occurring now, such as with hedge funds that have used generous amounts of debt (often borrowed in yen) to goose their returns. These "carry trade" players are unquestionably feeling some serious pain right about now, which is probably why the yen has been rallying furiously despite the frantic efforts of the Japanese government to weaken it. Therefore, the recent "tumult" could be a healthy cleansing process.

If you sense a "but" coming, you can go to the head of the class!

Vulcanize your portfolio.

My usually bullish partner and mentor, Charles Gave, has definitely captured my attention lately. He has authored a number of essays for GaveKal clients with a view diametrically opposed to Anatole’s sunny outlook.

Essentially, Charles is becoming increasingly concerned about some kind of deflationary accident due to the failings of the $11 trillion global QE programs (yes, they really have created that much funny money). Again, Charles is almost a perma-bull so this is truly out of character.

It might seem odd to be worried about deflation in a world of no-holds-barred money creation, but current inflation trends underscore his point. The reason is that recurring *EVA* topic: the velocity of money which is still falling, even in the US.

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Bill Gross, in his most recent newsletter, sounded as if he had done the Vulcan mind-meld with Charles.   (Click here to access this essay, one of his best in my opinion.) He cites five reasons why the Fed's QE is backfiring and actually working against a recovery.

Charles adds a sixth, which I admit I really hadn't considered until I read it from him: Since millions of investors need a certain cash flow to live on, when rates are pushed down this low, they need to allocate more of their capital to the income side of their portfolio. This takes funding away from more entrepreneurial pursuits, including the stock market but also private business investment.

As Bill Gross writes toward the end of his June letter, *Wounded Heart*: "Perhaps when yields,…and expected returns on financial and real assets become so low, then risk-taking investors turn inward and more conservative as opposed to outward and more risk seeking. Perhaps financial markets and real economic growth are more at risk than (Dr. Bernanke's) calm demeanor would convey."

It's hard not to see the irony in all of this: The Fed does everything in its power, and that of its printing press, to generate risk taking behavior. Yet, despite some successes in this regard, the net result is receding "animal spirits." Nevertheless, he soldiers on in the belief that the next QE will be different. You may have seen that even the original Bubblemeister, Alan Greenspan, has warned that the quantity of quantitative easing has become excessive.

So, what would an uber-rational investor, say from the planet Vulcan, do to protect against a deflationary bust like the Asian crisis or the housing implosion?   As Charles points out, long-term bonds, due to the aforementioned pounding, now offer reasonable value. Should fears of deflation be realized, they would likely provide outstanding returns from here. After an extended period of abstention, Evergreen is nibbling on some long-term bonds in case Charles is right.

Long bonds join the expanding collection of hedges we have been putting in place to wrap some protection around our clients', and our own, portfolios. Given that out of 57 forecasts tracked by Bloomberg, with not one of them calling for lower 30-year Treasury yields by the end of 2013, this certainly qualifies as a contrarian play.

It's possible that Ben Bernanke, after years of boldly going where no Fed chairman has gone before, is realizing that his starship Improvise has traveled too many light years into uncharted space. He may be deciding it's time to head back to planet Earth before the point of no return is passed. Undoubtedly, that would be the wise counsel of his ever-rational First Officer. But, then again, Captain Kirk frequently ignored Mr. Spock, often to his regret.

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