# ECONOMIC INSIGHT

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## Beware the Pounding of Hooves

Figure 1 | **US Equities: a dip too far?**


*Source: @charliebilello*

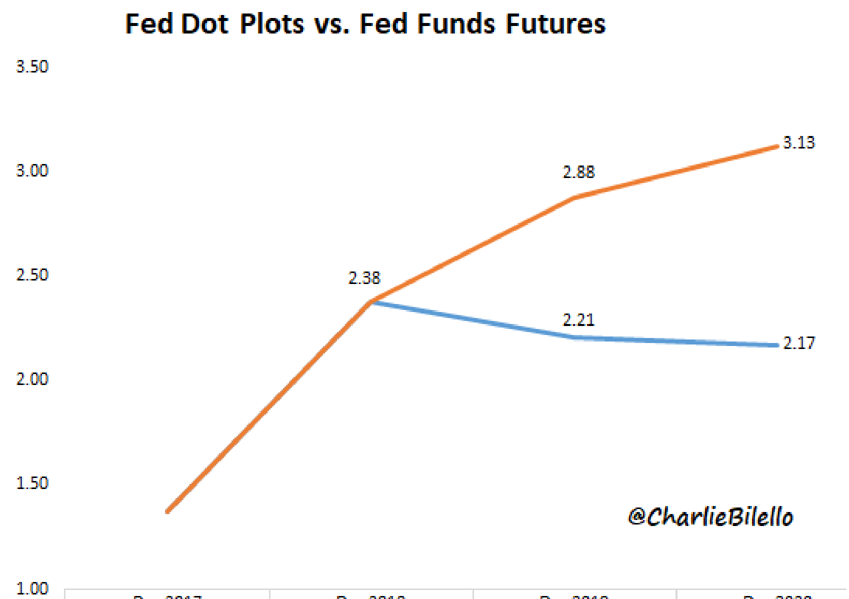
### Marching to different drums

Frankly, Figure 1 scares me. Not the chart itself, of course, as it is too long-term to influence directly the trading of hard-core chartists and their algorithms but rather the behaviour patterns it depicts. I have written before about lemmings and wildebeest. The former have had five major culls in the last 8 years, the most recent in Q4 of last year, and any that are left are now in danger from the current stampedes to 'buy the dip'.

After falling by over 9% in December the S & P 500 is up over 11% so far in 2019 with valuations yet again heading skywards. Not everyone is buying, however, and investors seem to be separating into various overlapping herds.

At the risk of over-simplifying, I am going to write here about three herds, US Individual Investors, Speculators and Institutional Investors, each with sub-herds stampeding in different directions and even some moving quite cautiously. Once again, I am obliged to concentrate on the US, which is where most of the money is or comes from and also the home of the imperious Federal Reserve.

Figure 2 | **Mind the gap**




| | Dec 2017 | Dec 2018 | Dec 2019 | Dec 2020 |
|---|---|---|---|---|
| Fed Funds Futures | 1.38 | 2.38 | 2.21 | 2.17 |
| Fed Dot Plots (Median) | 1.38 | 2.38 | 2.88 | 3.13 |

*Source: @charliebilello*

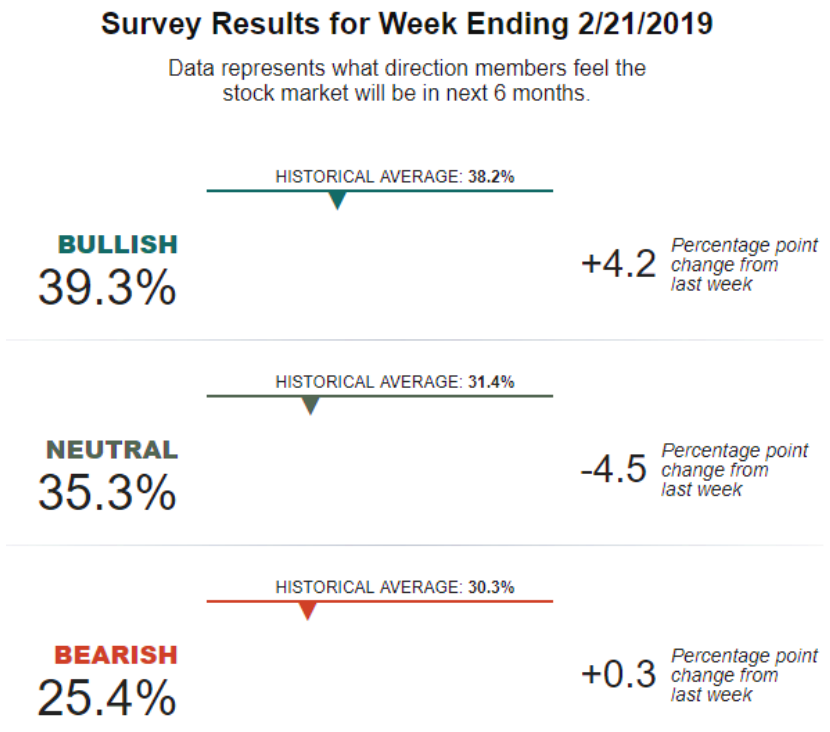
## A Powell 'put' after all?

Figure 2 from the tireless Charlie Billello of Pension Partners in US is also quite scary in highlighting the major difference between how the FOMC attendees forecast in December their own future rate decisions (the dot plots) and what the market thinks right now via futures prices. Since December the FOMC has had another meeting, Chair Powell has held a post-match press conference, minutes have been published and many speeches delivered by Fed luminaries. This appears to have convinced Wall Street that, after some huffing and puffing, Mr Powell has come round to the view of his three predecessors that the Fed must prevent a stock market crash no matter what else is going on (the so-called Fed 'put').

There is considerable evidence for this and it represents a significant turnaround from all the talk during 2018 of 'removing the punchbowl' via Quantitative Tightening. The prospect of no more rate hikes for a while and perhaps even a cut may be hitting the headlines but the even more important message from the Fed is that it will slow down the reduction in its balance sheet, which had fallen by nearly $500bn to $4tn since 2017.

Regular readers will be aware of my increasing scepticism over the central banks' economic impact but there is little doubt that providing market liquidity can directly affect asset prices. Accordingly, the Fed's latest decision to roll over most if not all its holdings of maturing US Treasuries and Mortgage-Backed Securities will at the very least, provide some breathing space in the next outbreak of volatility. Moreover, it chimes with the actions of other major central banks. The PBoC and BoJ are still injecting more liquidity while the BoE and ECB appear to be content to carry on indefinitely replacing maturing assets. It is, however, very possible that the central banks, even the mighty Fed, are losing their sway.

Figure 3 | **American Association of Individual Investors (AAII) Survey: Spring is in the air**




*Source: **AAII***

## US Individual Investors are gung ho again

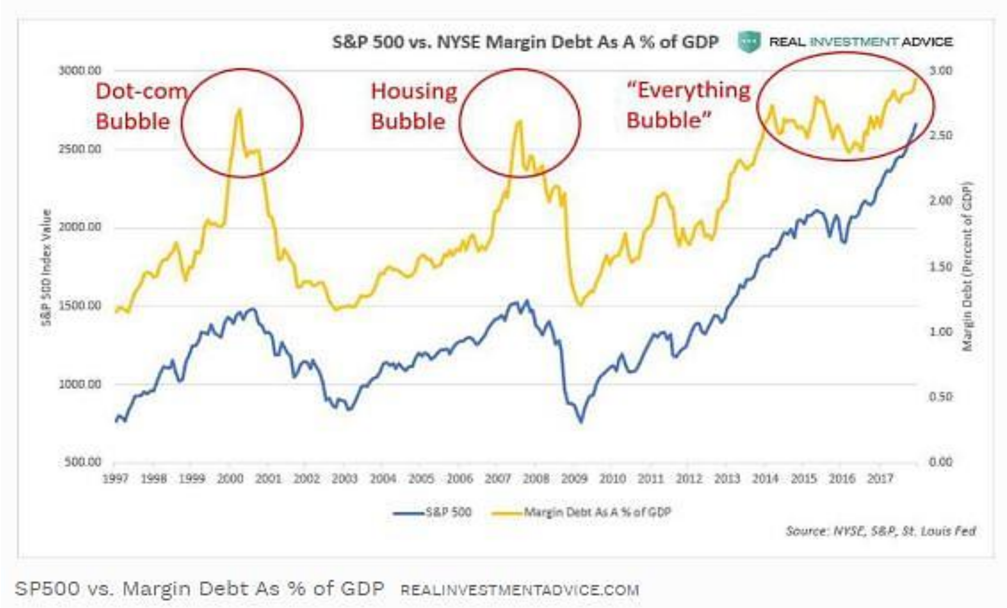
The AAII runs a weekly survey of its 150K plus members and Figure 3 shows the latest results. This confirms the dramatic improvement in the Net Bull-Bear Spread which ended 2018, after a torrid December, at almost minus 30% but rose to plus 13.9% last week. This is quite a turnaround, which itself followed a turnaround from the turnaround in October.

In fact, the swings in sentiment plot something that looks like a heartbeat graph. To say that some of these investors act like lemmings from time to time is not to disparage their knowledge of financial markets but they do tend to follow rather than lead trends. Accordingly, they can be caught out when they are 'buying the dips' at the same time as institutional investors are taking their money off the table.

Momentum investing is fine until it isn't. Investing in growth shares such as the FAAMNGs rather than value shares works well as long as the growth keeps coming. Index-tracker funds, especially low cost ETFs, save on fees but can cost dear if there is insufficient liquidity when everybody tries to get out at the same time. For now the sun is shining again: the Fed has changed course, some sort of trade deal with China looks probable, unemployment is close to records lows, inflation is subdued and higher average earning are boosted by tax cuts.

Inevitably, the FAAMNGs and other tech stocks are back in favour as are small caps (which are not really so small in the US) and junk corporate bonds. It almost seems churlish to point out that US Individual Investors will be badly hit if the 'seond leg down' pattern in Figure 1 is repeated.

Figure 4 | **Spectators at the margin: New York Stock Exchange Margin Debt**




*Source:* ***RealInvestment.com***

## Speculators: Relishing not fighting the Fed

This group of investors largely consists of hedge funds but also includes individuals, family offices or institutions deliberately taking big risks in the pursuit of big returns. Some use the leverage of derivatives, some borrow directly to fund their punts and some do both. Figure 4 is a useful rather than complete indicator of just how financially exposed the Speculators can be. Although this group includes notable contrarians it can be surprisingly herd-like when it comes to certain trends and their hyperactive trading is reflected in the CNN Greed and Fear Index. The Index is inspired by one of Warren Buffets more celebrated *bons mots: 'Be fearful when others are greedy and greedy only when others are fearful'*. It is another measure of investor sentiment but is calculated on trading trends and volumes rather than the subjective AAII survey.

Figure 5 displays the many wild swings in the Index over the last three years, which, at the risk of pushing a metaphor too far, can probably be described as stampedes. One can almost hear the pounding of hooves back from Extreme Fear in Q4 of 2018 towards Extreme Greed perhaps as soon as March. I often find these charts quite difficult to read but Figure 5 suggests that the Venerable Buffet's advice would have worked quite well over the last 12 months! Right now the Speculators seem to have replaced 'never fight the Fed' with 'the Fed has our back'. US stocks, large and small, are their main bets but they are also piling into Chinese equities as the PBoC is sounding even friendlier than the Fed. Oil is another 'rehabilitated' favourite, rallying by almost 24% so far this year and after its eye-watering 35% dive in Q4 last year.

Because of their clout and their mandates, hedge funds can use derivatives to increase their leverage in trading currencies as well as commodities, equities and bonds. The dollar proved to be a winner in 2018 against most others except, intriguingly, the unlikely duo of the Swiss franc and Mexican peso but profit-taking knocked it back in January. Fancy fees have to be justified by fancy returns, which in turn require taking big risks. Sam Goldwyn's classic 'include me out' somehow springs to mind!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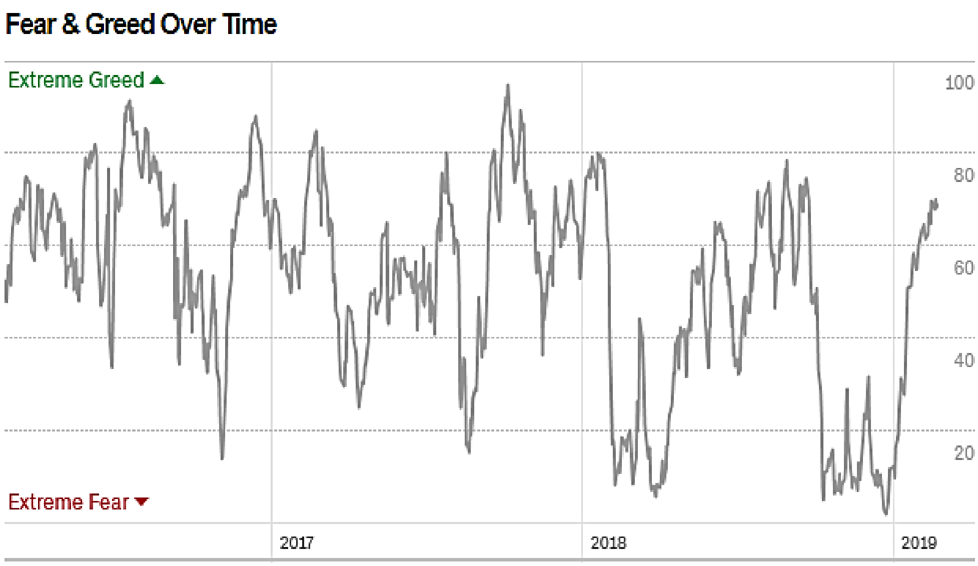



*Source: **CNN Business***

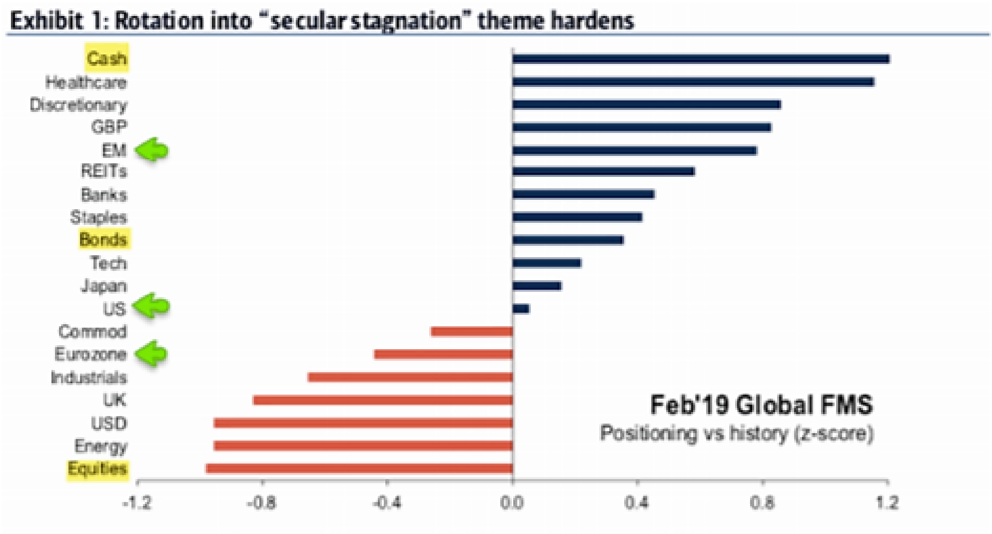
## Institutions are drawing in their horns

Politics continues to command attention from global investors despite their traditional preference of ignoring it. Trade wars and Brexit are still the cause of uncertainty but I sense even once they are resolved other issues will come to the fore: climate change, inequality, public services and migration? On the economic front, slowing growth almost everywhere and subdued inflation also present challenges for fund managers trying to improve or match their quartile performances over the last decade since the Great Financial Crisis, when the tide seemed to lift all the boats.

Figure 6 from BAML highlights the move away from equities (especially US equities) into the highest cash holdings for 10 years and other signs of caution include the increased weighting in Consumer Staples, government bonds (despite negative yields out to 10 years in Switzerland and Japan and 5 years in much of Europe and the plunge below 3% in Q4 of the entire US Treasury yield curve) and Gold's finally testing new 5-year highs. However, money has somehow to be made and investors still seem reluctant to abandon Consumer Discretionary and Tech for the steadier-yielding Utilities and Energy sectors.

Despite a surge in private sector debt there is a strong appetite amongst some institutions for higher-yielding BBB or junk-rated bonds. There have been some forays into Emerging Markets, especially China, but not yet into UK or European equities. There is much talk of the revival of value investing. Much of this makes sense and it is hard to argue with a cautious strategy of cash, investment grade bonds and gold mining stocks balanced by cash-generative value stocks provided they are liquid. We shall find out soon enough!

Figure 6 | **BAML Survey: Getting more cautious**




*Source: **B of A Merrill Lynch Global Fund Manager Survey *data since 2006 for commodities & realestate, since 2001 for all others***

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