Aviator Update – April 2020
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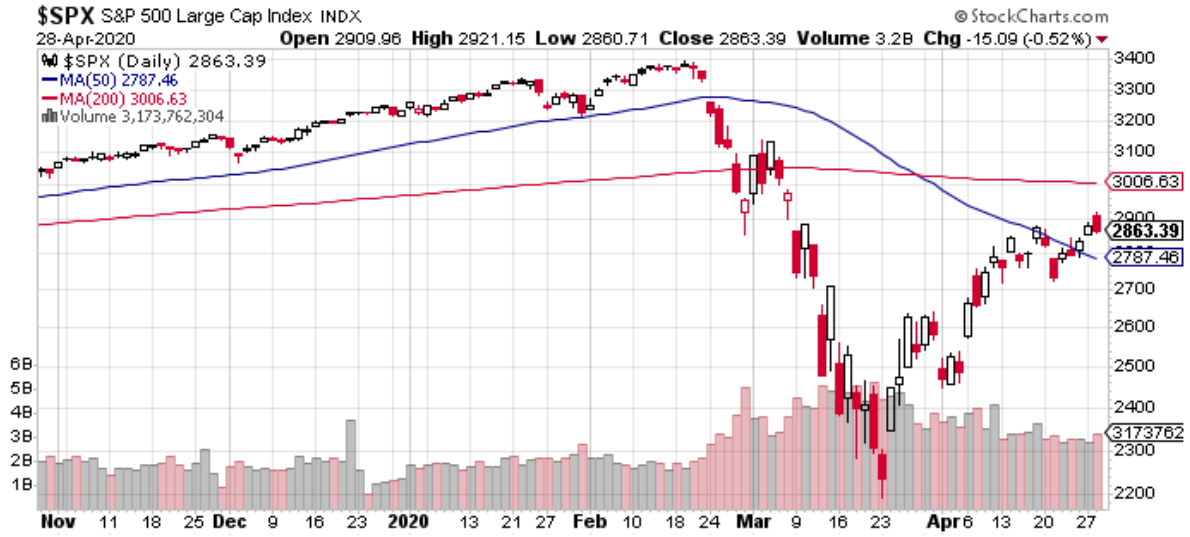
AVIATOR CAPITAL

Okay, now what… Part 2…

A month has passed us by and not much seems to have changed. I don't know about you, but every day feels the same at the moment. I still can't go to the gym. The pub is still shut. At least the weather in my part of the world has been good and allowed me to take plenty of long walks and think about finance (staying well clear of other people, of course).

The world is not boring for a finance nerd at present. There's so much I could talk about at the moment that it would be easy to write hundreds of pages of commentary ("easy" that is if you take away any time restraint). Best I focus on the biggest things consuming my thoughts.

The stock market reaction has been relatively as we would expect from the historical playbook:



Little dip… little bounce… big selloff…bounce… I admit the scale of the recovery to date has surprised me. Given the incredibly murky outlook, the historical precedent would have the S&P500 consolidating at the moment in a range capped by the reflection bounce highs around 2600 as participants collectively ask "okay, now what?"

When you scan the internet at present, you quickly realise something… The commentators with a positive market view almost exclusively have a "technical" approach to the market ("chart goes up and to the right… buy, buy, buy") whilst those that approach investing from a fundamental perspective (myself included) are very cautious.

We can take this analysis a step further. It is possible to get a sense of who's doing the buying.

A lot of major broker/dealers have teams engaged in… how do I describe this simplistically… let's go with "modern" investment strategies. And there's quite a bit of interesting commentary to be found out there from some very experienced strategists.

Nomura is well known for its "Quantitative Investment Strategies" ("QIS") desk. I saw some commentary from their QIS strategy desk in the last few days of April with respect to their QIS CTA Model. They estimated that CTA positioning in S&P 500 futures would flip from "-69% short" to "+100% long" on a close above 2901. This comes off the back of their recent analysis of Vol Control strategies, which have been a strong buy since the lows.

Interesting… Let me offer a slightly more "plain English" interpretation;

They run various computer models which in essence are representative of the typical computer-based trading strategies engaged in by their clients and quant trading firms globally. Not "the" model – everyone has a slightly different approach, developed from their research and their goal of developing an "edge" over competitors. Nomura's models suggest that various trading houses that focus on the S&P 500 futures market have been a big buyer in recent weeks and others will get "buy" signals from their models at marginally higher levels which will support a more aggressively "long" position.

There's all sorts of anecdotes supporting the notion that the buyers in recent weeks have been momentum-chasing algorithms and investors with a purely technical approach whilst anyone with an investment strategy that encompasses human input (including many major hedge funds) have been sidelined or even net sellers.

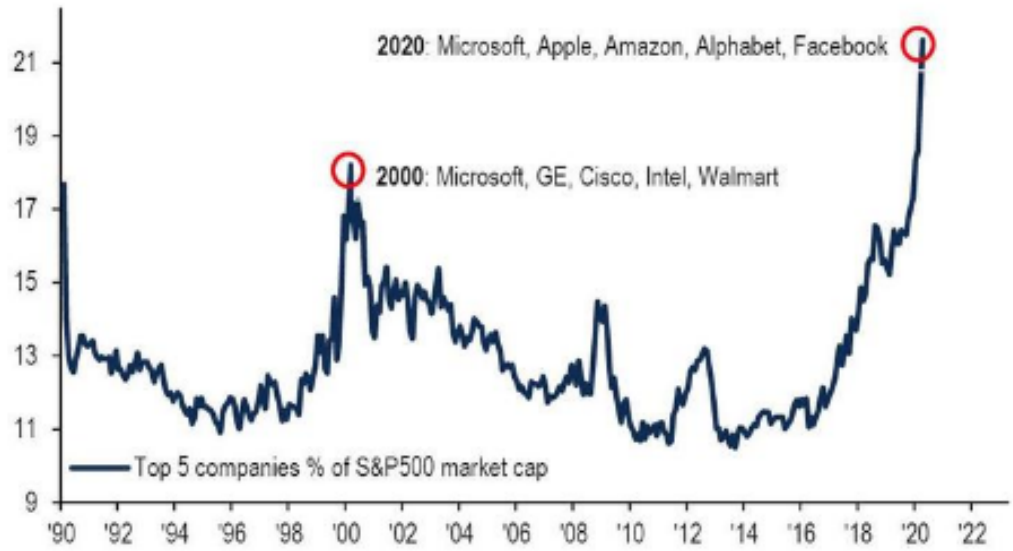
I often refer to the value coming from understanding how money is "run". This is particularly valuable at present.

Remember that this all works in both directions. Take away all other market participants and its possible that momentum-chasers could push a stock, or market index or currency or commodity, or cryptocurrency – anything that's tradeable – to "infinity". We do need to respect that. They care not for "value". But there *are* other market participants and the momo-chasers are not a constant, relentless source of buying pressure capable of always absorbing all the sell orders others throw their way.

If selling pressure results in a breakdown in trend and momentum, guess what happens? The momo-chasers become sellers! That brutal selloff beginning in late February? Understand that some very large funds first sold all their long positions and then some. And they will do it again if their models tell them to.

Drawing on historical precedent, there's other signs that the bounce might not be very durable. Volume has been poor. On an individual share basis, investors have been very selective with what they are buying. In fact, more than 20% of the S&P500 index now comprises of just five shares:

Chart 2: S&P500 now more concentrated in the 5 largest stocks than ever



Source: BofA Global Investment Strategy, Bloomberg

The gains of recent weeks have been concentrated in those companies perceived as the strongest and currently best positioned – those with strong balance sheets have bounced back whilst those perceived weaker companies remain barely above their lows.

This sort of dispersion is not normally a feature of "the bottom". If you're confident of a recovery in the economy and by extension the stock market – truly confident – you don't buy things already at elevated levels. Go grab some bargains! Durable rallies and periods of strong speculative enthusiasm are characterised by participation – everything goes up!

Turning to fundamentals, the data has been, well, terrible. This was expected and I imagine many people think its "market-positive" – there's that old adage along the lines of "the news is always the worst at the bottom". I suspect some are emboldened to buy because of how bad the news is, in an attempt to be contrarian.

I could go on for pages with examples of how bad the data is from all corners of the globe. But we all know that. What interests me more is the data compared with the share markets.

Some of the divergence is breathtaking. Here's just one example, highlighted by veteran economics commentator David Rosenberg. The **green** line is the 12-month forward P/E ratio for the S&P500. The **red** line is from the April Conference Board Consumer Confidence

survey – specifically, the number of survey respondents that feel business conditions are "normal":

Now okay this chart could "normalise" via a massive rebound in earnings – it's not pointing to an inevitable meltdown in share markets. But one way or another this and many similar examples where current economic reality is completely diverged from financial markets *will* normalise.

Historically, there's little precedent to the current economic downturn. Recessions don't normally begin in the services sector. Indeed, a reason often cited as to why the business cycle is smoother than in the past has been the growth in the services sector of the economy – now around 75% of a developed-market economy like Australia and the USA. And yet we've just witnessed a big chunk of the services sector – by far the largest economic sector – wiped out in just weeks!

When economies open again – and I'm actually optimistic that will be not too far away, at least in Australia – services will return. But it's not going to be like flicking on a light. It will take time for things to return to normal. People will want to restore savings depleted. *Businesses* will want to restore depleted savings (or be inclined to actually create some savings for fear something like this will happen again).

Remember what the economy is about – particularly the all-important services sector – one person's spending is another's income. The "paradox of thrift" popularised by John Maynard Keynes - whilst saving money is good for any one person, if enough save at once it reduces aggregate demand and damages the economy.

You can follow this trail further if you like. If demand for "stuff" remains depressed, it would suck to be a major producer of "stuff". Say… China…

So, the questions are: what damage has already been inflicted on the economy and what damage might still be caused even when things return to something resembling what we would refer to as "normal"? A sustained period of reduced demand means reduced revenues which means reduced corporate profits. Reduced demand for employees means elevated levels of unemployment, means individuals having difficulty meeting mortgage payments. I'm sure you get the picture. The economy will restart in the not too distant future, but the bad news doesn't necessarily cease at that point.

"Stimulus":

The stimulus response globally has been pretty good. But to restate the conclusions reached by those analysts that have reviewed the various stimulus packages in detail, none will fully offset the economic damage.

Remember that the stimulus is broken into two pieces – government ("fiscal") and monetary.

In Australia, the monetary stimulus has seen the RBA slash official interest rates to 0.25% and for the first time ever engage in "quantitative easing" ("QE").

As I mentioned a couple of months ago, QE was an inevitability coming straight from the playbook drafted during the global financial crisis. I've written at length since the GFC about what QE is and isn't. It's still very poorly understood, which is expected because it requires having a solid understanding of the monetary system, which few people actually have. The fact that it's now a thing in the little Aussie market might make it a little easier to describe and understand so let's briefly have another go...

The RBA announced in March that it will begin quantitative easing by purchasing government bonds in the open market amounting to around $5 billion per day. They stated their goals were to target a 3-year bond interest rate of 0.25% and to ensure an orderly functioning of the market.

So they wade into "the market" and buy government bonds. Bonds issued by the government that pay a certain interest rate ("yield") and are currently held by investors. Their purchases are funded by the creation of new bank reserves – "money". This is why QE inherently gets simplified down to "printing money".

They started not many weeks ago buying $5 billion in government bonds each day. This has dwindled to a small fraction. Given the small Aussie market, I'm going to put forward a suggestion as to why bond purchases have eased right up;

They buy bonds – an interest-bearing security and replace it with cash which earns, well, practically zero. I posit that the holders of bonds – entities such as the banks and insurance companies are effectively saying; "RBA, why do you want to buy all our bonds… why you take our interest income away from us?"

QE pumps cash into the interbank market. And it comes at the expense of robbing institutional investors of interest income. It does not pump money into the economy. It does not provide the banks more money to lend. Its an asset-swap.

The central bank's key role is to ensure the smooth functioning of the interbank market. In overseeing this, they conduct a form of "QE" all the time – it's called "open market operations". As the Australian QE experience has already shown, if the interbank market is functioning normally, there's no need for QE and it really won't achieve anything.

"Normally" is a key word here. And with that, let's turn our attention to the US.

The major market selloff beginning in February resulted in – and partly caused – money markets to become very strained. The US Federal Reserve predictably pulled out their playbook from the GFC and enacted some "QE". Let's see… we have:

The "Term Asset-Backed Securities Loan Facility", the "Commercial Paper Funding Facility", the "Money Market Mutual Fund Liquidity Facility", the "Primary Dealer Credit Facility", the "Secondary Market Corporate Credit Facility", the "Primary Market Corporate Credit Facility"…

I'm pretty sure I will have missed one or two others.

A little more than just buying a few government bonds! But the concept is the same – they are wading into these various areas of their financial markets and providing "liquidity" via purchasing bonds in order to do their best to ensure liquidity and "normalcy" in these markets.

Some of what they are doing stretches the boundaries of what's permitted under their charter and there is no doubt some of this amounts to a covert bailout of rich investors… but we'll save that for another day.

Right or wrong, from a markets perspective, this fire hose of liquidity is unequivocally positive. It does help achieve (but certainly not "guarantee") "normalcy" and reduces the potential for major market dislocations.

But understand that this monetary stimulus provides very limited "stimulus" – it doesn't help restore revenue to businesses. It doesn't help individuals who have been laid off pay their mortgage.

The Fed is emboldened to take major action thanks to the last time. This was all new in the financial crisis of a decade ago and nobody really knew what the outcomes would be. Thankfully, nothing "bad" happened and thus provided the confidence to do the same again only a little more aggressively this time around.

Indeed, many commentators are keen to highlight that this simply looks like a double-down on the last bailout with little regard to any fundamental factors that maybe need addressing. I completely agree. Both the fiscal and monetary stimulus implemented in the US will disproportionately benefit the wealthy and only serve to exacerbate the chasm between the "have's" and "have-not's". But that too is a story for another day…

It would be remiss of me not to mention Europe. They are probably the ultimate example of squandering the opportunity to fix things.

If you recall, condensing down the European Debt Crisis to one cause, it is because no single country has control over their currency. They all use someone else's currency which they don't control. Unlike other sovereign nations, they are "revenue restrained" and can run out of money.

Trade imbalances stemming from pasting together vastly different economies under a common currency (and thus exchange rate) resulted in debts accumulating in some parts of the union. When economies weakened during the global financial crisis, debt servicing became a major issue. The solution was some bailout payments and forcing affected nations into strict government spending limits in order to try and get their finances in order.

It's sad that "austerity" is cited as one reason why Italy's coronavirus experience has been so devastating – reports have been that their hospital system barely functioned prior to the current crisis owing to government funding restraints. Their hospital system became instantly overwhelmed.

Economically, we're almost back to the post-global financial crisis years. The government spending required to fight the virus at a time when the economies are weakened is seeing debt levels rise. Debt servicing is again in the spotlight and the various nations are back to bickering about how to address the issues. The banking system is full of sovereign bonds and a national default would tear the financial system to shreds.

A popular phrase you hear quite a bit at the moment is "we're all in this together". Unfortunately, when it comes to Europe, well, they just aren't.

There's a real chance we see a significant re-emergence of the European Debt Crisis. We have the playbook from last time to guide us – they like to play a game of "brinkmanship" where the leaders refuse to budge until its nearly too late and then come up with some midnight compromise that kicks the can down the road but doesn't fix anything.

When I survey the financial landscape of today, I actually get a feeling I recall experiencing in the global financial crisis and especially in the European debt crisis that followed.

I recall talking with finance colleagues about the Greece crisis. How the Euro currency system is flawed and there's a real risk the Euro breaks up. With a limited understanding of

what was going on, the attitude of many people (some of my colleagues included) seemed to be one of confidence that someone's "got this" – that someone or some group of people had this under control and wouldn't let anything particularly bad happen.

It seems to be a common trait in our modern world. We like to assume someone is in control. For example, we trust someone has a plan to guide us out of this current mess and return life to normal including restoring economic prosperity. Hopefully that's the path. But simmering under the surface are issues that are incredibly complex and potentially very damaging for the economy and markets.

I've been accused of being too negative a few times in the past, however, I sense that the person accusing me of being too negative had very little understanding of the situation.

Ignorance would be quite a blessing right now.

I could go on for hours but it's time to wrap this up… Conclusions:

- Equity markets remain overvalued on a historical perspective (and no, low interest rates do not "justify" this unless your preference is "minimal return with risk" over "minimal return with no risk").

- More than ever, markets on a week-to-week basis are pushed around by large pools of money controlled by computer algorithms that chase momentum and don't care about value. Understanding this is important.

- The rally off the March lows is typical of what you would expect. Indicators such as volume and breadth suggest investors collectively don't "believe" too much in the recovery yet.

- Economies are going through something with no modern precedent and the damage will take some time to assess and flow through. There is scope for a lot of nasty economic headlines before we can say this is behind us.

- My view on the share markets is largely unchanged in the last month. I don't believe near-term gains will prove "durable". I don't necessarily feel a further meltdown is a given. Based on historical precedents, my sense is when we look back at price charts for 2020 in a few years we will probably see a lot of chopping around. It's a good environment for proficient traders, but frustrating for investors.