Aviator Update – May 2022
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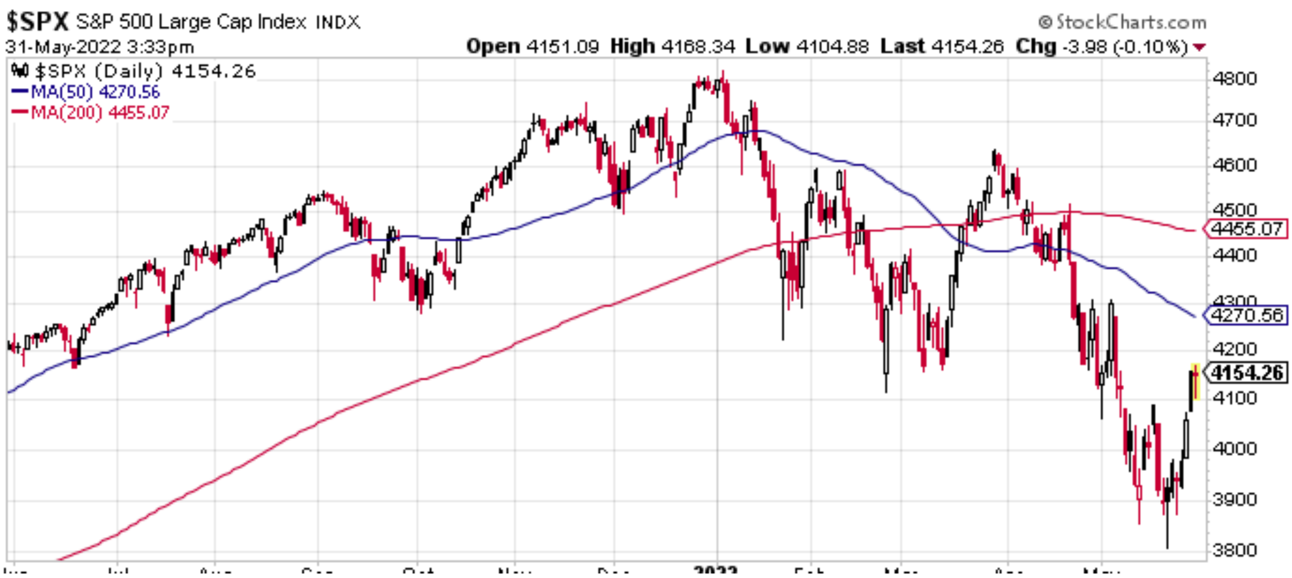
AVIATOR CAPITAL

Wringing out the excess

What drives asset price changes? That's a simple enough question, isn't it? Why do share prices change every day? If nothing has happened to that company (no news or events, just business as usual), then why does the price change at all?

There's a lot going on in the economy and financial markets at the moment… so much I'd like to talk about… The U.S. market has fallen for the good part of 2 months in a row – one of the longest stretches of consecutive weekly losses ever. It touched a 20% decline from its high reached during the first week of 2022.



We've been expecting a fall of this magnitude or more. Its long-overdue. Unfortunately, now it's arrived it probably makes predicting near-term price changes harder, not easier. With that in mind, I've been doing what I try to do most of the time – trying to distance myself from the day-to-day noise and get a sense of where we sit in the grand scheme of things.

Price is what you pay, value is what you get.

We know that, broadly speaking, share prices rise over time. Indeed, we know that share prices tend to rise <u>most</u> of the time. When a typical aspect of being a human in the western world is having a goal of increasing the size of our savings so we can cease active employment, having a place to invest our savings and reliably receive a decent return is clearly a good thing.

But why do share prices generally rise?

Well, it's important to remember what you're buying when you buy shares in a company. You're buying part-ownership of that company. As an owner, you stand to be delivered a share in the income that company generates – the revenues and profits it earns doing whatever it is it does.

Following on from this, it makes logical sense that the "value" of that share should be based around those cash flows that stand to be delivered to shareholders over the long-term. The "long term" is key here – one bad year doesn't necessarily matter. Similarly, one really good year doesn't matter either.

This is how assets get valued. Or, perhaps more accurately, this is how assets *should* be valued. By adding up the expected future cash flows of a business as far as the eye can see and then discounting them back to get a sense of what those stream of cash flows is "worth" today.

It's not easy – what's Commonwealth Bank going to earn in 2032? But this sort of analysis is what true investing is about – "value investing" …

The short-cut

If you're like me, you're not really interested in "bottom-up" stockpicking. Doing it properly is tedious and involves a lot of work – you need to know a company as best as you possibly can in order to predict its cash flows as best as you can. That takes a lot of time and effort.

But just because we might not be a true "value investor" doesn't mean we ignore valuation.

In the same way that we can model and value an individual business, there's reliable ways in which we can "value" the entire market.

Logically, companies operate in the economy. It follows that there must be strong relationships between economic activity and company financial performance.

For example, "GDP" is the value of all goods and services produced within an economy. There must logically be a relationship between nominal GDP growth and corporate revenues. And when we look, that's exactly what we find.

We'll come back to valuations in a little while but for now, we are able to draw a few simple conclusions:

The earnings of competently-managed businesses tend to grow with the economy

A growth in earnings results is a growth in value for that business

Short-term performance

Here's Netflix rising around 40% in the second half of 2021 from around $500 to around $700 per share. Then bleeding all that return back out over a few months into 2022… and then crashing to around $150…

So that's around a 75% fall. It's a decent business. It actually makes a profit (unlike many other technology companies). Sales grew 19% in 2021.

What happened? What will it take to get NFLX back to $700?

If you want to give me an answer laced with phrases like "platform innovation", "subscriber growth", "overhead reduction" and "exclusive content", let me just stop you there… The answer I seek is a lot simpler than all that.

In order to get back to $700 per share, somebody has to eagerly buy it at $699 per share! Prior to that, somebody has to buy it at $695 per share… $690…$680. From where it is right now, somebody needs to eagerly buy it at $200 per share!

That's what drives share price movements in the short-term:

Relative eagerness…

Netflix is a prime example of what has unfolded over the past couple of years. Clearly in hindsight investors were getting a little carried away with enthusiasm when they were paying $650 per share. But at the time it all seemed fine, didn't it? Try and think back to then – it was only 6 to 12 months ago.

The world was emerging from Covid and enthusiasm towards the future was high. Economic growth was set to accelerate. Inflation had yet to come out as any real issue and investors were rejoicing in a relentlessly climbing market fuelled by the Fed's zero interest rates and ongoing Quantitative Easing. Investor enthusiasm was high. The market was running hot. "TINA" (there is no alternative) to risk assets. Chatrooms were busy talking about the next "meme stock". An army of new retail investors were arming themselves with information from trusted "advisers" and "educators" on social media, seeking to turn their $700 stimulus cheques into an early retirement.

Recent Netflix results were good… They just simply weren't as good as investors clearly had hoped. Then it seems investors became relatively more eager to sell than to buy.

This has been a trend of late. A lot of stocks have followed a similar path – Facebook, PayPal… Kathie Wood's Ark Investments…

It's a case of "breaking stories". Investors were swept up in a story of endless strong growth. When cracks in the narrative were revealed, investors abandoned them faster than a 22-year-old retail investor could get some guidance on what to do from their trusted Instagram-based advisers.

Back to valuations

When you're looking for a shorthand way to value "the market", it's important that the model you use is actually useful.

Here's an example:

I just saw a commentator discussing how the recent market falls have taken the S&P500 trailing 12-month P/E ratio back to historically-modest levels. "Capitulation alert" they exclaimed.

Let's just think about that…

Corporate earnings and consumer spending over that period were juiced by trillions – literally trillions – of government stimulus. Interest rates were zero… inflation low… consumer sentiment quite robust as the world emerged from Covid.

Now we have economies trying to establish a new equilibrium without all that stimulus… inflation is a huge problem, impacting consumer spending and sentiment… wage pressures… interest rates are swiftly rising… de-globalisation forces are strong… supply chain disruptions… many are expecting the global economy to fall into recession… all these factors are pressuring corporate profits…

But sure, why shouldn't corporate earnings results from 12 months ago be a reliable indicator of what to expect in terms of share price performance in the coming few years? Try telling Netflix shareholders that!

Just for the record, here's what S&P500 profit margins have done of late:

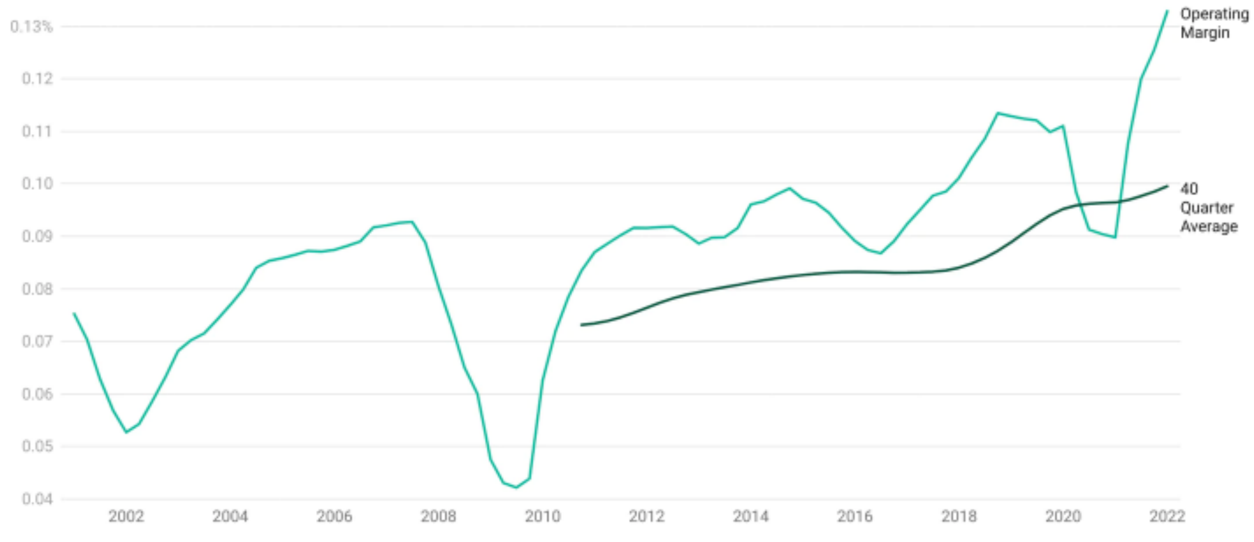
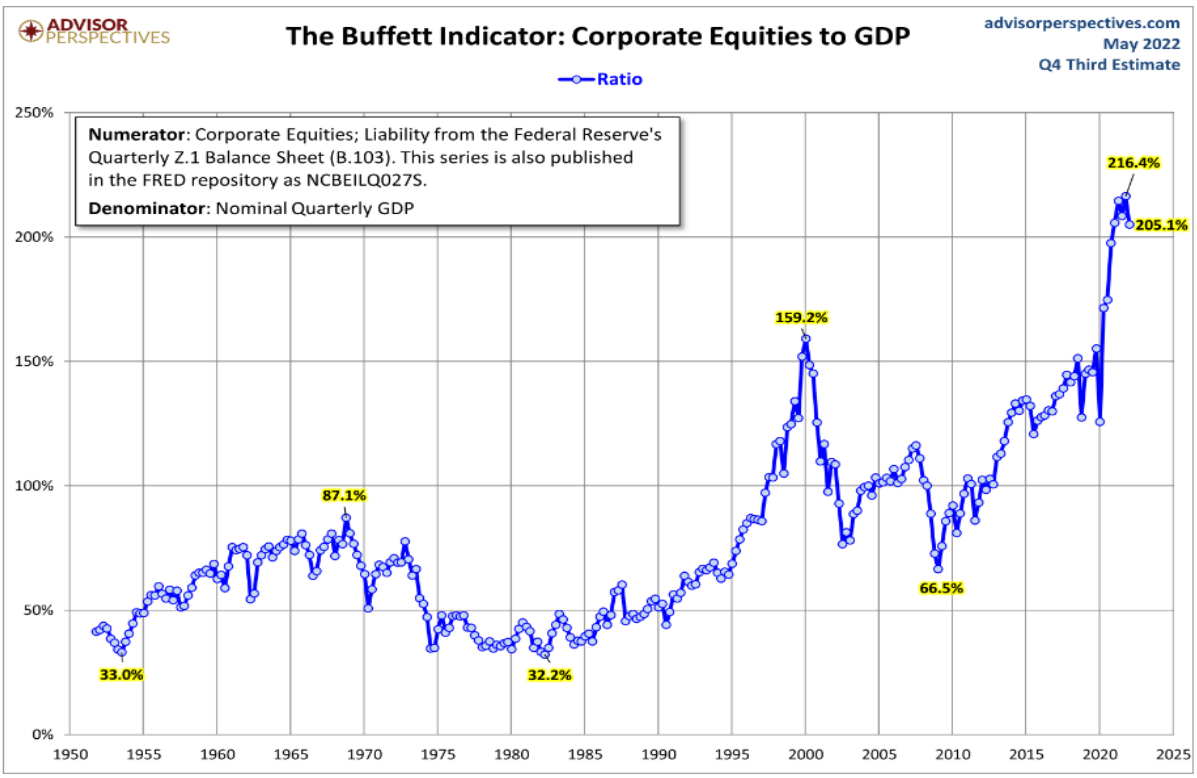


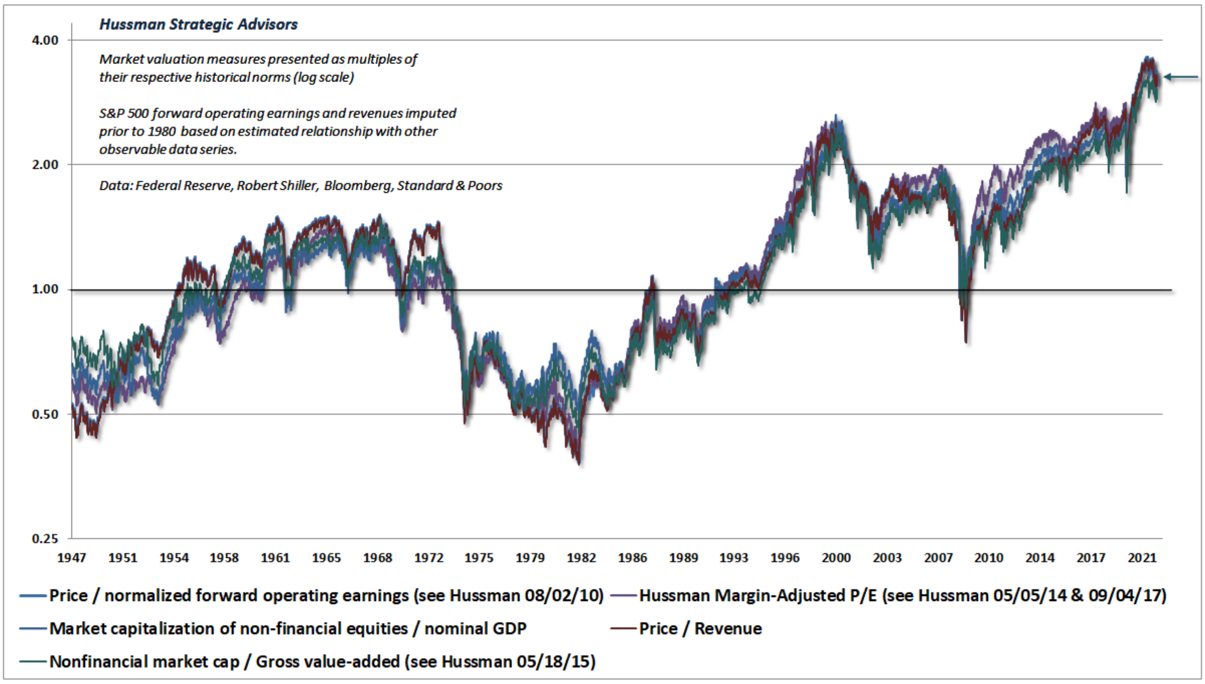
Chart: @kayfabecapital • Source: S&P Global • Created with Datawrapper

There are various models that are shown to have a high correlation to subsequent market returns. All of these do not simply rely on one years' worth of earnings – certainly not last year's. Many are more "revenue-based", which makes sense given the logical relationships between corporate revenues and the economy whilst net profit (earnings per share) are well known to fluctuate over periods of time... such as when margins explode higher to levels rarely ever seen (and never maintained for any length of time).

Here's one such model:



And a few others:



These reliable valuation models all show a market coming off the most over-valued levels ever recorded.

Just…crazy…

Its critical for us to realise exactly how extreme investor sentiment has been throughout this period. Over the last couple of years, I've commented several times on the "craziness" – I dedicated my March 2021 commentary to documenting some of it:

The boom in "Non-Fungible Tokens" (Twitter CEO Jack Dorsey auctioning off his first Tweet for over US$2M)

SPACS – the flood of companies listing that didn't even have a business!

Silly new ETF's to capture the punter's imagination (the "FOMO" ETF and the "BUZZ" ETF)

The crazy surge in retail Options trading

The rise of stocks as "memes" - Gamestop (and others)

Bankrupt companies like Hertz whose shares being bid hundreds of percent higher because… well…

All the frauds that generally accompany a hot market

The list goes on…

To repeat, it's important for us to really have some perspective around how exceptional investor sentiment has been. Its normal for investors to be optimistic about the future, but the type of behaviour during the last several years has been restricted to very small pockets of history.

Overlay that with valuations, we have ourselves some classic tell-tale signs of a market bubble.

Historical Precedents

We don't have many historical precedents to draw from as we navigate the current market environment. Refer back to those valuation charts – it's rare for valuations to push well beyond what can reasonably be considered a "normal range". Of course, there's other precedents beyond U.S. share markets – there's Japan in the 1980's… property markets pre-GFC (U.S., Ireland, Spain…)

All these events shared similar characteristics – extreme positive sentiment pushing valuations well beyond "normal" whilst all the while convincing investors this is the "new normal".

The precedents from these events is sobering – there's never been a time when an asset market became significantly detached from "trend" valuations and failed to revert back towards "trend".

Let me repeat that… There's never been a time when an asset market became as detached from "normal" as U.S. equities recently did and failed to revert back towards "normal".

Sentiment is the key

What happens to investor sentiment during periods where markets don't go up? It deteriorates. Investors get frustrated. Month-after-month, investors are left disappointed. Some give up – they get a few more overtime shifts at work rather than staring at their investments. There's patches where the markets go up for a few weeks or months – investors get excited… commentators get excited… And then a few days of falls crush the burgeoning optimism, adding to the frustration.

All the prior excesses get "wrung out" of the market. Enthusiasm, valuation… it all goes back towards "normal".

From this point, in order for U.S. equities to mount any kind of extended rally back to previous highs (that really aren't that far away), what we need is for investor sentiment to swing back to that extreme positive that persisted when the markets were first making those highs last year.

Could that happen? Yes, of course! It would be unprecedented, but having witnessed the craziness of 2020/2021, we cannot say for sure this won't happen.

Is it likely to happen?

Well, that's something you need to decide for yourself.

"But…but…"

"In terms of sentiment, there's been a lot wrung out already right? NFT's have crashed. Stocks like Netflix. Crypto… Sentiment in general is very negative – surely that's bullish!"

"In terms of valuations, what about share buybacks, global earnings, innovative technologies, low interest rates… I don't accept that shares are as over-valued as you suggest."

I can't tell you what to believe.

The historical precedents state that there's more to be wrung out of the markets in terms of sentiment and valuations. There's no precedent to an extremely richly-valued market coming well off the highs like it has then picking itself up and marching on to even greater heights.

But who knows. Maybe the Federal Reserve backtracks on their battle with inflation and loosen monetary policy… maybe sprinkle on some more of that magical "Quantitative Easing" fairy dust.

That seems to be the "hope" many investors are clinging to – the Fed will save the day. History holds that it's this hope that needs to be crushed before the markets can make a durable bottom.

In the meantime, prepare to be frustrated…