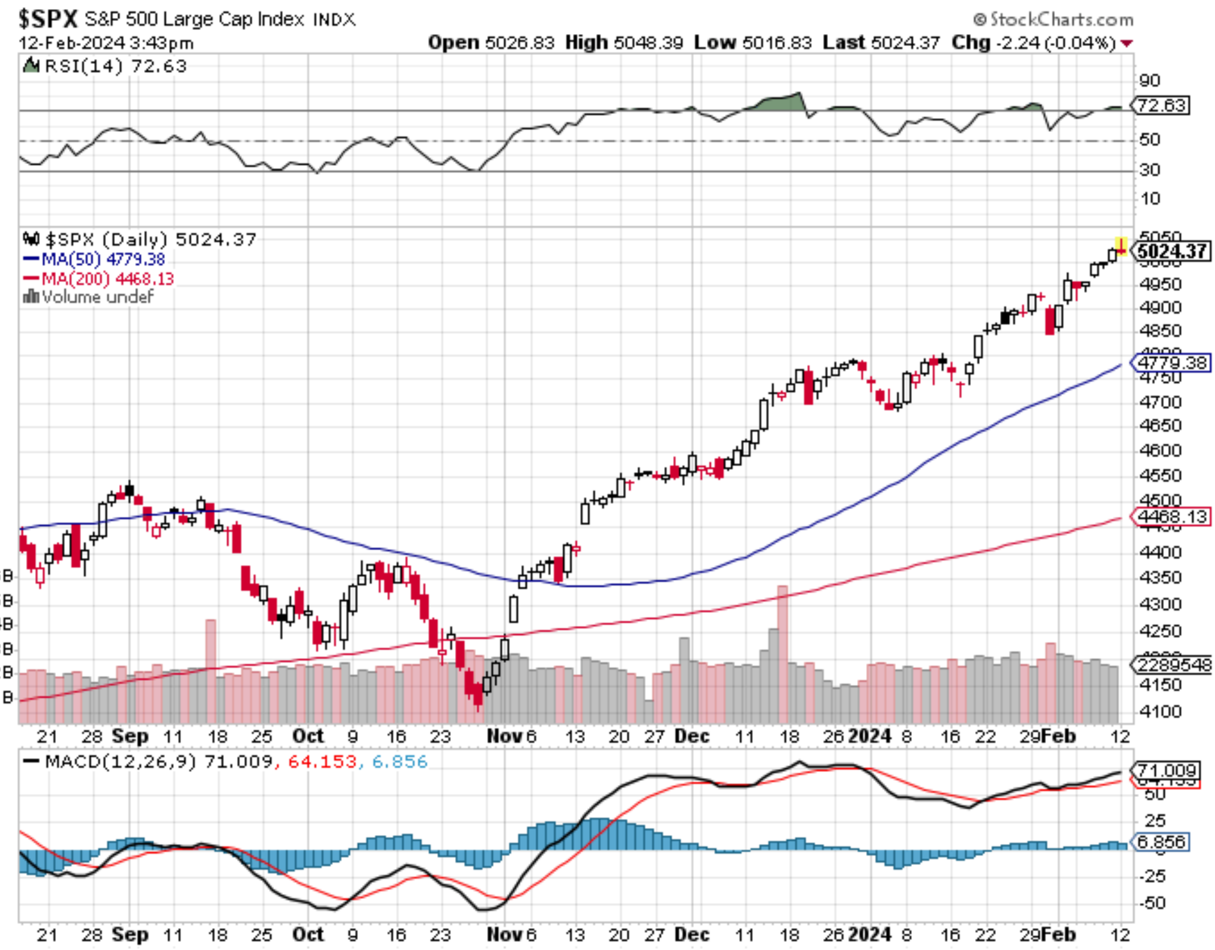
Aviator Update – January 2024
Lindsey Lawrance

AVIATOR CAPITAL

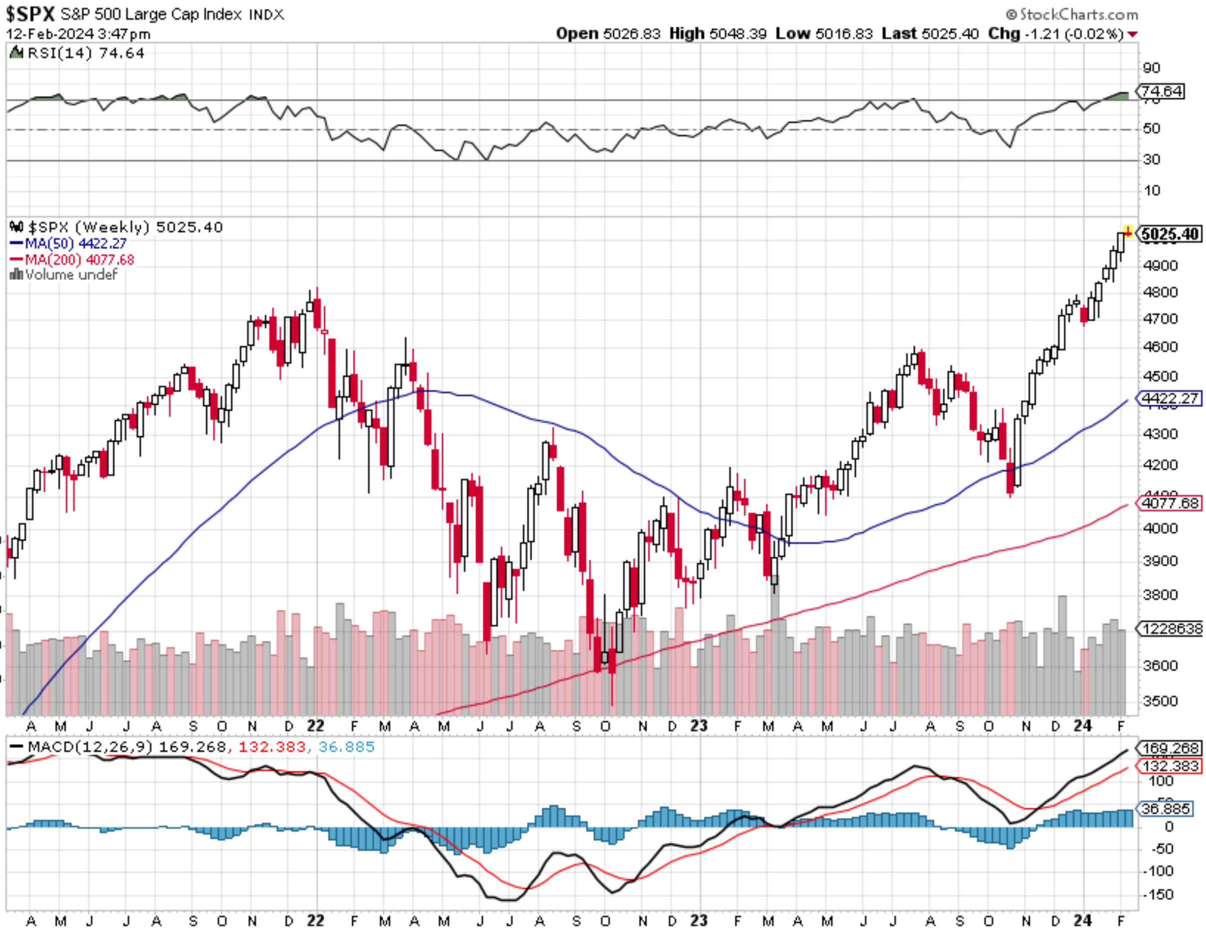
(More) New Year Observations

The new year is well underway now. So far, the year is tracking much the same as the previous year ended with many of the trends continuing.

As I write this, the US S&P 500 is up around 9% so far this year. That's roughly around the long-term average annual return. Any investor that's captured that gain might want to think about just selling out and taking the rest of the year off!



Shifting to a weekly view, things are, well, pretty crazy:



14 out of 15 positive weeks! What a run! I've seen it stated that this is the equal best stretch ever – equalling a stretch in 1973. That was during the "nifty fifty" craze. That culminated in bust and nasty bear market… but luckily for today's investors, this is a whole new era – recessions are a thing of the past, "AI" is changing the world, super-charging economic and profit growth… right?

As per usual, our market has followed along although with less enthusiasm:

The weekly chart is much less impressive:

Recapping some observations from the last couple of months, with the S&P 500 over 5,000, it now exceeds year-end targets posted by almost all (perennially-bullish) Wall Street strategists. Not really anywhere to go from here (except to raise targets!)

Passive? Really?

The S&P 500 returned around 28% last year. Congratulations to anyone that captured that kind of gain – most managers didn't (we certainly didn't and we're fine with that).

As its been widely reported, the vast bulk of last year's gain came from a small handful of stocks – those "magnificent 7". NVIDIA gained 239%!

If we ponder this a bit more, how did anyone achieve a "market return" last year? Well, they either "owned the market" or, to state the obvious, they owned stocks that did as well or better than the market.

Because most of the market's gains came from just 7 stocks, most other stocks, under-performed the market. Even if you owned a good chunk of "magnificent 7" in your portfolio, the return on a diversified portfolio will have been dragged lower by your positions in commercial real estate… or oil/commodities… or financials…

Data shows that the FOMO (fear of missing out") bug really caught a lot of retail investors as the market took off in November/December. And noticing that the market has been beating everyone, they decided to simply "buy the market".

Data shows that S&P 500 index tracking funds/ETF's experienced massive inflows in the latter half of the year. Massive… These funds, by definition, "own the market". When new investors put money in them, the fund issues the investor units and then "buys the market" – adds to their portfolio of stocks that replicates the market.

With these "magnificent 7" comprising such a large portion of the total market, they must buy vast chunks of them. Unemotionally… no consideration of valuation or anything else. Their duty is simply to own the market on behalf of their investors.

A lot has been discussed about the significant shift to "passive investing" that's been a trend over the past several years. Investors shunning "active managers" and simply "buying the market". But at this juncture, to call this style of investing "passive"???

"Owning the market" right now basically means having a very overweight positions in just 7 stocks. That's not "passive".

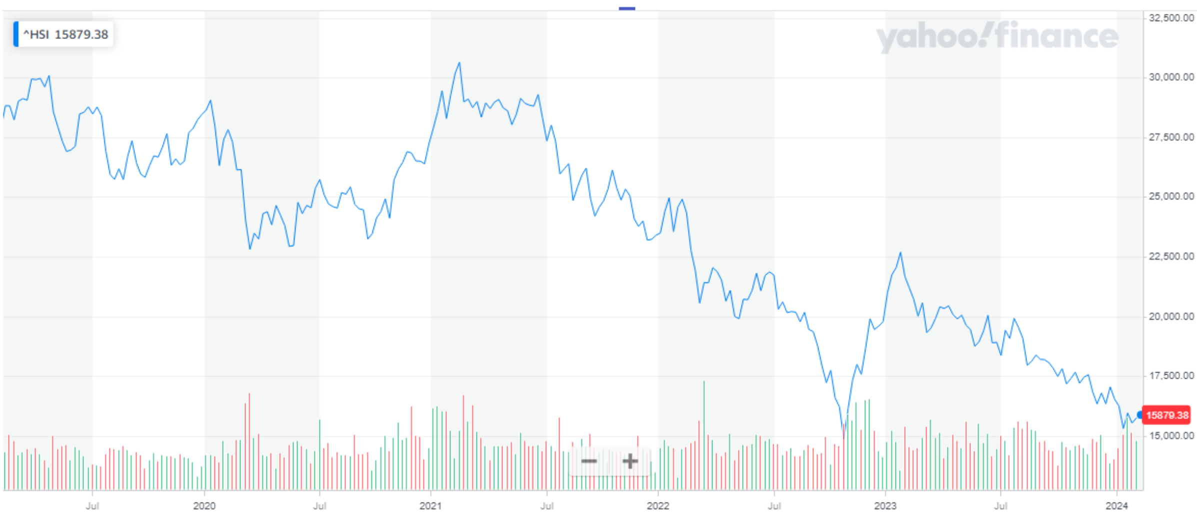
At its heart, a true "passive" investment is owning the entire investment universe. U.S. shares, Australian shares, Norwegian government bonds, Brazilian residential property… everything… As soon as you start dialling back on the content of your portfolio, you become "less passive". Owning the S&P 500 is not a passive investment, especially at the current juncture with its concentrated nature.

Oh, and remember, the "funds flows" thing works in reverse too. If investors decide they want to sell out of the market, the redemption process entails the manager selling holdings in the underlying shares representing the market. For everyone's sake, I sure hope everyone that's been buying "the market" is a buy and hold investor. Of course, most aren't…

The only game in town…

When you look around the world, it's not all new highs. We've discussed at length the problems China faces in their badly imbalanced economy and as their epic property bubble hits the inevitable glass ceiling.

Here's Hong Kong's Hang Seng index – down close to 50% from 2021 highs:



There's little doubt in my mind these factors are related. Capital is leaving China and there's little doubt some of it has been flowing into US stocks – they are "working"… it's the only game in town.

Past performance…

During the last couple of months, I've spent a lot of time reading and reflecting. I've read a lot of fund managers' investor letters and market commentary for the final quarter of 2023.

There's a real sense of "relief" in a lot of letters. Many managers saw their returns outpace the market during the final quarter.

Although few have said anything too specific, the "relief" wasn't just related to their short-term performance. There is this palpable sense of "glad that's all over"… that the recession risk permeating the market during 2023 is all behind us… rate rises are all over and its now a tailwind of rate cuts as far as the eye can see… and the market is back on its normal upwards trajectory after a couple of volatile years.

Some pointed to the elevated levels of optimism as being a concern – aware that excessive optimism is a powerful short-term negative. Yet, paradoxically, these managers are very optimistic themselves…

Recency bias is such a powerful force in financial markets. The markets look great, right? Why on earth would they go backwards? It's interesting that this bias affects professionals just as much as any amateur.

Value is what you get…

Circling back to "owning the market", there has never been a worse time to own the S&P 500. That may seem like a bold statement to make. But my point is simple…

Remember that the return you can expect from an investment is directly related to the price you pay. That's not a theory, its simple logic and maths – prospective return doesn't improve as prices rise. The higher the price you pay, the lower your expected return over any given future timeframe.

Therefore… by noting the S&P 500 at all-time highs is the same as saying future prospective return is at all-time lows.

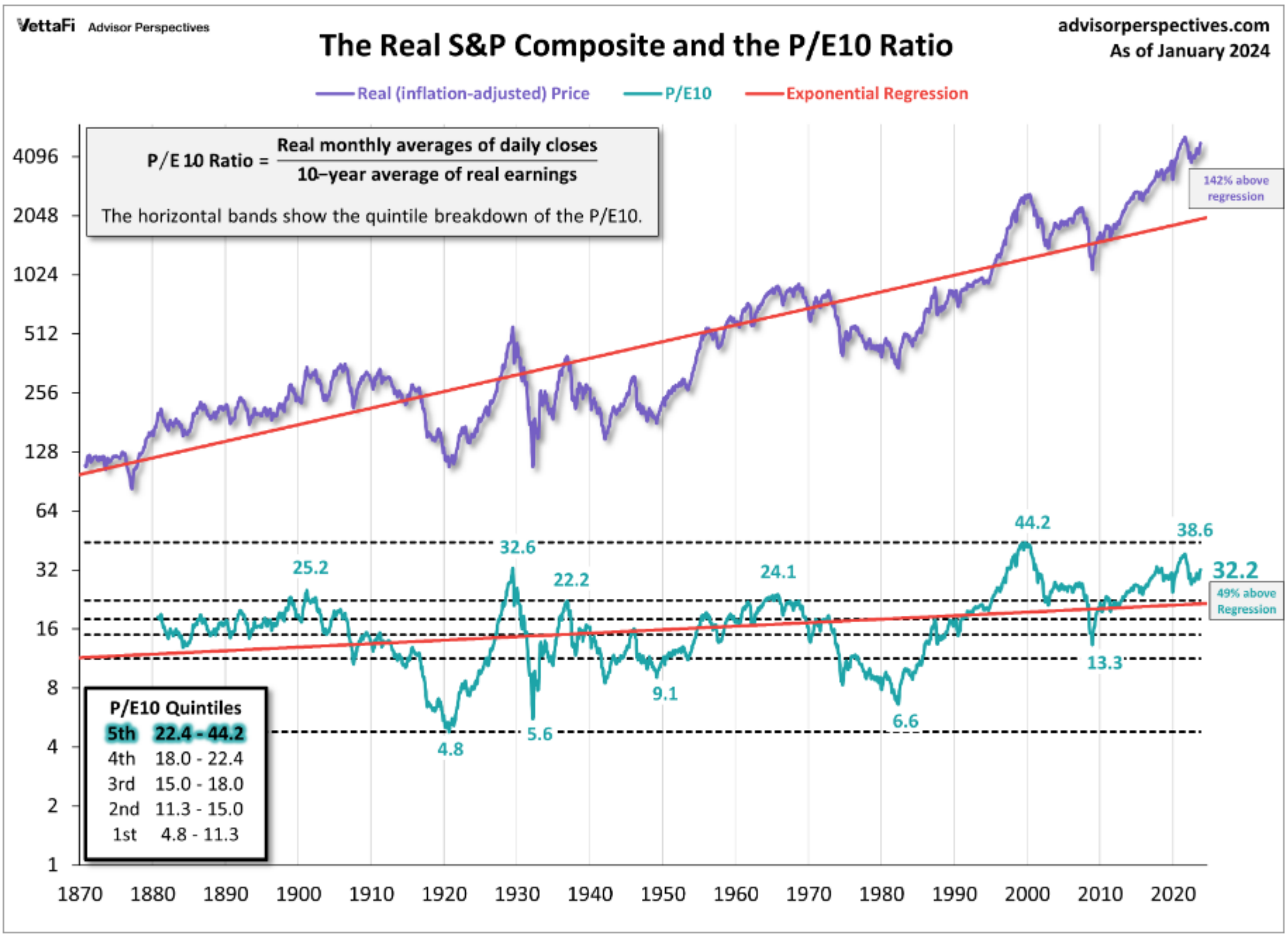
Of course, that doesn't mean you can't expect to generate an acceptable future return from this point. In order to gauge what sort of return we can reasonably expect at any point in time, we need to look at valuations.

There's little more to say about the valuation situation that we haven't been reporting on for the good part of 2 years. Valuations, based on reliable long-term metrics, are about as high as they have ever been.

At this point, it doesn't even matter whether you refer to a "useful" valuation model. Practically any and every conceivable valuation metric shows U.S. shares are about as over-valued as they have ever been. If you don't believe me, go do a bit of research yourself.

Anyhow, as evidence of this claim let's today have a look at the 10-year average P/E/ ratio for the S&P 500. This formula is designed to "smooth" the inevitable fluctuations in the business cycle and deliver a better picture of where valuation stands at any given time relative to history.

Courtesy of Advisor Perspectives, here's the P/E-10 going back to the 1900's. A reading above 22.4 puts it in the top 20% of readings. The current reading above 32 has only ever been observed on three other occasions – 1929, the 2000 tech bubble and the 2021 Covid bubble.



Of course, valuations don't tell us anything much about the short-term. They are hugely informative about the longer-term.

Its highly likely that when we look back on this moment from some point in the fairly distant future, it will be remembered as a terrible time to buy shares.

Believe what you will…

I've spent quite some time over the past couple of years encouraging everyone to get clear in their mind what they believe and how they approach investing. Recapping some of this, here's a little of what we believe at this juncture:

We believe the current market setup of an incredibly stretched market on multiple time horizons (daily, weekly, monthly) together with high optimism and historically-extreme valuations is an accident waiting to happen.

Clearly, we're not chasing the market higher. We believe opportunities are much easier to make up than losses and it's a time to exercise extreme caution rather than get swept up in the "FOMO".

We believe patience will be rewarded. We believe in cycles and believe great opportunities lie on the other side of this cycle peak – wherever that may be.