Aviator Update – September 2022
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AVIATOR CAPITAL

Give me your best ideas

It's been another rather eventful month for markets. Little has changed in terms of the key "themes", although we have seen somewhat of an escalation in certain areas.

As we close out the last few trading days of the month, the US equity markets are battling to hold above the lows set in June. It has been a rough month and the markets have worked themselves into somewhat of an "oversold" state – as we've discussed in recent months, fierce "clearing rallies" are a standard feature of this market environment.

There's one piece of feedback I frequently receive in relation to my commentary. It goes something like this:

"You're an Australian-based investment manager producing commentary for an Australian audience and yet you rarely mention Australia. Why?"

It's a fair point. The answer is relatively simple although I like to think the details behind the simple answer will stimulate some thought. Today, I want to share the reasoning behind the current intense focus on U.S. markets whilst also touching on some things happening at the moment.

"Setting the mood"

You might have noticed that the Aussie share market has a habit of following the U.S. markets. As an example, during one of the big down-days over the past month, I saw a headline on a mainstream news website stating "ASX falls after U.S. tech share selloff".

Taken on face value, this observation seems rather nonsensical – the Aussie market has very few technology companies, especially ones large enough to move the entire market. Given this, why would the Aussie market be spooked by a selloff in the U.S. centred around a subset of companies that really don't exist in Australia?

There's not really a clear answer to this. There are however some logical conclusions we can arrive at based on two facts.

Firstly, below is a current list of the 15 largest economies in the world according World Bank data:

1. United States: $20.89 trillion
2. China: $14.72 trillion
3. Japan: $5.06 trillion
4. Germany: $3.85 trillion
5. United Kingdom: $2.67 trillion
6. India: $2.66 trillion
7. France: $2.63 trillion
8. Italy: $1.89 trillion
9. Canada: $1.64 trillion
10. South Korea: $1.63 trillion
11. Russia: $1.48 trillion
12. Brazil: $1.44 trillion
13. Australia: $1.32 trillion
14. Spain: $1.28 trillion
15. Indonesia: $1.05 trillion

Aside from China, the U.S. is by far the largest economy in the world. It's more than 15 times as large as our economy.

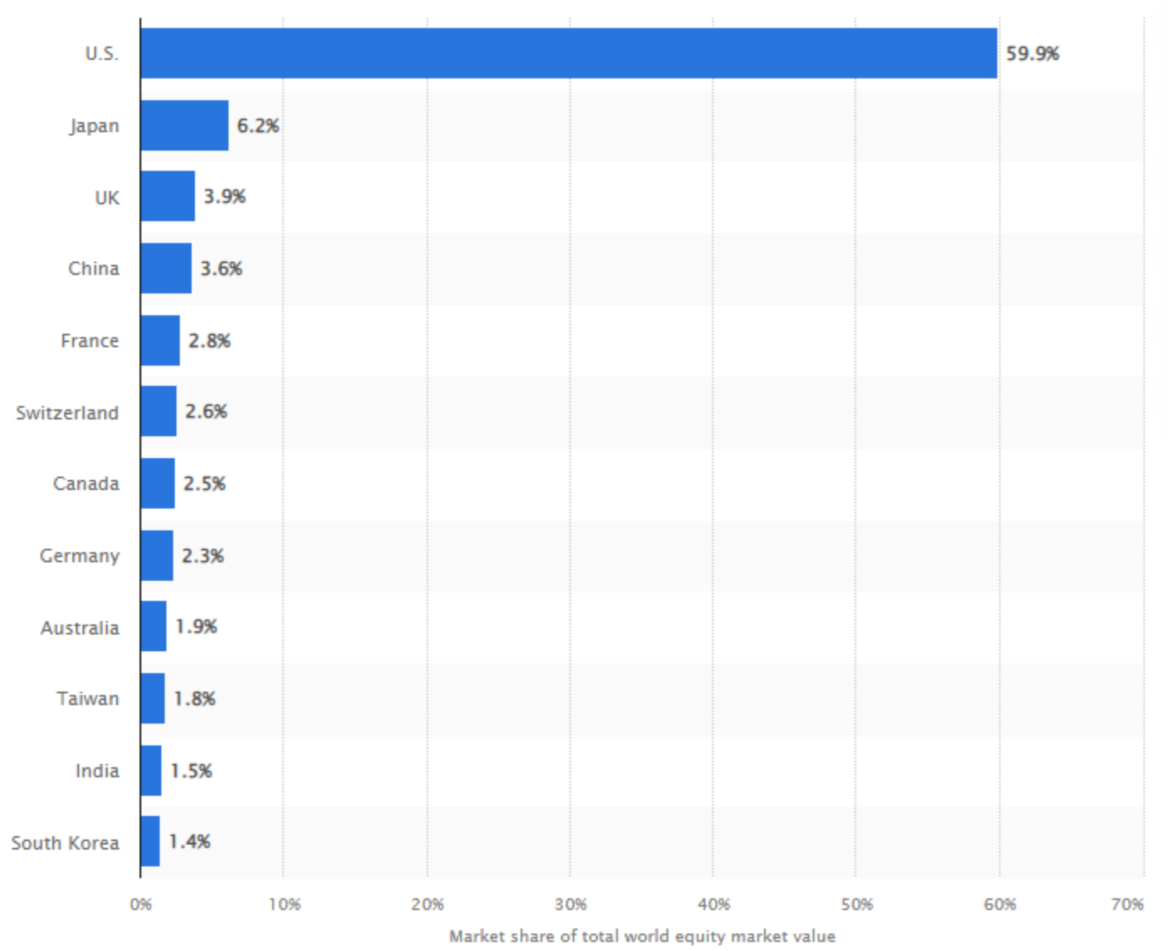
China is worth a special mention. The main thing China has going for it is a lot of people. On a per-capita basis, its GDP is around $10,400 versus the U.S. at $63,400. Further, the trouble China has is related to "quality" of GDP – their economy is heavily weighted towards "making stuff for export" and "building stuff" whilst the U.S. economy is very diverse. China is trying to steer its economy away from these sectors, but that's not easy, even under their "centrally-planned" political model.

In summary, the U.S. is by far the biggest of all diversified "western" economies. It is therefore logical that economic pressures (good and bad) occurring in the U.S. likely influence and potentially reflect other much smaller economies.

Tying this back to share markets, if U.S. shares are declining (or rising) based on perceived economic forces, then it makes sense other markets play "follow the leader".

For the record, Australia comes in with GDP per capita of around $52,000 – this actually puts us right near the top of the list. We truly are a "wealthy" country.

Next, the following chart shows the relative size of global share markets:



Quite staggering, right?

When U.S. equities markets are so huge relative to everyone else, its again logical that they tend to "set the mood" for investors globally.

Of course, the degree of correlation between the markets changes over time. It is however rare for the correlation to be negative for any meaningful length of time.

When you look at certain periods of time, another interesting (and very important) observation comes to light;

The correlation has tended to be at its lowest during periods of "calm". Conversely, the correlation has tended to rise and be at its highest during periods of "turmoil".

"Normal Times"

Thankfully for investors, markets are in a fairly "normal" state most of the time. Valuations "reasonable", economic conditions and outlook "benign"…

During these periods, investors are mostly concerned about making money. This means something slightly different to different "types" of investors (e.g. funds managers, private client advisers/stockbrokers/financial planners, individual investors).

Typically, for those involved in selling investment products or services, much of their time is spent trying to sell more product or services. This generally involves spending significant energy telling everyone that will listen about how their experience and approach to the markets is superior to everyone else!

Stockbrokers, for example, spend their time telling people how a custom-curated portfolio of direct equities stands to generate superior returns compared with a portfolio of managed funds.

If they only focus on Australian shares (no allocations to overseas), they will tell you about how this only adds risk such as FX movements. If they do advocate overseas investments, they will tell you how great this is and how they are better that anyone who doesn't.

Financial advisers shout about how a custom-curated portfolio of managed funds provides access to some of the best funds managers in the world.

Of course, all of these people will also usually tell you about how they have plenty of experience doing this and they are the one to choose for all your investment needs.

As an industry collectively, we're (practically) all going to tell you it's a good time to invest – perennial bullishness, that's the name of the game – there's no money to be made in telling customers to sell and/or just sit on cash.

Furthermore, as an industry, we're good at delivering customers what they want. During "normal times", there's a constant demand for ideas that will generate a superior return. And boy is the finance industry good at delivering!

Remember the late ‘90’s? This thing called the internet was going to change the world. Investors wanted in on anything internet-related. Wall Street was able to deliver a new company to invest in every other day. That worked out well, until it didn’t.

How about after the tech bubble burst? Interest rates were cut to low levels. Investors were hungry for yield. Wall Street delivered in the form of “mortgage-backed securities”. They seemed to become less popular after they blew up the world during the global financial crisis…

During this cycle, many funds managers had to get themselves an “ESG” fund offering – that’s the trendy investment theme at the moment and you don’t want to miss out.

Oh and during this cycle we created whole new asset classes for return-hungry investors to speculate on! In recent years, if you weren’t buying crypto or NFT’s, well, clearly you just want to stay poor forever…

Whilst of course I have my own beliefs as to how best to approach investing, I’d argue that during “normal times” it really doesn’t matter that much. Sure, some investors and approaches will do better than others, but you really stand to be delivered a fairly satisfactory return regardless of how you approach investing.

Whilst drafting this, I had the idea of assembling (hypothetically) the “A-Fund” – a managed fund composed entirely of companies beginning with the letter “A”. The research and data aggregation got tedious very quickly but suffice to say I’m very confident that a portfolio of international companies beginning with “A” would exhibit a recent track record that is quite satisfactory.

“Abnormal Times”

Over the past 100 years or so, the markets have been within “normal times” probably 85 or 90% of the time.

The rest of the time, well, the markets have deviated significantly away from anything resembling “normal” when viewed from a trend valuation perspective.

There’s been some periods where valuations have fallen well *below* trend although these periods have been very brief and rare – the early ‘80’s was the last time and before then was around World War 2.

Slightly more common have been periods where valuations have greatly *exceeded* anything resembling “normal”. The markets have spent perhaps 10% of the last 100 years at valuation levels significantly exceeding “normal”.

When valuations have previously deviated far from “normal”, its culminated in a market selloff that has restored valuations back towards “trend”. With respect to U.S. shares, these include 1929 and 2000. To a slightly less extreme extent, extremes were witnessed in 2008 as well as in the mid ‘60’s.

Now, I want to refer back to Aussie/U.S. market correlations. Recall that correlations have been strongest during periods of “turmoil”.

It’s my thesis that several years ago, U.S. equities markets entered an “abnormal period” of extremely extended valuations. In fact, reliable valuation models show that the highs reached in 2021 have never been seen before – it was the most over-valued in the last 100 years.

As I’ve repeatedly stated, stretched valuations are not informative of short-term movements.

However, as just observed, all previous periods of extended valuation to the extent observed over the past several years have culminated in a decline back towards “trend” – there is no compelling reason to believe this time will be different.

Regardless of your approach to markets, I’d suggest its always important to have a sense of which way the wind is blowing over in the U.S. Right now, there’s a hurricane buffeting the U.S. (as it turns out, this is true right now both metaphorically and literally!)

Bonds leading the way

By far the biggest development occurring over the past month is the continued turmoil in the bond markets. Whilst it’s understandable that bond yields continue to be pressured higher given central bank interest rate increases, indicators are suggesting things have become very disorderly.

Disruption and liquidity issues in the bond markets is the stuff of “financial accidents”. The problem also is the bond market is huge and “opaque” – major problems can appear from nowhere (and in this environment they probably will).

This observation made on the 27th September is quite informative and succinct:

Jim Bianco biancoresearch.eth Retweeted

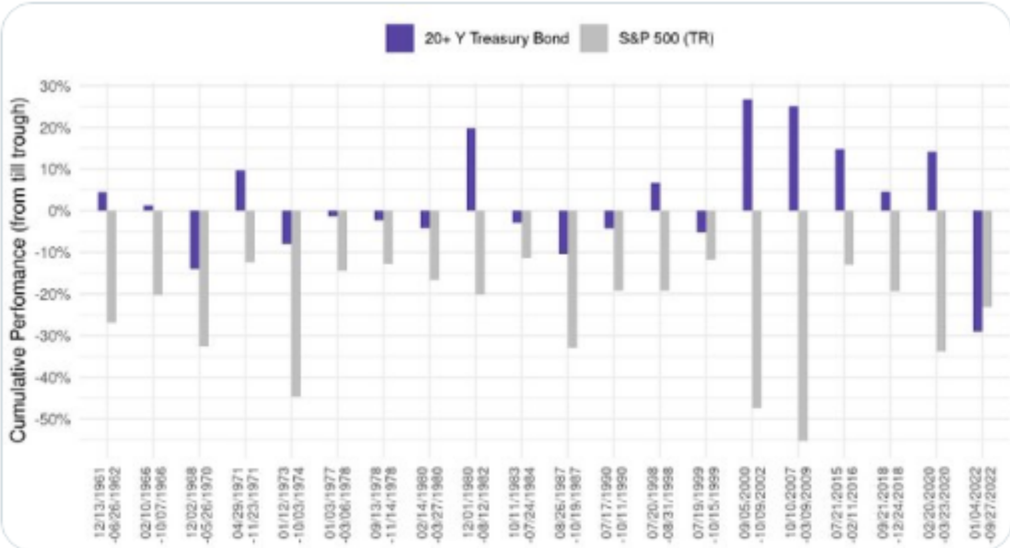
Michael A. Gayed, CFA @leadlagreport · 6h

Below are the top 20 largest peak to trough drawdowns for the S&P 500 going back to 1961.

Never, IN HISTORY, in an EXTREME drawdown for stocks, have Treasuries, THE risk-off asset, GONE DOWN MORE THAN STOCKS.

Updated.

WAKE. THE. FUCK. UP.



Oh, and for what it's worth, the world's second largest bond market – Japanese Government bonds – is under great stress with their central bank needing to take extreme measures to defend their yield caps.

Give me your best ideas

Generally speaking, the main criticism I have towards most of my investment industry peers is they don't really strive to understand market history. Referring back to the discussions above, knowledge is optional in "normal times" – investors will do okay regardless of approach and its best for the adviser to devote their energies to growing their client base and fee income rather than wasting time studying financial market operations and history.

I strongly believe that it's during these "abnormal times" that investment advisers have the greatest scope to "do good" – these are the times where approach and decisions really matter and can make a huge longer-term difference to client portfolios.

Sadly, most advisers are ill-equipped to guide clients through these times. Separately, many are too scared about potential under-performance (as well as consumed by self-interest) to advise clients to do anything other than buy or hold.

“Okay, so what do you think we should do?”

Well, that depends on how you approach the markets and what you believe.

If you’re a long-term investor and are comfortable staying 100% invested in whatever you’re invested in, then don’t let me tell you that you shouldn’t.

As I’ve frequently commented on, we approach the markets differently to most investors. We’re in search of that elusive “absolute return” – we want to make money irrespective of what the market does.

This requires us to be comfortable with the prospect of being wrong on our own. This really is very profound given that “relative under-performance” is not tolerated in most areas of our industry.

If you said to me “I too want to make some money in the next 12 months – give me your best ideas”, I’d offer up the following:

Realise that we’re in the midst of a very special period in market history. The U.S. should be your key focus. Although markets have declined somewhat, valuations remain well above trend and among the highest levels ever (outside of the 2021 bubble).

If historical precedents are any guide, it’s probable that markets will work their way back towards something resembling “trend” valuations. It’s a little embarrassing to even discuss what this means in terms of reliable valuation models – they have the S&P 500 in the 1600 to 1900 region so around 50% lower than current levels.

Note that markets certainly may bottom out in this cycle at higher levels. However, valuations are still way too high at the moment and betting a durable low forming around these levels is not wise from a historical perspective.

Note also that the falls so far are a classic example of what to expect - these unwinds tend to happen in “waves” – severe selloffs into oversold conditions then fierce “clearing rallies” (some lasting months).

If it’s your goal to make money in the next 12 months, I’d suggest you want to be short U.S. equities. The S&P 500 is a sensible option, although note that history shows the “riskier” areas of the market stand to have greater downside potential. Therefore, although carrying greater risk, you might want to look a small-caps or growth (the NASDAQ 100 being a logical *option although "small cap growth" offers the greatest potential reward with commensurate greatest risk).*

Depending on desired approach, short positions should be added to during those fierce clearing rallies and then trimmed during selloffs.

Of course, I need to emphasis this is not "advice". I'm merely expressing – in real-time – where I think we're at and what I think you might consider doing if it's your goal to "make money" in the coming 12 months.

Best of luck everyone – we all require a little more of it than normal to successfully navigate the intense swings this type of market environment delivers.