Aviator Update – April 2023
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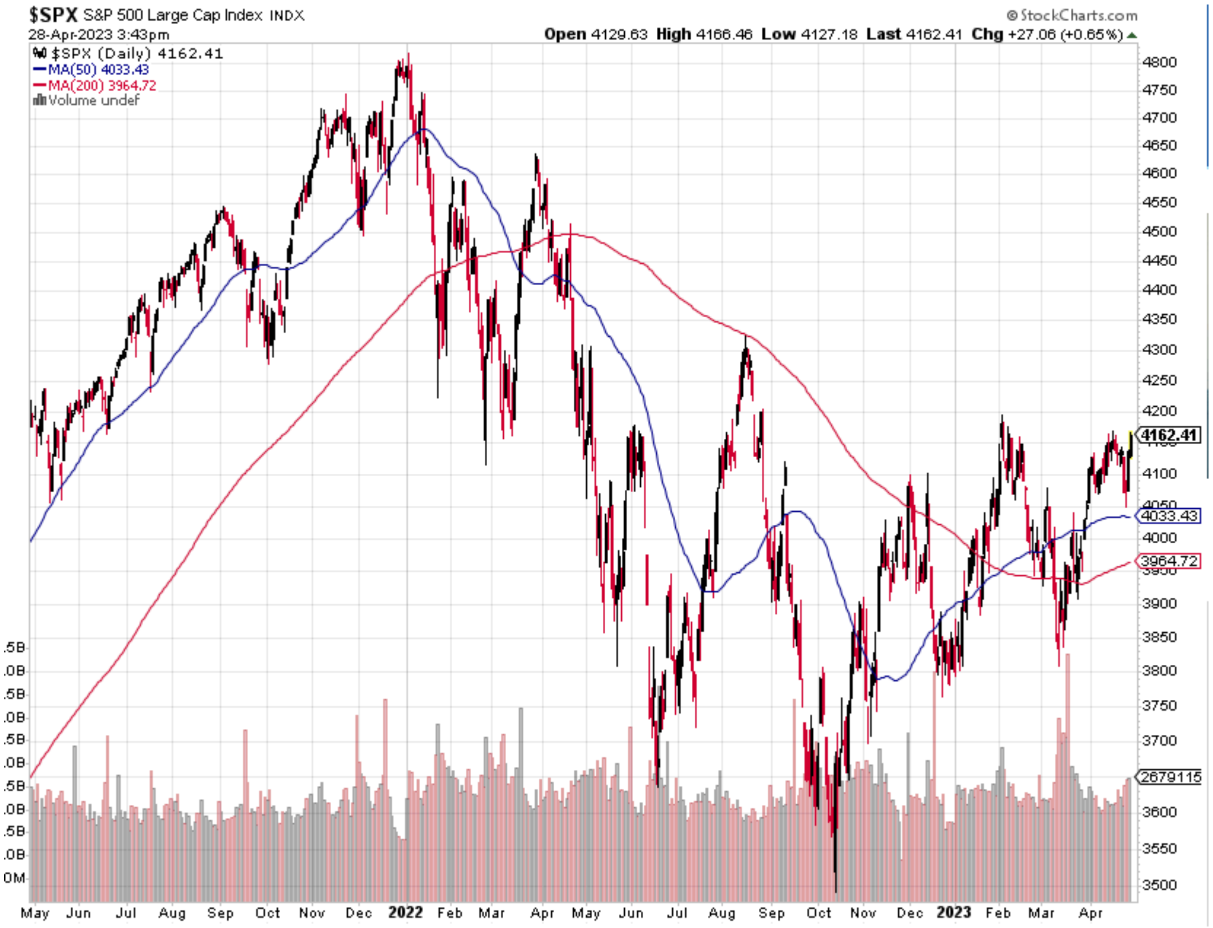
Something to believe in

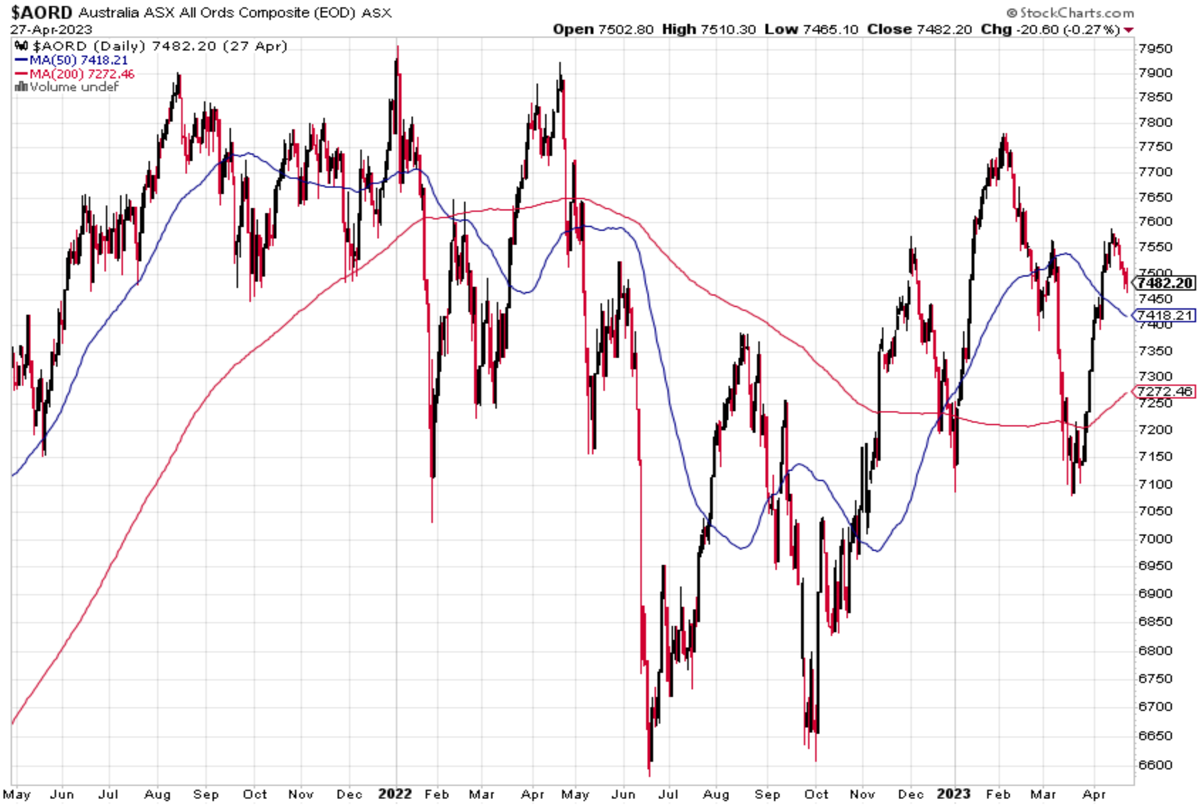
It's been another rather amazing couple of months for financial markets. Last month, I was in Fiji – deliberately not looking at the markets - when I happened to catch a headline on the TV reporting that Credit Suisse had gone belly-up and was in the process of a forced marriage with UBS. This was on top of the finance world digesting the second largest ever bank failure in the U.S. – Silicon Valley Bank. When I returned to my screens a few days later, I expected to see carnage. "How far have major indices fallen?" I wondered to myself.

I really was amazed to see that these events had little effect on the markets.

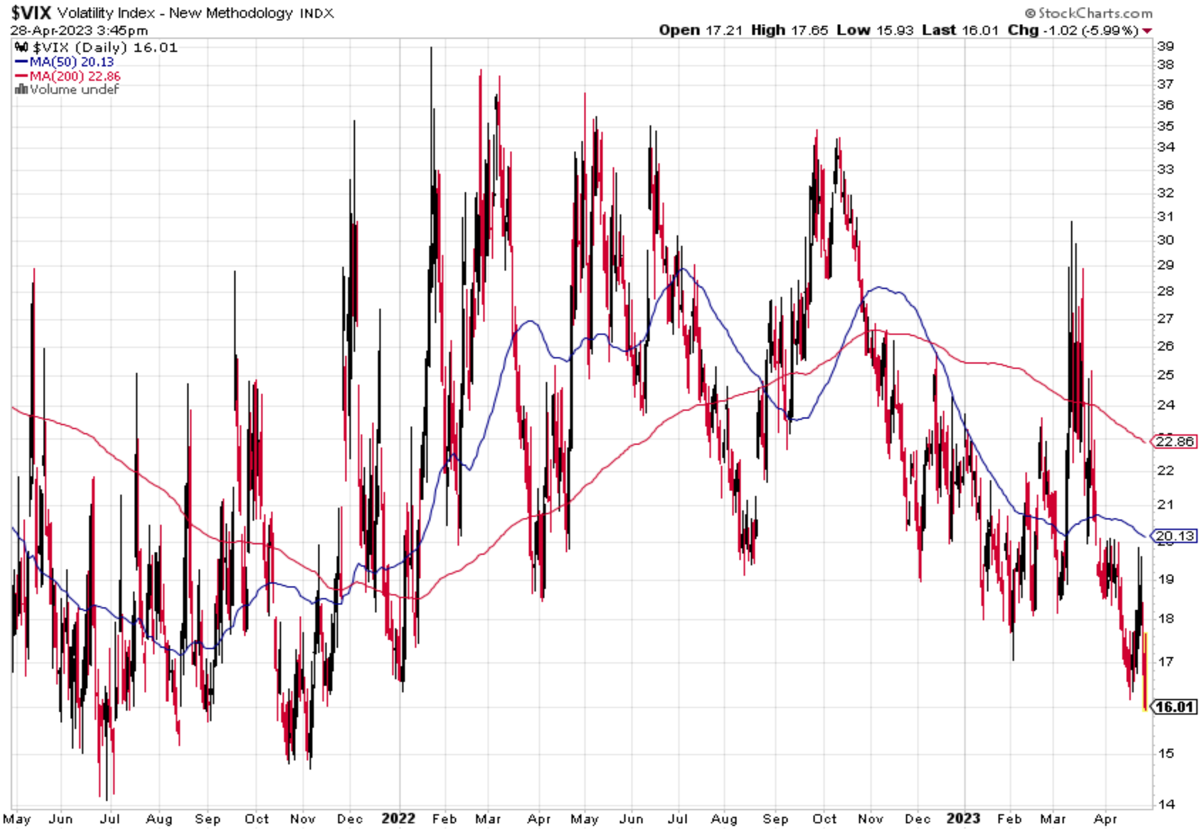
The calm carried over into April. A 2-year view of the U.S. S&P500 shows it drifting towards the upper end of this band it's been in for around 12 months now.



A similar story for our market where the All Ordinaries has been stuck in a wide range for, well, 2 years or more.

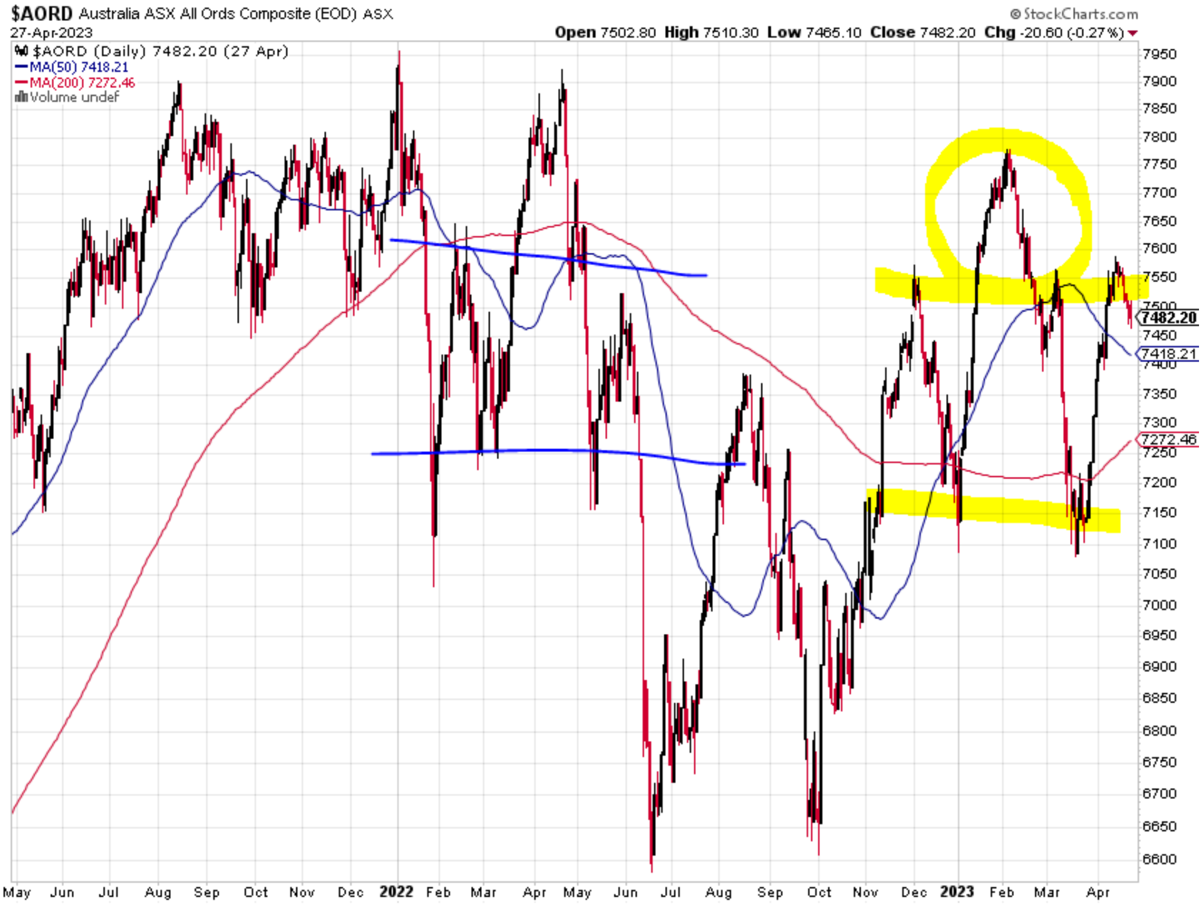


The calm has also been showing up in volatility measures. Implied and realised volatility has been plumbing lows not seen since before the bubble peak was hit in early 2022.



To anyone with an eye for technical analysis, these charts look quite fascinating. The S&P500 undeniably looks pretty good at present – a series of "higher lows" – the makings of an up-trend. What remains to be seen is whether it can decisively break the trading range to the upside and begin to make a series of "higher highs".

What immediately jumps out on our All Ords chart is a textbook "head-and-shoulders" setup in progress. That isn't a positive setup. Below is the same chart as above with a few annotations. A very similar head-and-shoulders formed last year (marked in blue) – notice what happened when that neckline broke!



This relative calm littered with both positive and negative factors means nobody is winning – it's a pretty even match between the bulls and the bears.

It's an environment where it seems anything is possible…

Given this, it would seem to be an opportune time to reflect on the core elements of our market views as well as our investments views in general.

Amazing times

This current market cycle has been rather incredible. Starting after the global financial crisis and running for 14 years, this cycle has been one of the longest in history. Its delivered gains in the order of 665% to the U.S. S&P500.

An underappreciated feature of this cycle that has never been seen before has been the change in central bank monetary policy. Throughout history, central banks have almost exclusively had a "systematic" approach to monetary policy – decisions made based on economic data and conditions. Instead, a feature of this cycle has been "quantitative easing" – this idea of holding official interest rates near zero whilst simultaneously buying interest-bearing government bonds out of public's hands, replacing them with zero-interest base money.

"Systematic" monetary policy has been replaced by this "activist" monetary policy where central banks (the U.S. Federal Reserve in particular) have decided to step away from their legislated mandates and use un-tested tools to influence and control the economy. Fed members themselves have acknowledged in the past they don't know what the full impacts of these programs will be. We believe that current problems such as bank failures are an outcome of prior policies… and we suspect there's a few more "issues" to come as things continue to unwind.

The Covid period was also unprecedented in the modern world. The world basically stopped. In order to keep the economy going as best as possible, many governments responded with extraordinary support/stimulus programs – running deficits never before seen. This wave of stimulus has distorted things in ways that we feel most investors underappreciate.

14 years. It's a long time. For many younger investors, it's the extent of their experience. Understandably, it all just seems normal – markets no longer have cycles, the economy will be bailed out by over-zealous politicians and central bankers at any sign of weakness. Inflation? Doesn't matter – prices rising are good for businesses! Valuations? Not relevant in the modern world…

Speaking of Valuations

Frequently, I find myself engaged in a conversation with someone about investing and financial markets. For several years now, my message has been largely the same – it's really hard given that valuations in the world's largest and most important capital markets complex – the U.S.A. – reached "bubble" proportions during the craziness of 2021 and the probable unwinding of this means investors face a very treacherous landscape.

I find I often get a rather blank look as I tell this story to the "intelligent layperson". I put this down to a few factors – mostly an inability to really appreciate what I'm talking about and also the fact that few others tell such a story.

How do you value a business? Let's say your mate asks if you'd like to buy into his building business – 10% stake for $500,000. (He says wants some added capital to buy some new equipment or something.) Seems he's doing well for himself – drives a big new Chevrolet monster truck, the family just got back a from holiday to the U.S…

If you talk to your accountant about the offer, he'll surely want to see the financials. Not just for this year but for the last few years. He then might coach you through an assertion that a reasonable value would be a weighted average of the last 5 years profit.

Your mate retorts "yeah but we're growing fast – future profits will be a lot higher!"

The good old price/earnings ratio.

When it comes to stock market listed companies, the P/E ratio is the standard valuation metric you'll hear. It's generally even simpler than that example applied to a private business - rarely will "analysts" seek to do any sort of basic manipulation or analysis – such as a weighted average 5-year P/E.

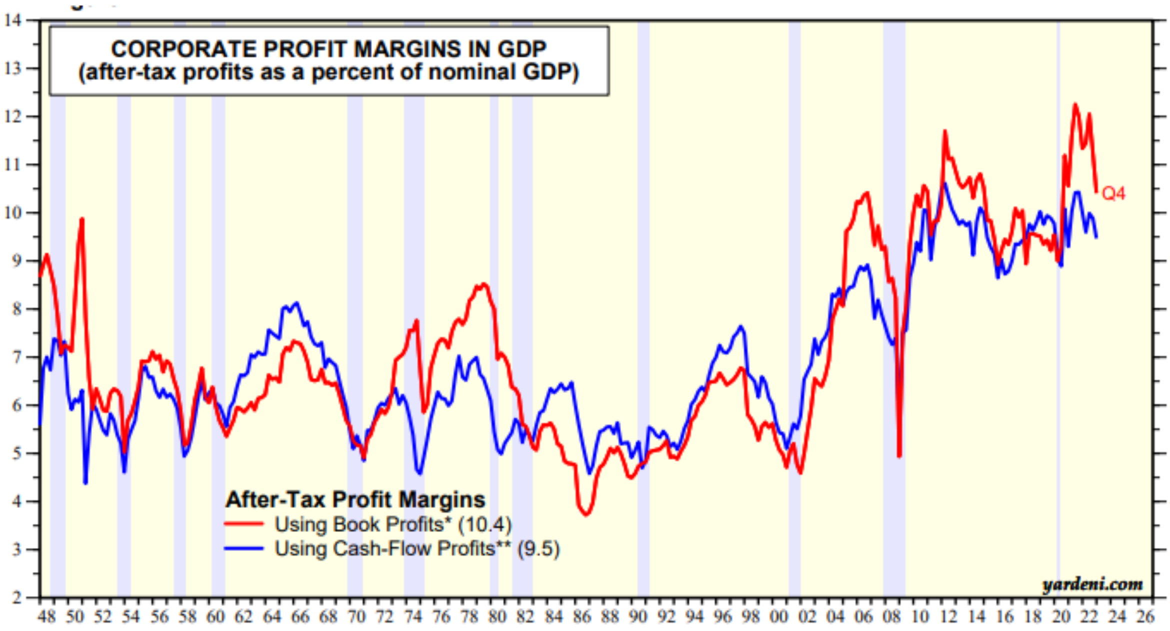
Is the standard single year P/E really useful? A stock is trading on a P/E of 17. Is that good?

A valuation model is only as good as its predictive powers. If it's good, you will be able to show it - there will be a very high correlation between the information it provides and subsequent market returns.

Here's the thing… When you invest in a business, what you stand to be delivered as an owner is the very long-term stream of cash flows that the business will produce. You're not buying just one year's profit.

If you want to use a simple valuation model of "price-to-something", it's important that the "something" in the denominator accurately represents that long-term stream of cash flows that stand to be delivered to you as an owner.

One of the things with "earnings" (profit) is that they tend to fluctuate over time. Here's a graphical representation of this in the U.S. thanks to Ed Yardeni:



* Tax-accounting basis as reported to IRS.
** Book profits including Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj), which restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Bureau of Economic Analysis.

Notice that profit margins soared to record levels post-covid (i.e. post-covid government deficit-funded stimulus!) Understandable if you understand the accounting identities that operate – one sector's "deficit" is another's surplus and surging profit margins is one way the government's deficit showed up in the private sector.

As deficits deflate, is it reasonable to assume margins stay at record levels? Wall Street analysts sure think so.

Related to this chart, the P/E was very reasonable during the years leading up to the GFC of 2008. "Valuations reasonable… just keep buying…" Whoops!

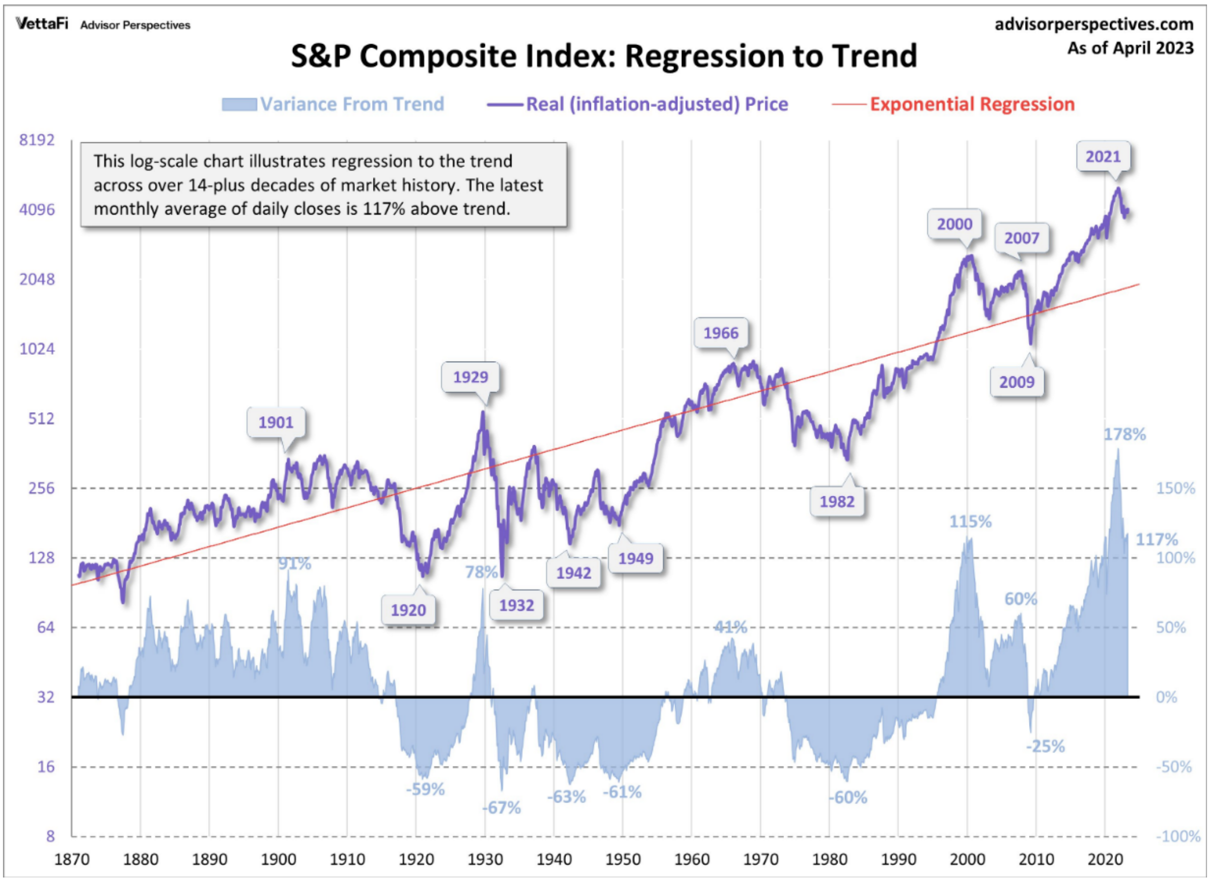
In our quest for a valuation tool that has some real predictive powers, what we find if we do the research is a "net earnings" or "profit" based denominator has a poor correlation to subsequent market returns. Instead, what we find is a denominator based around revenues or general economic activity has a very high correlation to future performance.

This makes logical sense. Companies operate in the economy and their revenue growth potential should – in aggregate – be pretty closely tied to economic output.

What's that you say? Your objective is to invest only in businesses that will grow revenues and profits at a much higher rate than the economy? Like your mate's building business. Great! You go do that. Choose very wisely – you need to both identify that company and also ensure you pay a sensible price for it. The market has a way of treating companies very harshly as they (inevitably) transition from high-growth to "sustainable growth".

What do you mean "mean"?

I want to take us on a tangent at this point. Putting valuations and earnings and recessions and all that stuff aside for a moment, long-term observations reveal that markets have reliably moved in cycles. The following chart is quite fascinating:



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S&P Composite Index: Regression to Trend

This log-scale chart illustrates regression to the trend across over 14-plus decades of market history. The latest monthly average of daily closes is 117% above trend.

This chart plots an exponential regression trendline through the S&P Composite index. Currently, it's a long way from "trend".

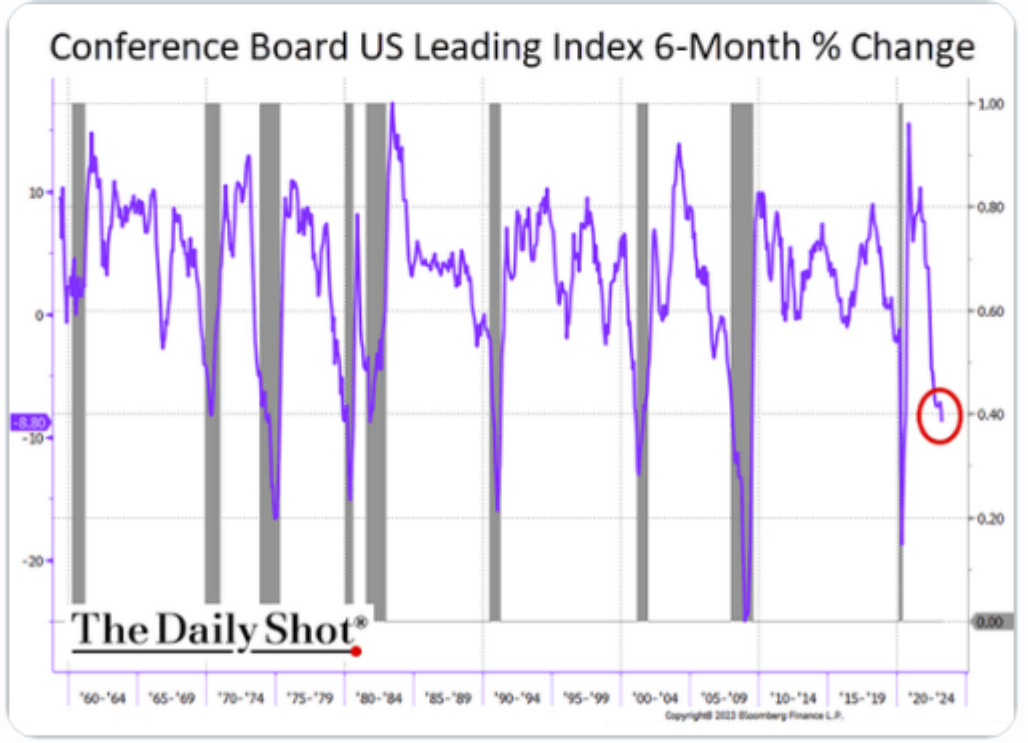
What's that you say? An exponential regression line applied to price data – hardly very scientific!

Yes okay – maybe that's fair. But let's at least file this in the back of our minds.

(Brief) Economic Update:

As observed earlier on, this quiet period has been offering up something for everyone. But having said that, there's been a lot more "bad" than "good" of late.

Take the latest monthly reading for the Conference Board's "Leading Index":



It's never had a reading this low without a recession ensuing. That's quite a decent track record.

Here's another little titbit from financial history:

In the last 100 years, there's never been a case where share markets avoided falling to a new low after an economic contraction commenced. On average, the bottom came 9 months after a recession began.

What's that you say? Just one data point? "Cherry-picked!" You can show me a few positive data points?

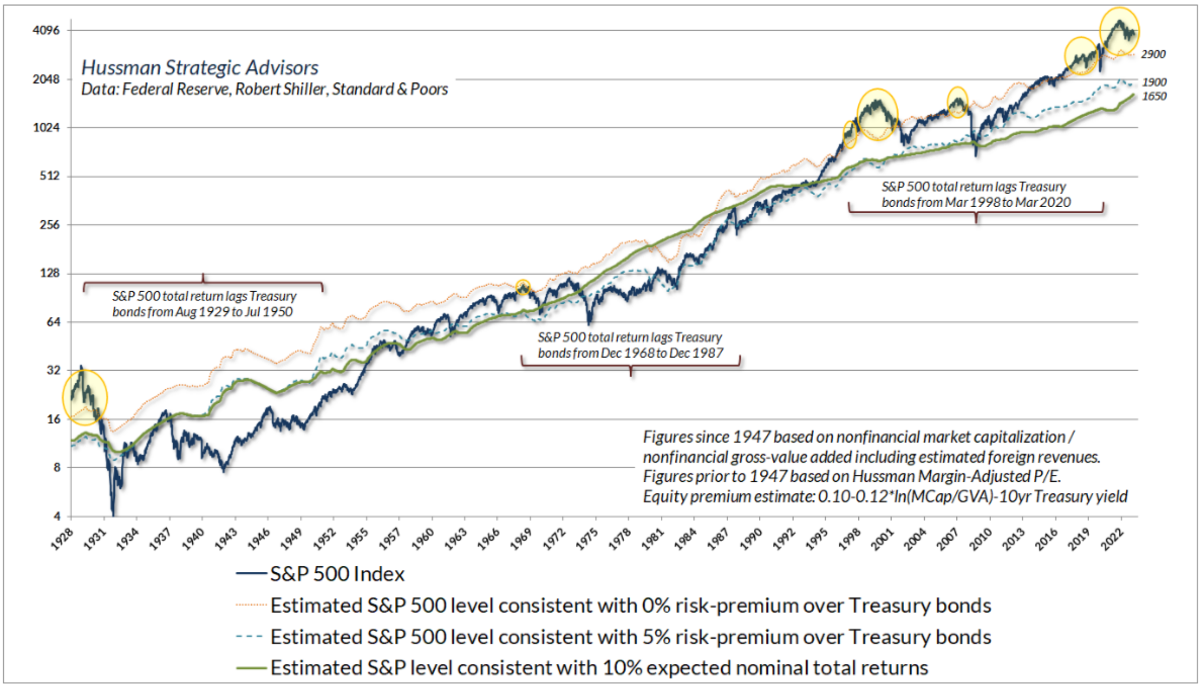
True. Now, these data points are historically-significant, but it is just one data point that's subject to changing.

This is kinda my point – right now, there is something for everyone to believe in.

Back to Valuations

I frequently cite the work of Dr John Hussman. I'm not ashamed to admit I'm not capable of emulating the standard of valuation modelling he and his team does (lack of time being one major drawback) thus I'm very comfortable to cite his work. He's done us all a big favour by laboriously testing every imaginable different valuation metric and identifying valuation models that have very strong predictive powers – that is, very high correlations with subsequent market returns.

The chart below is an interesting format for presenting their most reliable valuation tools:



The chart plots the S&P500 against a series of different levels representative of certain prospective return parameters.

To assist with your understanding of this, let me ask you a question:

What sort of annual return do you think you can reasonably expect on a share portfolio? What does history tell us?

How about around 8 or 9%? Does that seem reasonable?

Well, that scenario is basically the blue dotted line – 5% over treasury bonds.

So at what level would the market need to be today in order to realistically, reliably, expect that level of return over the longer-term?

About 1900.

Wait – what? The market is over 4100 – that’s about 55% lower.

Well… yes, yes it is…

Valuations have only been this stretched beyond “trend” on a handful of occasions. The levels reached in 2021 are all-time records.

So what does this mean? What do we do about it? Well, that depends mostly on what you believe.

Firstly, note that we're not predicting a fall of any specific magnitude. Whilst a fall of 50%+ would only bring markets back to "trend", we're not predicting this outcome. It won't surprise us, but it's not a prediction.

Also note this type of modelling isn't asserting that every stock in the S&P500 is expensive…just the average stock. A valuation model like this is accurate to a large degree because the S&P500 is made up of mature businesses with revenue streams that can be accurately modelled relative to economic factors such as GDP. Some S&P500 components will be much more reasonably valued than others whilst some will have, in hindsight, much better revenue and profit growth over the coming 5 or 10 years.

If anything, this environment is a stockpicker's market. Choose well… choose only those companies that are "reasonably" valued and will grow revenue and profits very strongly for the period until broad valuations are restored back to more reasonable levels. Be very cautious towards richly-valued growth companies that might suffer a downturn in profit in a bad economy – these will probably be punished badly.

Have another close look at that valuations chart. Also go back and have a close look at that "trend regression" chart. Several important observations can be made:

A significant deviation beyond "trend" isn't an immediate trigger for a "correction" back towards trend – indeed, the only way the market can become strenuously extended beyond trend is if it's already passed through lower levels of "over-extension". Markets can stay over-valued for extended periods.

But observing the other instances of strenuous over-extension, note the market has tended to resolve these quite abruptly within a couple of years.

Said another way, strenuous over-extension has historically resulted in a significant market fall within a few years of that strenuous overvaluation first being recorded.

Again, not a prediction – just an observation.

What we believe:

We believe in market cycles

We don't believe the "cycle" ended and re-set during Covid

We believe a continued unwinding of the excesses that have built up over the last 14 years of misguided zero interest rate policy will deliver more negative "surprises"

We believe that history is a reliable guide to future events

We believe in “normalisation” rather than endless extrapolation

We believe that opportunities are much easier to make up than losses

Most of all, we believe that strenuous valuations hover over the market like a giant slab of concrete suspended from a fraying rope. Not only does this cap upside potential – the rope can break at any time with little warning, doing significant damage to any unsuspecting share portfolio milling around underneath.

To repeat one of my favourite catchphrases – it’s really hard for investors right now.

Anyway, enough of what we believe… what do you believe?

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