Aviator Update – October 2022
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Reflections

As I've scanned the financial world this last month, I've found myself doing a lot of reflecting on things. Where have we been? Where are we heading? How do our core investment theories stack up based on what's occurring and historical precedents?

A key feature of the internet age is an abundance of information. This is clearly a good thing, although it comes with a few drawbacks. Should we choose; we no longer need to be subjected to views (on any subject matter) that differ from our own – we can always go directly to sources that reflect our own world-view. This confirmation bias can lead us to make uninformed decisions.

As investors, it's important that we acknowledge this. There's always a psychological tendency to be drawn to views that reflect our own. That can be a costly mistake 0for an investor.

A key trait of a successful investor is an ability to see things as they are. Part of this is related to knowledge and experience but there's also management of that psychological aspect.

Even more importantly, we can't ever get too stuck in our views – the financial world is always shifting and we need to shift with it. Failure to do so will cost us money and opportunity. In fact, if there's just one thing that brings an investor unstuck, it's a belief that the current trend will last forever.

Core Thesis

The core of our current investment thesis has been in place for several years now. It goes something like this:

Most of the time – perhaps 85 to 90% of the time, markets are in a fairly "normal" state. Valuations are "reasonable", economic conditions "benign". During these periods, investors can go about their business without much concern and with an expectation that owning shares (and other risk assets) will reasonably deliver them a "historically-average" type of return.

Every now and then, markets find themselves in an "abnormal" state. The primary feature of these "abnormal" states are valuations stretched well beyond "norms" (reasonable historical averages as measured by historically-informative valuation models).

The U.S. equities markets reached very elevated valuations several years ago. This was a cue to become defensive. Not “sell everything”, but elevated valuations tell us that future prospective returns will be lower than “normal”. History also shows that historically-overvalued markets are prone to abrupt and sizeable falls.

Then came Covid. It goes without saying that this was an amazing period in modern human history. With respect to share markets, first they sold off hard. Then they ripped higher.

Valuations reached levels never seen before in the last 100-plus years. With this, we saw some really rare and incredible behaviour by investors. Investors bid up the price of all kinds of assets to levels never seen before without any regard to valuation or the merits of the investment. There was even creation of new asset classes (with no discernible value) for people to invest in.

Breathtaking valuations combined with crazy investor behaviour. This combination has only been seen several times. That right there is a bubble.

It would seem that we’re now on the other side of that bubble.

Best at the top… worst at the bottom…

I’ve read a few commentary pieces over the past month where the author has described how similar the current environment “feels” to 2007/2008 and/or the 2000/2001 tech bubble. This has had me reflecting on my own experiences…

Before and during the 2008 global financial crisis, I was working as a stockbroker at a boutique Aussie investment bank – maybe 150 staff across 5 or 6 offices. The firm had a rather “aggressive” reputation – we were a firm you sought out if you wanted advisory and trading services on FX, futures and equity derivatives.

We had about 25 in our trading room. Varying in specialties – equities, FX, futures, derivatives… Our team of 6 specialised in Australian equity derivatives. Our team head was the oldest of the group and, at 30 years of age, he was making more money than the rest of us could imagine.

Being in his 50’s, Les was one of the older guys on the desk. He managed equities portfolios for a modest client base (mostly just amusing himself doing what he enjoyed prior to retiring). Being in our 20’s, we enjoyed hearing his stories from when he was a young broker.

He told us about the crash of ’87. He was working as a broker on the floor of the ASX in Sydney. On Tuesday 20th October, they came to work and learned that the U.S. markets had fallen more than 22% overnight.

He described the eerily quiet scene as markets headed towards opening. The chalkies (the people responsible for writing up the orders and recording the trades) began writing up orders – a sea of sell orders… As the market opened, there were no bids for some stocks – no trades could even be executed. Les recalled how, for some "blue-chip" companies, somebody would finally shout out a buy order… maybe 30% below the closing price the previous afternoon.

Bang – the order was matched with an eager seller and trading finally commenced with the company losing 30% of its value in an instant.

The ASX would close down 25% that Tuesday…

Although he didn't use the specific word, Les was providing us a valuable lesson in liquidity – how investors tend to take it for granted until you actually need it. I couldn't fully appreciate it at the time. Sure, I was active as a young wannabe trader throughout the 2001 tech crash, but I was too naive to really learn much more than how easy it can be to both make and lose money. I was soon to get my own real-world lessons on liquidity…

Also around this time, I overheard Les having some "tense" discussions with clients.

"No… look, it just "feels" different…I've seen this sort of thing before… this isn't good… you just need to trust me…"

I asked my team head; "what's up with Les?"

"Oh, he thinks the market is going to go to shit and some of his clients are pissed off because he's sold them out of the market and they are losing money given its going up…"

"huh…" was basically my response…

In reality, our team didn't really even have an opinion. We were busy each day servicing our clients – helping them with (mostly) short-term trading ideas. If a client had cash in their account, we'd find them a trade meeting their desired interests/objectives. Maybe we suggest buying a Call spread on something that had pulled back to some support line on the chart. Perhaps selling Calls over a stock holding or a "synthetic long" on the ASX200 index.

Our "research" was mostly confined to reading analyst notes on the names we traded – BHP, Oxiana, Metals X – ensuring we could have intelligent conversations about them. There wasn't really any time for much macro analysis.

And anyway, the market was doing great! The outlook was great. Global economic growth was solid, China was on the rise, flooding the world with cheap "stuff" thus pushing inflation low whilst also consuming more and more Aussie resources… All the CEO's that presented

in our morning meetings gushed about all the opportunities that awaited them. Analysts and strategists agreed that the outlook was great. Life was good…

Until it wasn't…

There were so many lessons to come out of that period in time.

One of them was how long bull markets lull everyone into a sense of complacency and security – endless gains are all "normal". Every "dip" is to be bought.

Related to this is the fact that bull markets end on good news. Things always look the best at the top.

Reflect back – not to 2007 but to last year… How did things look and what was the general narrative? Well, we were right at the start of a glorious post-covid recovery, right? Inflation was low, monetary policy accommodative, corporate profits strong (and projected to get even better). The outlook was great.

There was another important lesson from 2008. Legendary investor and market historian, Jeremy Grantham, had done a reasonable job at calling the market peak. He did a reasonable job at calling the bottom also! He titled the commentary piece he released within weeks of the bottom "*Re-investing when terrified*".

Bad markets always look the worst at the bottom.

Let's reflect on that idea today. How do things look? How do things "feel"? There's certainly a lot of pessimism. But this is nothing compared with the low points of bad markets such as 2008.

I want to share one more highly relevant memory of the GFC era. There was a bit of a joke in the industry about how on big down-days (in various markets, not just shares), there was known to be a bunch of "quants" out there staring at their screens in disbelief. "Do you have any clue what's happening" one would ask his colleague. "Nope…you?" would be the response.

These were 20-something year old Wall Street "whiz kids" – computer, statistics and math experts that built these quantitative trading models based around sound statistical modelling. According to them, things that were happening in various markets simply shouldn't happen. They were seeing 3, 5, 7-sigma moves – moves that statistically should happen maybe once every hundred years. And during some short periods they were seeing them happen *every day*!

The U.K. pension mess currently unfolding is just another example of things happening in finance-land that, "mathematically", shouldn't happen. These pension funds were sold

creative leverage strategies to help combat the falling interest rates environment they had experienced for, well, around 30 years.

Another case of betting a trend lasts forever and relying on mathematical models that work until they don't. The trend changed – interest rates spiked. The model blew up. The leveraged trades blew up.

The 2008 experience (as well as other historical precedents) suggest it's probable we will see more events like this unfold. Crazy amounts of leverage have built up during this last 10+ year period of low interest rates – excessively low rates, deliberately pursued by central banks in order to stimulate economic growth and made possible by the absence of inflation.

Investors know this. They know there's a real chance of more "financial accidents". This puts investors (big investors that move markets) on-edge. They know that they can't take liquidity for granted. Therefore, if there's a rumour of bad things happening in a market they are involved in, the tendency is to sell first and ask questions later. Big investors know it's better to sell fast, take a loss – perhaps unnecessarily – and ensure you live to trade another day.

This is very much a feature of this market environment and another lesson from 2008.

It's my opinion that the world is only just starting to "absorb" the shock levied on it from inflation and interest rates. The consensus is still that inflation will return to 2% by next year, interest rates will come down and everyone lives happily ever after. I'm receptive to this being a possibility, but I'm also wary that, even if that scenario largely plays out, we still have some more of this painful period of "absorption".

Phase-2:

What are we hearing from many analysts at the moment? By that I mean your typical perma-bullish, sell-side analyst. Something like this:

"*The markets have pulled back quite a bit and that's understandable given interest rate rises. But there's signs that inflation is topping out and with this most of the interest rate rises are behind us. It's our view that we're now on the cusp of an interest rate reduction cycle which history shows will be positive for risk assets. Also, when you look out at 2023 earnings estimates and especially 2024, the market is now trading at a forward PE in the mid-teens, which is very reasonable*…"

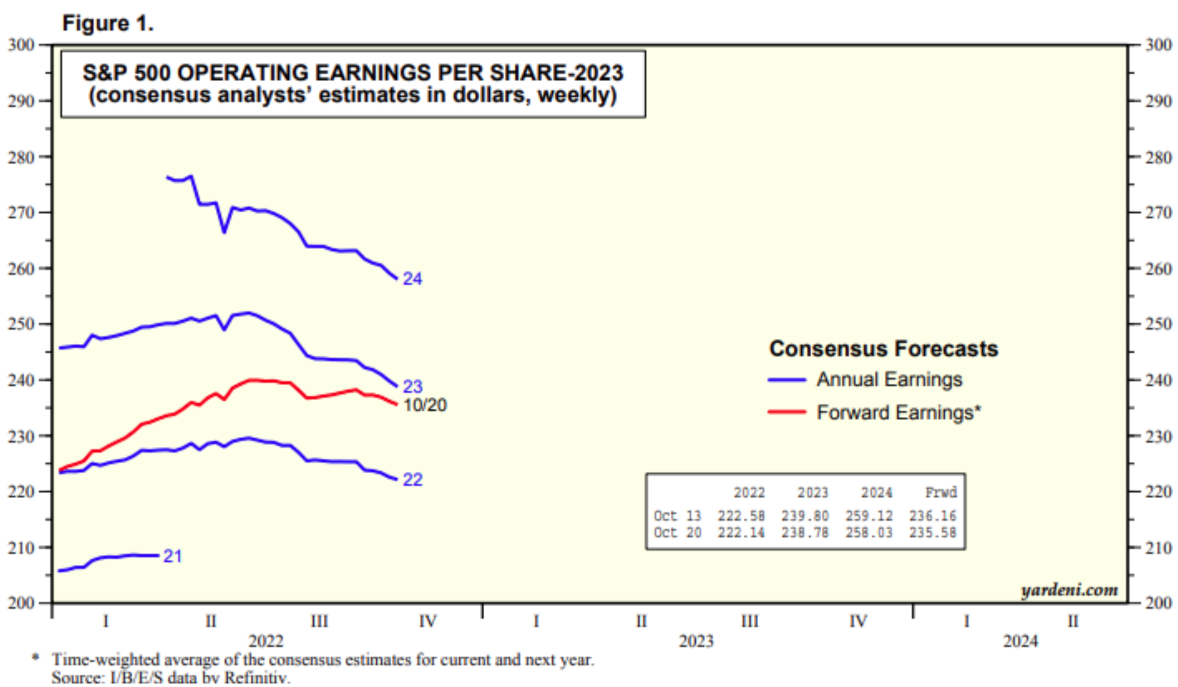
I have a number of issues with this sort of analysis. The main one relates to the valuation model being used – being the "forward PE".

It makes logical sense that stock prices should be reflective of future earnings. They do. The trouble is that stocks aren't a claim on just one years' worth of earnings – they are a claim on the very long stream of cash flows that will be delivered to the owner of that asset.

Historical observation shows that there's very little correlation between year-on-year changes in earnings and share prices. Therefore, a simplistic model that concludes "the 1-year forward PE is reasonable" is no real use to us.

There's another problem with this approach. Earnings estimates are subject to a lot of variations and analysts are notoriously bad at predicting "unexpected" changes.

As I've referenced in the past, Ed Yardeni does us all a great service by tracking consensus earnings estimates for the S&P 500. He creates little charts that plot the change in consensus estimates over time – what he calls "earnings squiggles". Currently, it looks as follows:



The shape of the squiggle shows how earnings estimates have changed over time. They pretty much always slope downwards. What this means is that as time passes, analysts are generally "revising down" their expectations. In other words, they were too optimistic to begin with.

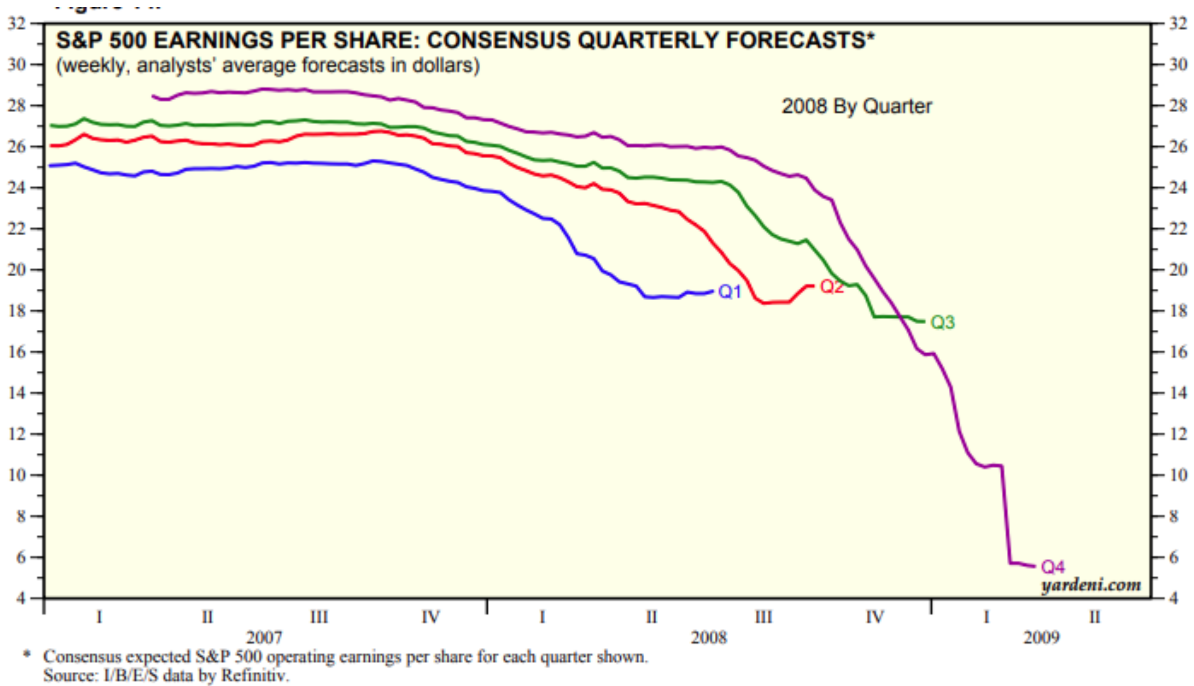
Earnings estimates for 2022 have come down but are still expected to come in around 222. 2023 and 2024 have also come down quite a bit – the consensus is now 238 and 258 respectively.

If we assume for a second that their estimate of 2022 earnings actually plays out, the expectation is earnings will grow by around 16% over the coming couple of years (from 222 to 258). In an economy expected to grow by… well, what do you reckon?

It’s my suspicion this kind of earnings growth is rather unlikely.

“*But surely all these high-priced Wall St analysts know what they’re doing – we can trust them to be relatively accurate, right*?”

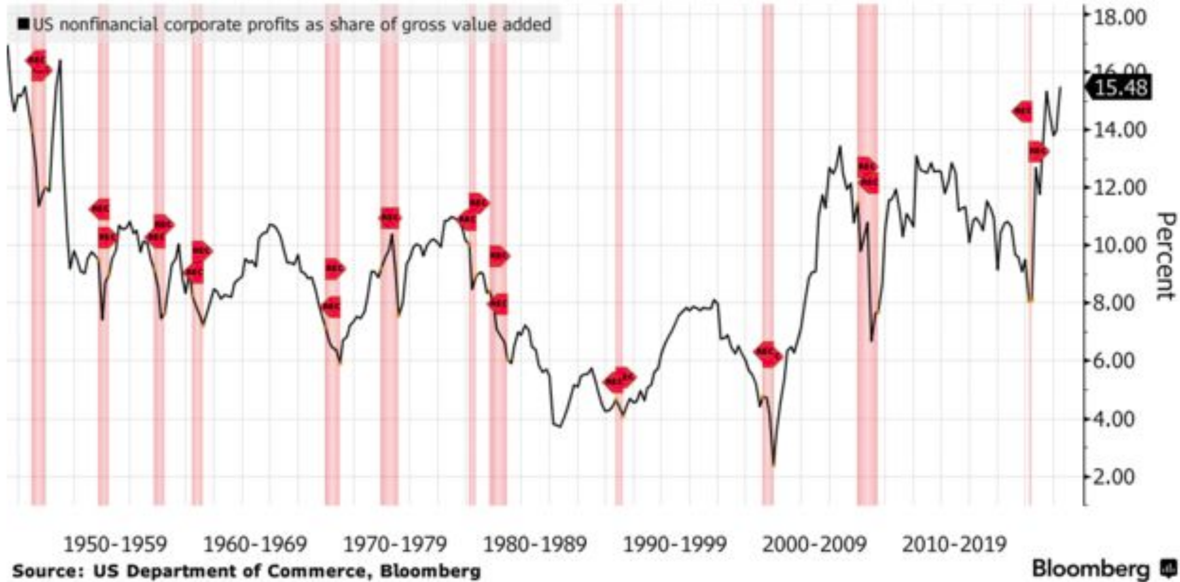
Well, let’s reflect back on 2008. Here’s the chart:



Follow the purple line. Towards the middle of 2007, analyst consensus estimates for Q4 2008 were around 28. They ended up coming in around 5. Whoops… Only out by a factor of nearly 6.

Earnings Under Pressure

Whilst I’m not suggesting we’re on the cusp of an earnings collapse similar to 2008 (although that’s certainly possible), a solid case can be built around a “pullback” in earnings. The centrepiece of my case relates to this:



Profit margins have grown to record highs. There's some logical explanations for this – the biggest being the fact that, mathematically, corporate profits are linked to the size of government budget deficits.

What happened during Covid? Many nations spent huge on stimulus programs. The stimulus response in the U.S. (and Australia for that matter) was close to 20% of GDP!

The economy is now in the process of adjusting to a new equilibrium without all that stimulus. It's a bit of a process and a predictable outcome is downward pressure on corporate profits.

Of course, corporations are also dealing with all this inflation – particularly the pressure being levied by employees for higher wages. Higher wages means lower profit margins, unless you are able to pass through all input cost increases to your customers. Some companies can. But not everyone. And by the way, we'd like to hope they collectively can't because that means inflation only persists!

Corporates have also been gouging on cheap debt and are historically highly-geared. Many will also experience pressure from rising interest rates. When they go to roll over a credit facility, they will get a bit of a shock – "the current rate on our facility is 2%... what do you mean it's now 6%?" The higher cost of servicing debt will also impact profits.

There will probably be some "financial accidents" linked to difficulties rolling over debt. That's just what happens.

To summarise, there's significant pressure on corporate profits. It will take close to 30% fall in profits simply to bring profit margins back towards historical highs. Arguably, that's the optimistic scenario. If the economy enters recession, profits will probably fall a lot further than that!

“Anti-wealth effect”

Reflect back a couple of years and you’ll recall some talk about the “wealth effect” resulting from rising asset prices. Recall that some Fed governors even specifically noted it as a “policy objective” linked to suppressing interest rates. It’s a rather controversial theory, but there’s no doubt some truth to it – rising asset prices make people feel wealthier and thus more inclined to spend therefore aiding economic growth.

It works in reverse to. A rather remarkable feature of the current downturn is the “breadth” of losses. Bonds – the “defensive” asset – are down staggering amounts. The falls are perfectly appropriate as they reflect the rapid raising of official interest rates.

What this means is despite share portfolios not being down incredible amounts, there’s surely been some massive damage done to diversified portfolios. Further, some “low risk” investors have just experienced significant losses.

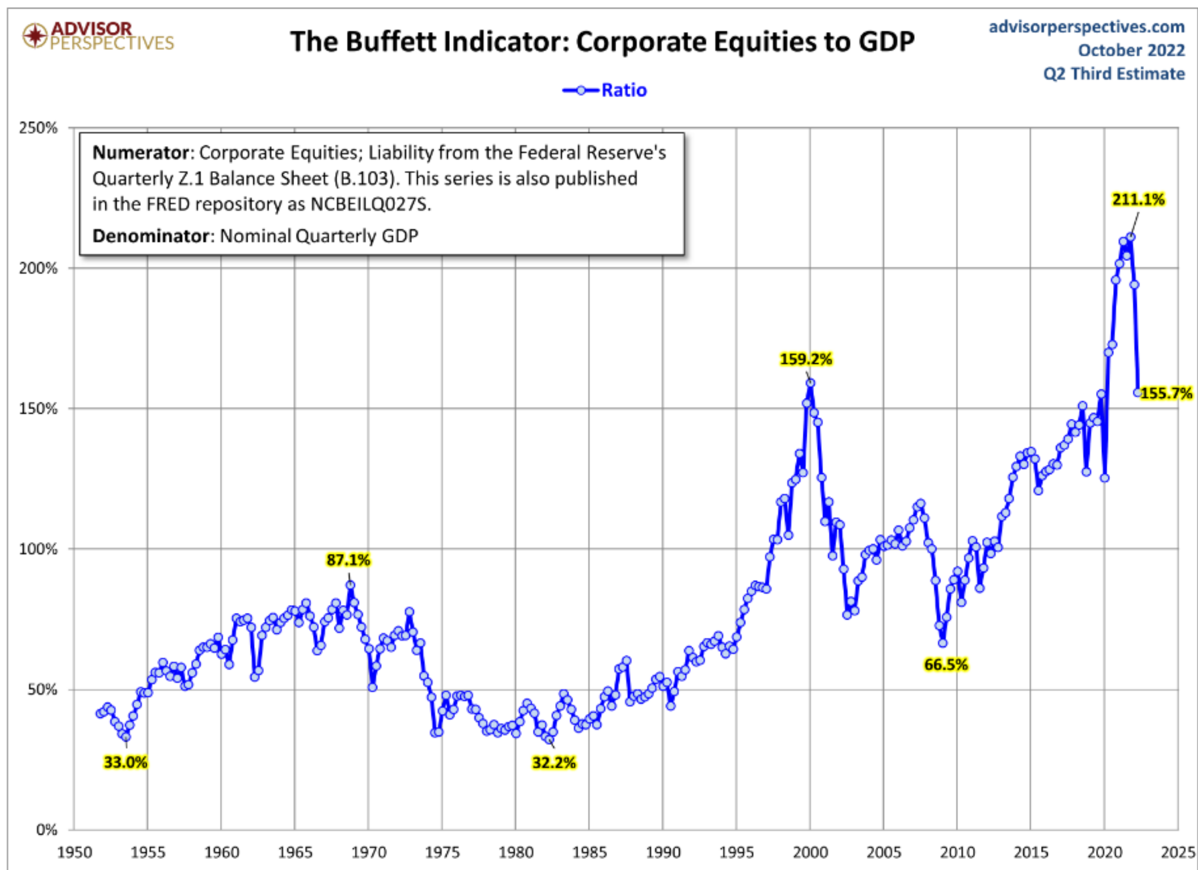
Its only logical that there will a degree of “anti-wealth-effect” from this. Just one more drag on the economy.

Not there yet

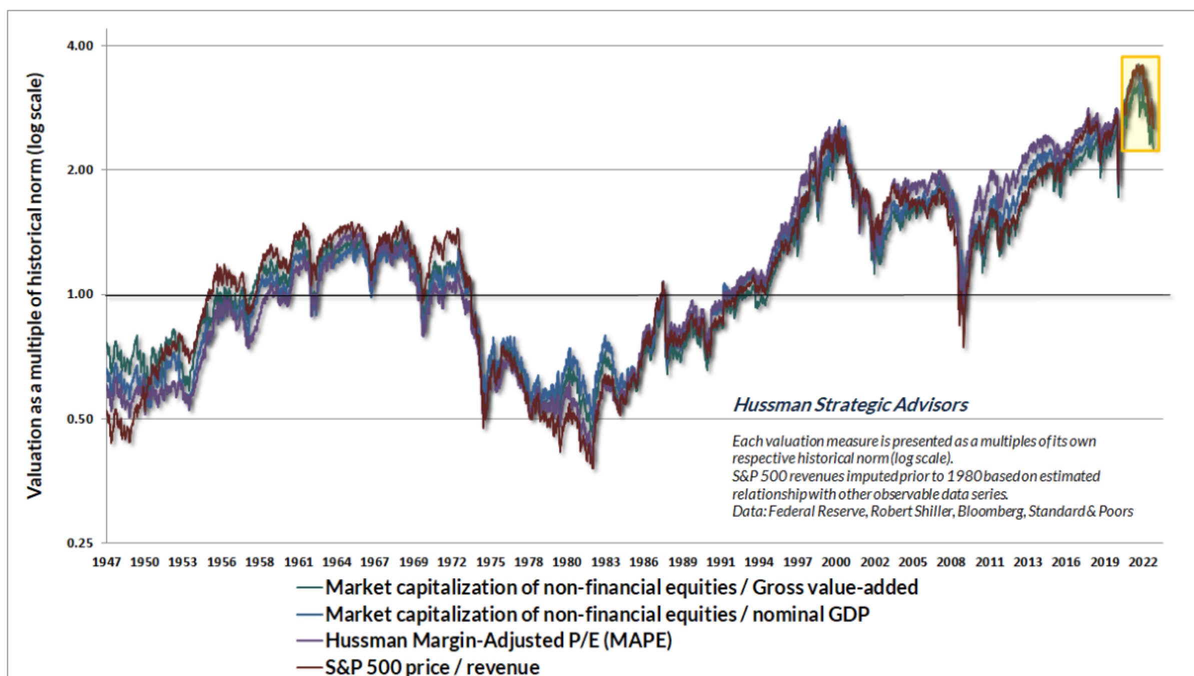
I think we’ve basically seen the first “phase” of what might turn out to be a multi-year “bear market”. The falls have been enough to unwind the frothiness of the preceding bubble but have not restored valuations to anywhere near “normal”.

In support of this, as I frequently have done, I offer up the following valuation models that are proven to have a high correlation to actual returns.

First is the “Buffett Indicator” – corporate equities to GDP, which Warren Buffett has described as probably the single best guide to where valuations sit at any point.



Next are a collection of valuation models formulated by Hussman Funds:



As I've noted in the recent past, its rather uncomfortable to talk about what it would mean for the U.S. equities market to return to "historically-normal" valuations – it's so far below even current levels that it seems absurd. It implies further falls of 50% or more.

Every cycle is different and its entirely plausible the market will not return to "historically-normal" through the completion of this cycle. In fact, I'd be a bit surprised to see falls of the magnitude required to restore "historically-normal" valuations. It is worth noting however that every other time valuations have become extended well beyond "normal", they have retraced to very close to "normal" – history isn't favourable.

I believe the next phase for the markets is significant pressure from falling profits. It's happening already – companies of all shapes and sizes are announcing earnings below consensus estimates. More concerning, many are also withdrawing forward guidance – stating it's too hard to predict.

We're also likely to see more interesting "financial accidents". These are nearly impossible to predict but also carry the biggest risks – to a large degree owing to the smart investors' willingness to "sell first, ask questions later".

But remember, a standard feature of bear markets is the "bear market rally". There will be periods where markets advance meaningfully – perhaps for months at a time. Also note that the strongest "up-days" occur within bear markets! This is what makes navigating this kind of market environment so difficult.

Reflecting on all this, I'm quite satisfied this all passes the "see things as they are" test. All these expectations and observations are supported by historical precedent. There will be a bottom at some point – we need to stand ready to change our view and capture the opportunity it will offer.

And just remember, it will likely "feel" very bad at the bottom…

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