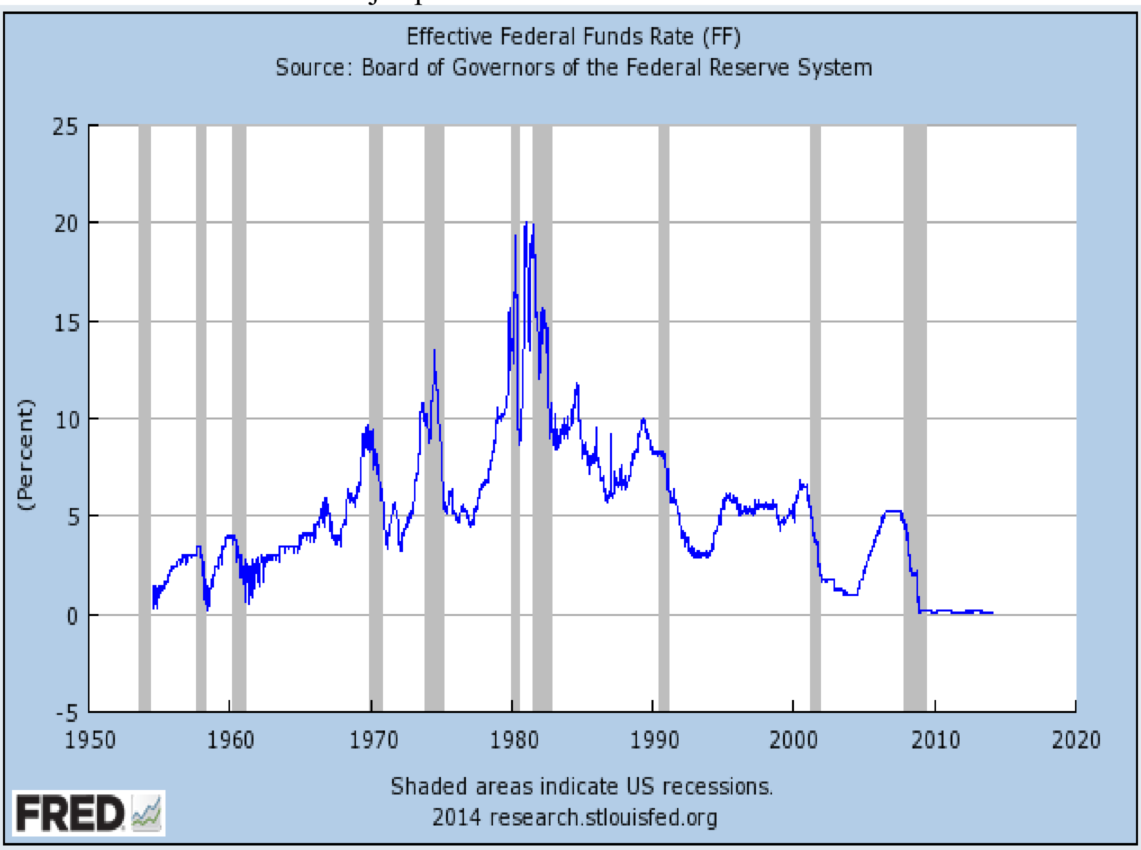
Some things we know about current investment markets.
7/3/14 for clients of Puzzle Financial Advice

With so many strange things happening in the investing world, what do we really know? That may sound like a strange question, but with so many historic extremes in place, we cannot simply assume that investment markets will behave "normally" (eg as per my paper "Puzzle Investment Toolkit" that I circulated in September 2013). Therefore, it is important to step back fairly regularly, to think about what it is that we can rely on with a reasonable degree of certainty.

This is a very unusual set of investment markets, fundamentally because of 3 major factors (among a host of extreme other factors):-

- **Massive money printing by developed world central banks**. I never thought I would see such an event in my lifetime because it breaks most of the fundamental rules for good economic policy.
  - Clime Asset Management in "The Yield Conundrum" (attached) 13/2/14
    - *"Despite tapering by the US Federal Reserve, in a global sense **we remain firmly within the grip of quantitative easing**, or at the very least a period of sustained easy money and low rates. In fact, **Japan has cranked up its QE activities, and the Eurozone is more wedded to the concept of monetary stimulus than ever before.** Government bond rates around the world remain close to historic lows. Consider the yields on 10 year government paper across the major economies: in the US, Treasuries yield 2.8%, in Germany Bunds yield 1.7%, in the UK Gilts yield 2.8%, and in Japan yields are only 0.7%."*
- **Ultra-low interest rates for a historically long period of time.**
  - USA & Europe & Japan. And that makes up most of the developed world as a % of GDP – and in fact a major part of the world as a % of GDP.



  - Before we leave this point about ultra low interest rates for a long period of time, I think it is important to remind you of the observation by the great thinker Woody Brock (circulated to you on 13/2/14), when discussing the risk of unwinding ultra easy monetary policy:-

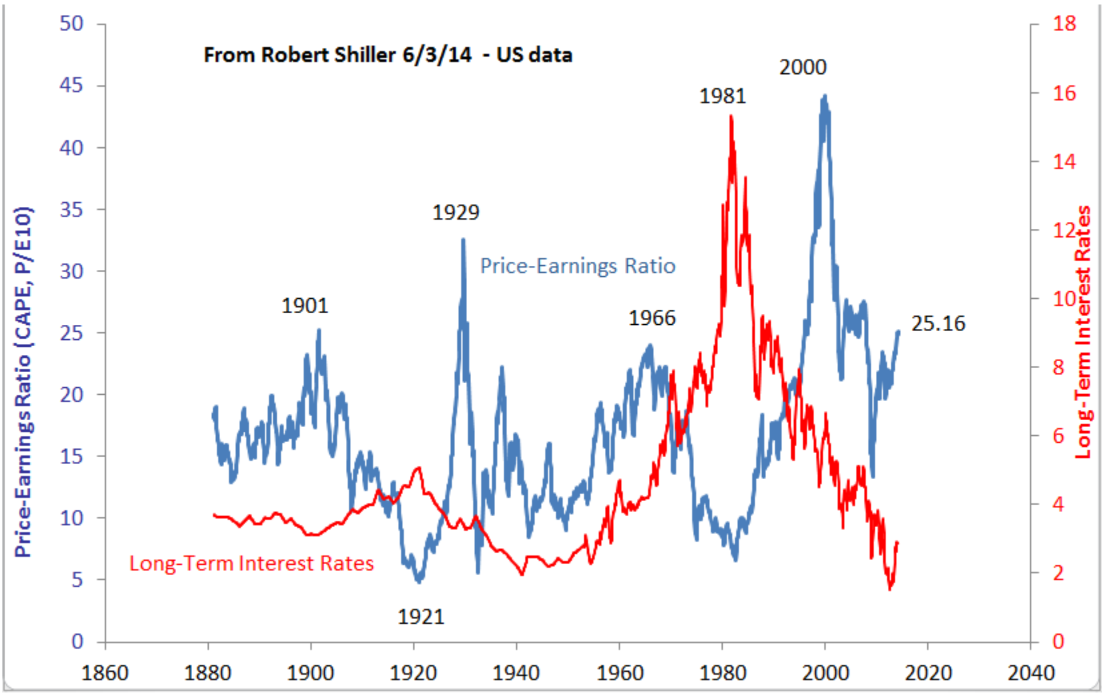
- *'But what about the second dimension to the unwinding of ultra easy monetary policy, namely, higher Fed funds rates and an upward shift in the entire yield curve – for reasons having nothing to do with QE? This is seldom discussed. From the research we have carried out, it is this second dimension of the end of easy monetary policy that is the more important of the two. The nation (USA) has never experienced six years of hyper low interest rates. What impact has this had on the restructuring of the balance sheets of insurers and banks? In striving to match assets and liabilities across 24 consecutive quarters of near zero rates, what tricks might financial institutions have played (reaching for yield via derivative positions) that could backfire and occasion a financial crisis once the yield curve rises from the dead? In particular, what about the increased utilization of new "collateral and maturity transformation" schemes that could occasion future panics?' http://d21uq3hx4esec9.cloudfront.net/uploads/pdf/131221_TFTF3.pdf*
  - Key point here:
    - The USA has begun by commencing tapering – and may start raising cash rates within 12 months. This would be the beginning of the end of the ultra easy monetary policy. As we move out of the ultra-low monetary policy period, you should expect to find some “unexpected” places where ultra-low interest rate policies have caused/encouraged some business to take on extreme risks – and these companies may fail or otherwise experience major falls in their share prices.
- **The historic extreme level of debt (as a percentage of GDP) in much of the developed world.**

I also strongly recommend you watch this video on money printing – and some of the ramifications. http://www.clime.com.au/clime-on-tv/euro-bond-markets-worse-us-banks-gfc/?mkt_tok=3RkMMJWWfF9wsRokuavKZKXonjHpfsX56%2BkqWqSylMI%2F0ER3fOvrPUfGjI4ARctnI%2BSLDwEYGJlv6SgFS7PFMbZp2bgNUhA%3D

So what are some of the things that we know? Here are some simple things that we know.

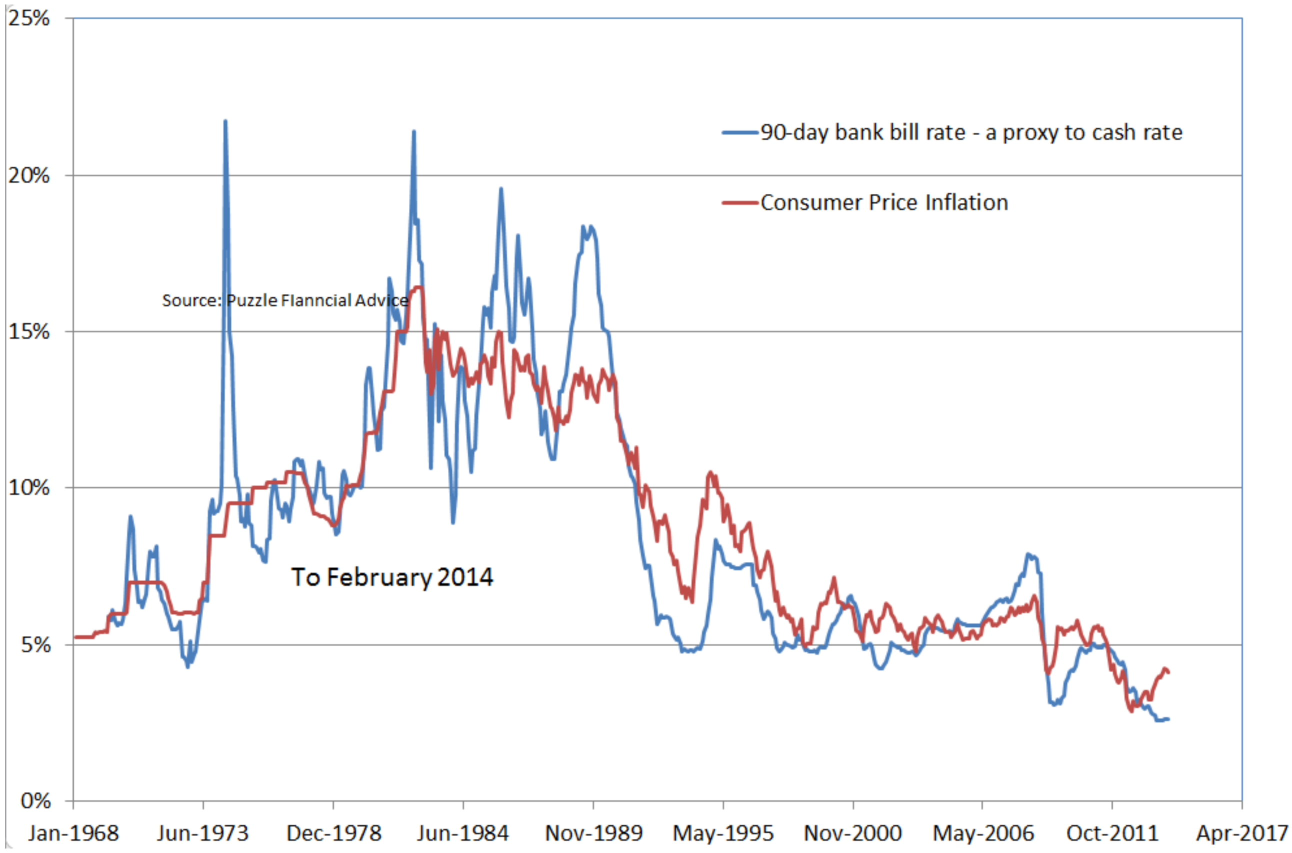
I know that when markets are strange for a significant period of time (eg years), most investors lose focus on the fundamentals of investing – and on the things that you can rely on for the longer-term. So what are some of the things that we need to ensure that we do not forget in this historic extreme period:-

- **When things are strange (divergence from normal), at some point things revert to "normality."** This is one of the most reliable investment guides.
  - **When share markets are expensive (very high P/Es), they revert back to more normal valuations at some point** – and we can see this is what has happened with US share markets.

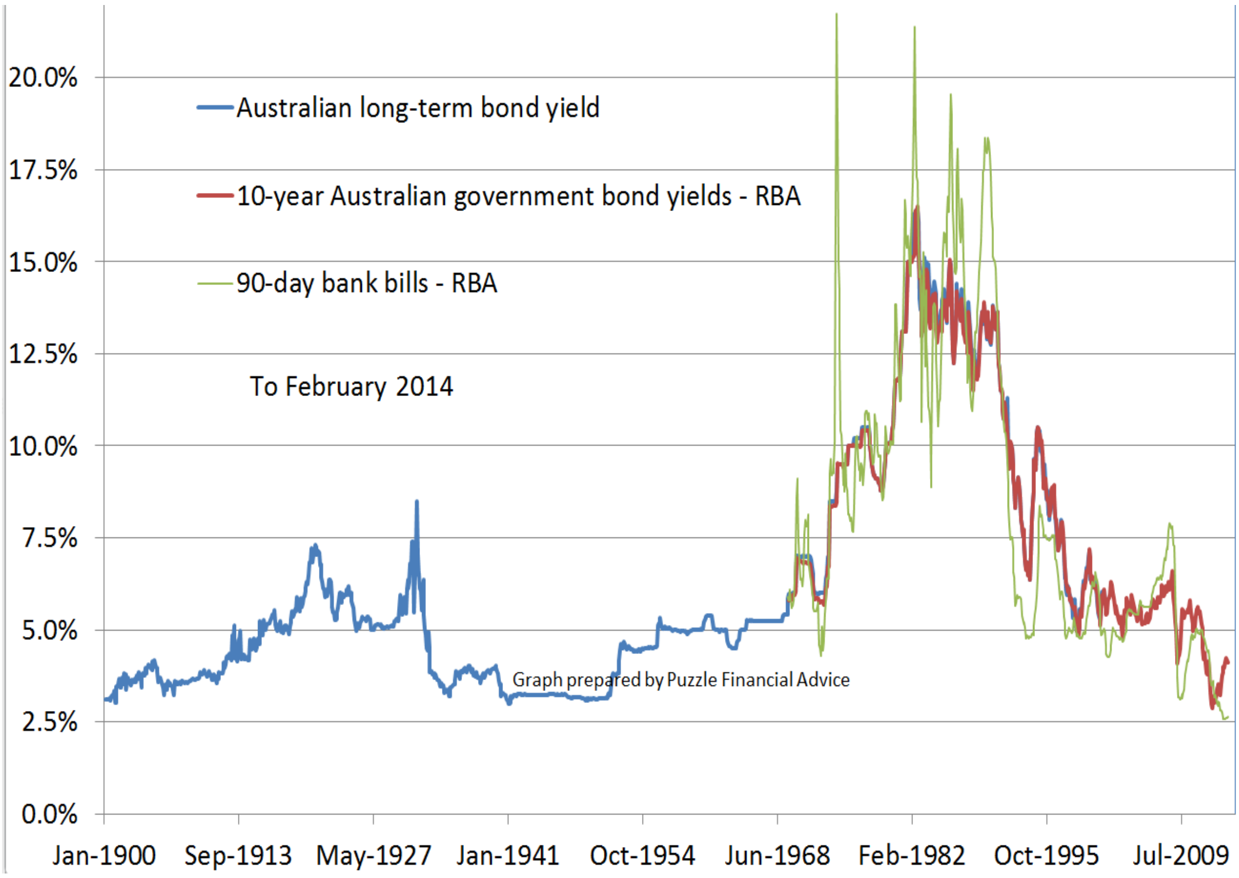


    - Bottom line:
      - This means that on broad averages, we should see expensive share markets fall in due course. This includes Australian & US share markets on broad averages.
        - Quote from the Clime article attached.
          - *"Over the last 12 months, the big banks (which make up about 30% of the Australian share market) have risen by 20%, but at current levels look stretched on valuation terms. Dividend yields on the big banks have come down from 6.5% two years ago to 5.6% today. While these banks are well run and have better quality earnings than their international peers, they are certainly not bullet proof. Banks are leveraged, cyclical plays on the economy and should be purchased at meaningful discounts to valuation. At present, most trade at premiums to valuation."*
      - If you buy expensive assets (even if they are good company's), you have a high probability of getting a low or negative return over the medium-to-long term.
        - A relevant quote from AFR article 26/2/14 "Why Alliance Bernstein is underweight on Australia", we have the following quote:-
          - *The head of equities at global funds management giant AllianceBernstein, Sharon Fay, is happy to swim against the tide. The veteran money manager, who oversees $US150 billion ($166 billion) of equity assets, jokes: "**In my 24 years in value investing, I have owned every sector of the market, because at some point, they are all out of favour.**"*

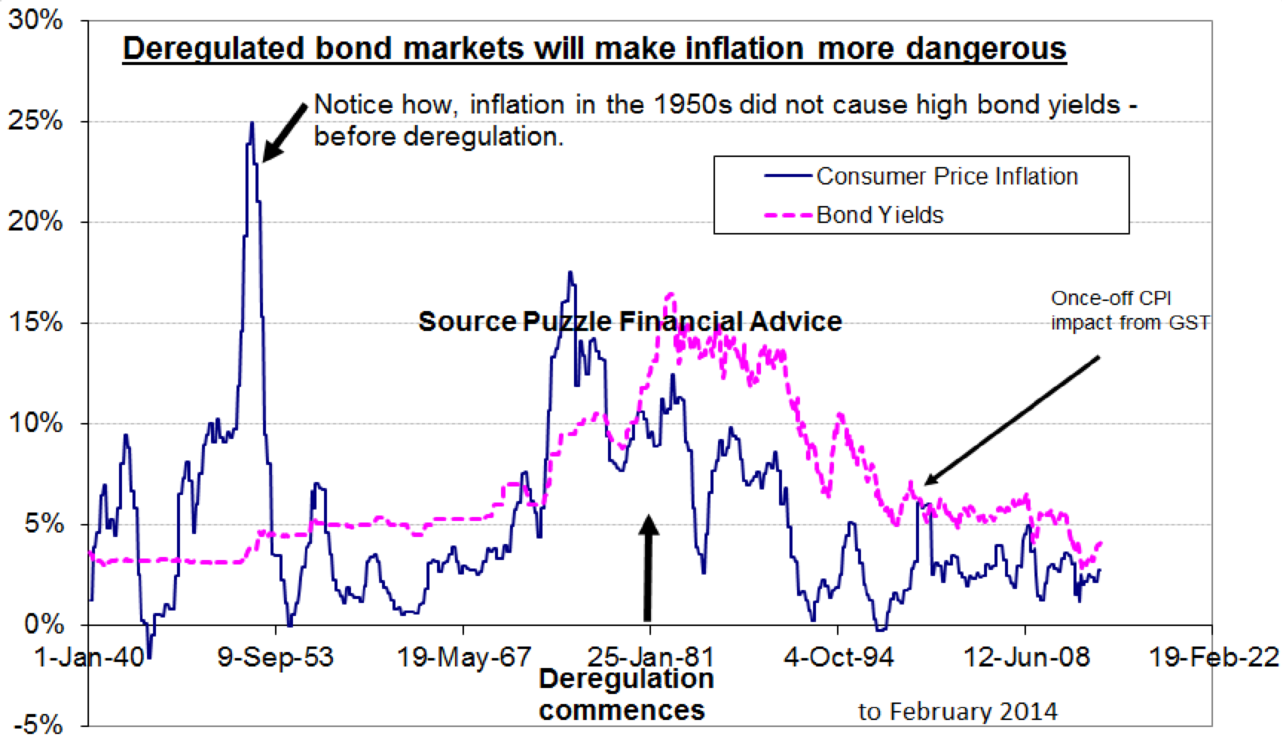
- **When cash rates are held low by central banks for shorter-term economic reasons, in due course they revert to more normal levels.** David Hale was suggesting that the USA might surprise, by delivering stronger than expected growth this year. This is why David Hale suggests that the US Fed might then surprise by starting to raise cash rates this year. This would take some pressure off other central banks, and in particular the Reserve Bank of Australia, because it should cause the US$ to rise versus other currencies … .making it easier for the A$ to fall … making the Australian economy more competitive.
  - Bottom line:
    - So in due course, you should see cash rates start to revert to more normal levels at some point …. probably with the US leading the pack. But I do see the possibility that the RBA might cut rates further over the next few years, because of the issues raised in the paper I circulated on Friday 28th February. This would also help the A$ to fall further.
    - Key point: With the official consumer price inflation rate now over 4%, the RBA cash rate should be far closer to 5%, rather than the current setting of 2.5%. So over the medium-term, 5% cash rate is the initial target at which you should be expecting the cash rate to go to over the medium-term – see historical experience below. [As the US Fed starts raising cash rates, this will make it easier for the RBA to raise cash rates.]



- **When bond yields fall to historic lows like they did about 18 months ago, then over time bond yields revert to higher levels.**
  - Now this issue is less straight forward than the above 2 issues. Some factors that are relevant here are:-
    - Part of why bond yields have been very low, is because of the mechanism that the US Fed (and other central banks) have been using to print money. The US has been buying US Government Bonds on the market – and the extra demand for bonds has been pushing bond yields down (and bond prices up). As the US Fed tapers its Quantitative Easing, it would be buying less bonds. With the reducing buying demand for bonds, everything else being equal, this would allow the normal supply and demand for bonds to push US Bond yields back to more normal levels. At a presentation last year (see my circular at the time), Hamish Douglass from Magellan said that he thought US Bonds yields would revert to about 8%pa over the next year or two – perhaps even 10%. If investors are expecting a yield of 8%-10% for US Bonds, it would be normal to expect that investors, investing globally, would demand a similar yield from Australian bonds. This would put a fair bit of downward pressure on many share prices and listed property.



- The other factor that has help cause lower bond yields is low inflation.
  - In USA and Europe, official consumer price inflation has been very low. In fact in Europe, they are still worrying about the risk of deflation, and as we speak, the European Central Bank is pondering extra monetary stimulus for the Eurozone.
    - Note: In normal times, Australian bond yields tend to be priced off US bond yields. Historically, our bond yields have normally been higher than the US bond yields.
  - Please note the relationship between consumer price inflation and 10-year government bond yields since the Australian government bond market was deregulated. To state "the obvious" 10-year government bond yields tend to be priced at an incremental yield above the expected consumer price inflation rate.
  - And you can observe that we had very high inflation in 1980, followed by disinflation (falling inflation rates)... and over the last 10 years or so, we have been experiencing bouts of deflationary fears.



  - Developed world central bankers are terrified of deflation at this point in time, and want inflation at almost any cost. This is a key reason why central banks have embarked on massive money printing. Because central banks have have shown such conviction in preventing deflation, for the moment at least, let us assume that they will prevent any significant deflationary event.
  - That said, the massive money printing binge, has set the scene for quite serious bout of consumer price inflation at some point ahead. If this occurs, you should expect bond yields to rise with inflation – like the 1970s ….. except in a deregulated market for bonds, you should expect bond yields to be rising with inflation, rather than lagging it as it did in the 1970s.

So far we have talked about:-

- Three fundamental causes of today's warped markets:-
  - Massive money printing by central banks.
  - Ultra-low interest rates that have been held low for a historically long period of time.
  - The historic extreme level of debt (as a percentage of GDP) in much of the developed world.

Then we started talking about some of the things we know about investment markets:-

- When share markets are expensive (very high P/Es), they revert back to more normal valuations at some point.
  - More generally, if you buy assets when they are expensive, then you should expect to get a poor or negative return over the medium to longer-term.
  - Price matters. It is not good enough to buy a good business (shares in a good company), if your are paying too much for it.
- When cash rates are held low by central banks for shorter-term economic reasons, in due course they revert to more normal levels.
  - On this basis, a medium-term target for Australian cash rates should be about 5%pa.
- When bond yields fall to historic lows like they did about 18 months ago, then over time bond yields revert to higher levels.
  - On this basis, a medium-term target for Australian 10-year government bond yields should be about 8%-10%pa.

Those are critical issues, but there are other things which are important.

- Investors are most reluctant to buy, when assets are cheap...... and most keen to buy when assets are expensive.
- Timing matters.
- Gearing is dangerous when interest rates are rising.
- When an asset price falls by a significant margin, over a significant period, most investors tend to sell out, just because it has fallen.

- **Investors are most reluctant to buy, when assets are cheap...... and most keen to buy when assets are expensive.**
    - A simple and obvious statement maybe ….. but worth spelling out.
        - It is very important that investors learn to recognise that when they feel the normal human reaction to panic-sell when markets are down, that they should really be thinking whether they should be doing the exact opposite.
        - Likewise, it is very important that investors learn to recognise that when they feel the really comfortable about investing in risky assets, that they should really be thinking whether they should be doing the exact opposite.
    - In March 2009, when we were at the bottom of the share market, most investors were terrified of buying ….. because markets had fallen i.e. investor-behaviour is heavily driven by what an asset price or asset sector has done (technical behaviour), not what it is likely to do. Most investors are not focused on the fundamental value of an investment, and therefore do not recognise the good times to buy.
    - Investors are most comfortable in buying an asset after it has risen a long-way. They feel comfortable about buying then, because that asset has been delivering good returns. Again, investors ignore the fundamentals eg that the market tends to be expensive at that point in time.
        - Bottom line:-
            - It is important that you focus on the fundamentals when you buy, because if you do that, you should be able to get a good return over the longer-term.
- **Timing matters.**
    - In fact, right now, timing is critical because so many asset prices have been distorted by money printing. Timing is a tough game, but it can be dangerous if you ignore it.
        - Bottom line:
            - It is important that you focus on the technicals (chart dynamics), because even when assets are cheap, they can get much cheaper before delivering good returns.
            - This lesson (with hindsight) was heavily reinforced last year for me because:-
                - On fundamentals, gold miners were already cheap in March 2013, about 3 months before gold bottomed. Because gold miners had already been falling for a number of years – and had already fallen a long way it seemed like a good time to buy.
                - However, even when an investment falls to a level at which it is good value,it is usually desirable that we wait until it bottoms before we buy – because cheap assets can get much cheaper before they start rising in value again.
                - So we must focus on both the fundamentals AND the technicals to maximise our chances of a good result over the short (1 year), medium (5 year) and long-term (10+-years).
    - Another example of why timing matters – because this principle applies to broad market sectors as well as narrow segments or individual stocks. The chart below is the experience of a US share investor over the last 20 years. A few observations:-

        - If you look at the starting point and the ending point, it may not appear too bad. But:-

        - Keep in mind that the Robert Shiller cyclically adjusted P/E ratio tells us fairly clearly that the US is back into a speculative bubble, and so a fall in US shares of something of the order of 50% over the next few years, should not be unexpected – and that is likely to cause significant volatility on a global basis.
        - Most ungeared investors are not emotionally equipped to survive the sort of journey that the USA share investor has experienced, without panic-selling near major market bottoms. In fact, many studies have shown that most investors get substantially below the long-term market average performance because they tend to buy near the top and sell near the bottom. This is simply the way human beings are wired to behave. This effect is studied in "Behavioural Finance".
      - Therefore we need to use everything we know about investing, to avoid making this mistake that most investors make (buy near top and sell near bottom). To avoid those mistakes:-
        - We need to be always seeking to understand value. Is that asset fundamentally cheap (consider buying) or fundamentally expensive (consider selling).
        - We always need to watch the technicals.
          - The technicals tell us when it is a good time to buy a fundamentally cheap asset. (Near a market bottom)
          - However, the technicals do not always give us much warning when it is time to get out of an expensive market (eg in 1987) ….. so it is safer to start selling down an asset that has become very expensive. Sometimes, it may simply be better to just sell out of the expensive asset entirely … knowing that it might continue to rise a long way after it has become expensive – as we saw in 2000 when US shares broad indices, US dot coms, US telco and US growth stocks became a quite extreme speculative bubble.
- **Gearing is dangerous when interest rates are rising.**
  - In an interest-rate rising period, geared investments can rapidly deliver large negative returns.
  - Since I do not believe most investors are emotionally well-equipped to ride through the normal volatility of ungeared shares, they are even less well equipped to rise through the normal volatility of a geared investment.
    - Note: Long-term US Fed studies show that in the big events in history, shares and property both fall by similar amounts – and so this message is as important for property as well as shares. Reference examples:
      - Japanese shares & property fell by similar large amounts as a result of the 1990 crash – both about 60%-70%
      - In Hong Kong, shares and property both fell about 60% in the 1998 Asian Crisis.
  - Long-term yields seemed to have bottomed in most of the Western developed world around mid 2012 – and now seem to be headed up over the next decade.
  - With short-term yields, we seem to be on the cusp of central banks raising cash rates. The US seems likely to be first to raise rates, the rest of the developed world seem likely to follow later as their local economy allows.