



thenavigator

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MAD WORLD

I'm not sure if it's because of my age, but things seemed to be better in the past – the 1980s, 90s and perhaps even the early 2000s. Music, cars, society, politics and so on.

Perhaps life was simpler then. If you wanted nice things, you had two binary choices – you either had to have rich, generous parents, or you had to go out to work. The harder you worked, generally speaking the nicer the things you could buy. On the whole, girls wore skirts and lipstick. Sometimes guys did as well, but they tended to be pop stars – it was never a big issue and was considered quite cool due to the rarity factor. Tears for Fears were one of the most famous bands during this era, and one of their most popular songs was **Mad World** from the aptly named album *The Hurting*:

All around me are familiar faces
Worn out places, worn out faces
Bright and early for their daily races
Going nowhere, going nowhere

Their tears are filling up in glasses
No expression, no expression
Hide my head, I want to drown my sorrow
No tomorrow, No tomorrow.

When people run in circles it's a very mad world.

Well, investors have definitely been running around in circles this year, and they are unquestionably crying tears over their fears as major asset classes – namely equities, bonds and gold – are down sharply on a year-to-date basis and have offered investors “pale shelter”.

How can I be sure
When all the time you change my mind
When you don't give me love
You give me pale shelter

Pale Shelter, Tears for Fears, from the album *The Hurting* (1983)

CHANGE

One of the most famous and highly successful investors in recent history was Sir John Templeton, who had a habit of pushing back against groupthink (something we actively try to do every day). One of his more famous quotes was as follows:

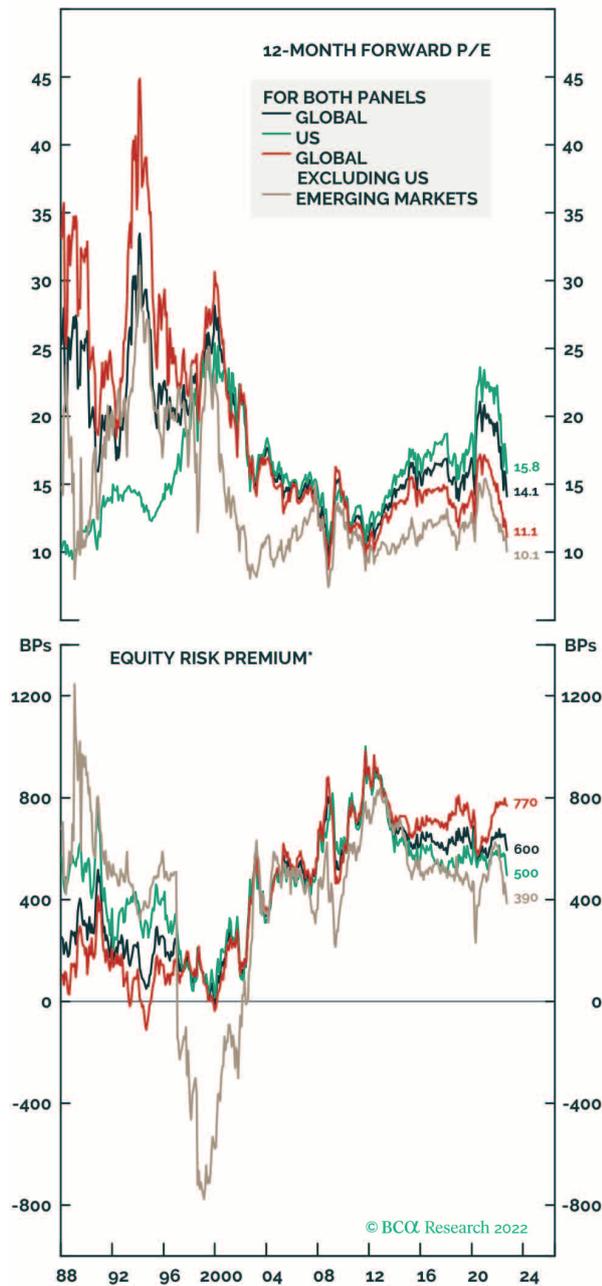
“Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria.”

Instead of succumbing to the groupthink which seems to suggest we are in some kind of Dante novel along the lines of: “Abandon hope all ye who enter here”, we need to analyse where we actually stand in terms of his famous quote.

My belief is that we have witnessed the euphoria part of the bull market and have been paying for its excesses of the last 12 years, towards the end of which no skill or thought was required as everything just went up.

While it is impossible to be exact, my other guess is that we are at a point of significant pessimism in the markets. It remains to be seen whether it is the point of maximum pessimism.

Looking at the markets as a whole, valuations have moderated significantly from the excesses seen, but this is even more pronounced at the non-US stock level.



*12-month forward earnings yield minus real 10-year government bond yield.
Bond yield deflated using headline consumer prices and 10-year cpi swaps.
Source: refinitiv/ibes, and msci inc. (see copyright declaration).
Note: Gglobal is the market capitalization-weighted average of the US, Euro area, Japan, UK, Canada, Australia, Switzerland, Sweden, and emerging markets.

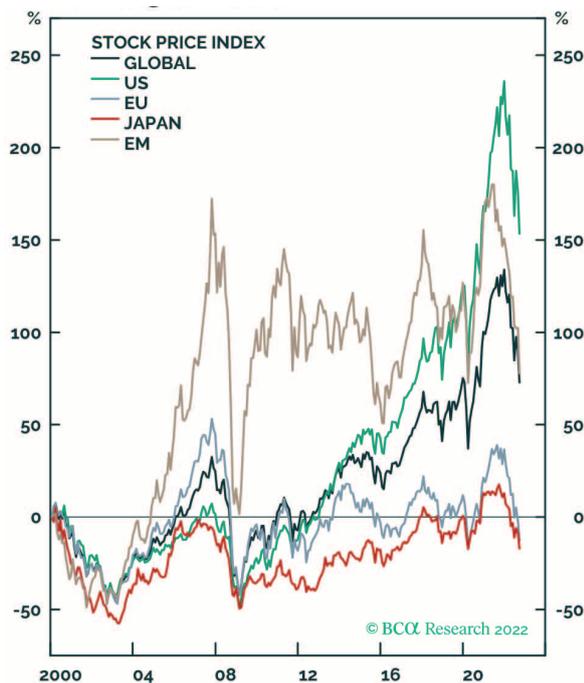
The same can be said of the equity risk premium (in simple terms, this is the amount you need to be rewarded as an investor for taking the risk of buying equities versus bonds), which looks to be at an extreme level, especially in European equities. European equity funds have now seen over eight months of equity outflows. Cumulative redemptions are now worse than during the Covid-related sell-off and are comparable to those of the 2011-12 eurozone crisis.

Are things really that bad? Or is it a question of the market consensus being significantly wrong? What if Europe has a mild winter? In this case, European equities – which in my view are priced for a depression and not just a recession – would appear significantly undervalued and could stage a powerful recovery, not just in relative but also in absolute terms.

Reflecting back on the eurozone crisis, when there were very real fears that the euro area would collapse, you have to ask yourself whether we are really going through such grave times. Even during the crisis, stocks reached a point where they just stopped going down on bad news because it was expected and had already been discounted.

GOLDFISH SYNDROME

Investors have a habit of focusing on the recent past and extrapolating this out into the future in a linear manner. Groupthink would have you believe that US stocks will continue their outperformance indefinitely, as will the USD, which is up around 21% over the last year. However, US stocks have not always outperformed.



Source: Msci Inc. (See Copyright Declaration).

Note: Shown in US Dollars; Series rebased to Jan. 2000 = 0%.

If we go back to the 2000–2008 period, European and international stocks outperformed their US counterparts handsomely. This also coincided with the bursting of the dot com bubble as demand for technology and technology stocks was brought forward due to the Y2K phenomenon. It could quite easily be argued that the Covid-19 pandemic may have had similar characteristics in bringing demand forward for this sector.

One of the major drivers of US equity outperformance since the global financial crisis has been faster sales growth and an expansion of profit margins, in particular driven by growth stocks. But one of the most pressing thoughts on my mind, recently amplified by results from companies such as Amazon, Microsoft, Google and Meta, is whether growth stocks have now gone ex-growth or will do so in the near future. This would result in the removal of a key pillar of support for continued US stock outperformance.

While many investors are parsing these recent results to extrapolate them into a belief that the US economy is in – or is heading towards – a steep recession, consumer spending has remained robust, presenting investors with a conundrum.

Perhaps things are simpler than they seem when we look at things from a human psychology point of view. Is the shiny new technological gadget worth as much to us now as a big party with friends or a holiday abroad? On a comparative basis, it would seem to me that consumers are just exercising their discretion as to where they want to spend their money.

Covid has, I believe, made consumers more impulsive, decisive and opportunistic in their spending patterns, with the result that they want to partake in activities that they believe may not be available in the future.

All roller coasters eventually end with a period of calm to allow you to get over the shock, and it is likely to be the same for the financial markets.

Disinflation (not deflation), where inflation figures moderate, is likely to cause central banks to pause (but not cut) their interest rate hikes. Meanwhile pervasive negative sentiment, especially in non-US markets, and high cash balances are sowing the seeds for the next bull market. In the not too distant future, investors will fall head over heels for equities again.



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