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Spring 2024

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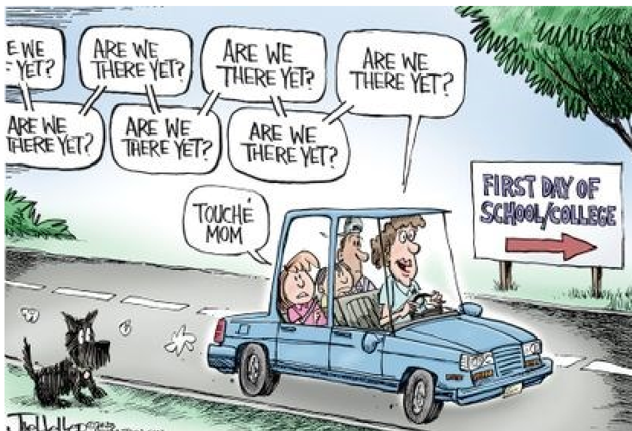
“Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria." [Sir John Templeton]



Anyone who knows me well would call me an optimist. Some might even say (incorrectly) a perma-bull. Being an avid Atlantic salmon fly fisherman, you have to retain a certain amount of optimism given that you are fishing for a creature whose numbers are significantly declining and which stops feeding when it enters fresh water. Not only that, you are using the most difficult method to catch them.

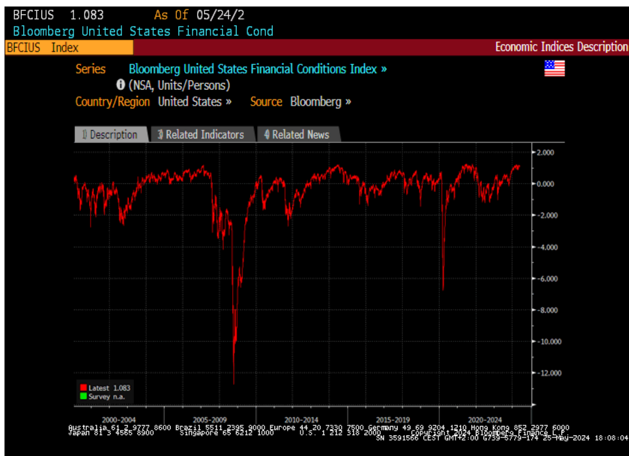
However, when it comes to markets and in particular US equities, my thoughts have become increasingly gloomy. The secular bull market in US equities which began in 2009 – or 2011 depending upon how you measure it – has been nothing short of spectacular.

When looking at the age of the current secular bull market, whichever way you measure it this market is now well and truly a teenager! As any parent knows, teenagers are not renowned for their communication skills or calmness. In fact, the recent volatility in US equities could be down to teenage angst.

For the first time in over a decade, we have taken our foot off the gas pedal in terms of both equity exposure and exposure to US equities in particular. Please don’t misunderstand us: we are positive on the US economy and consumers and reckon that we are heading towards a no-landing scenario (i.e. not a soft landing with slowing growth but also no recession), instead entering a period in which growth in corporate profits and the economy performs pretty well despite higher interest rates.

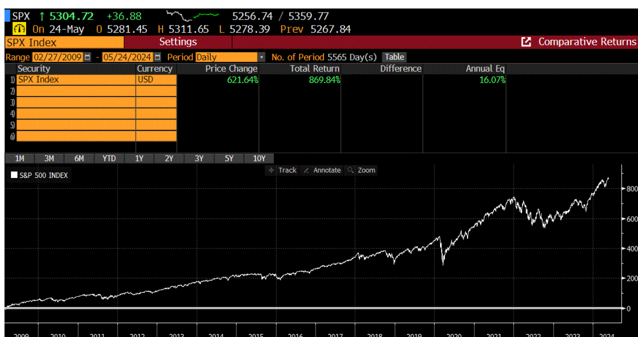
This of course raises the question of what will happen in terms of US interest rate cuts. Since the beginning of the year, we have taken a sceptical view of those who expected six rate cuts, which were then reduced to three and now just one. We believe that there will be zero rate cuts in 2024, with a possibility of US rate rises next year. With 50% of the world’s population now under 30, more members of Generation Y (millennials) than baby boomers and Generation Z heading the same way, we see signs of the classic inflationary problem of too many people chasing too few goods.

Despite what many have described as restrictive US monetary policy (high interest rates), inflation is still some distance from the Fed’s target level, the US economy remains robust and financial conditions now actually seem to be easier.

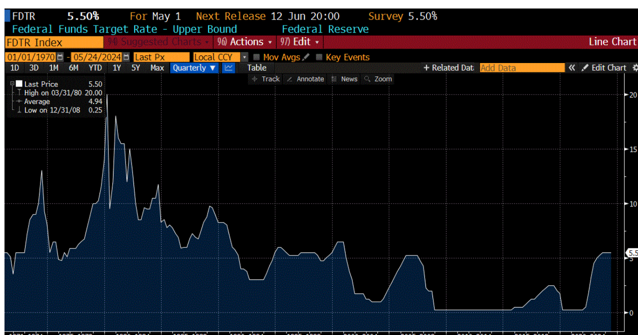


Source: Bloomberg United States Financial Conditions Index, chart by Bloomberg

How can this be? Well, one theory that has been expounded is that US consumers have fixed their mortgages at very low rates for the longer term and put their excess cash on deposit at higher rates, meaning that they are effectively receiving a new format of the stimulus cheques they were sent during Covid. As a result, they are spending this excess interest income. So why are we so negative on the US market indices if the economy is going to do just fine?



Source: S&P500 since beginning of bull market in March 2009, chart by Bloomberg



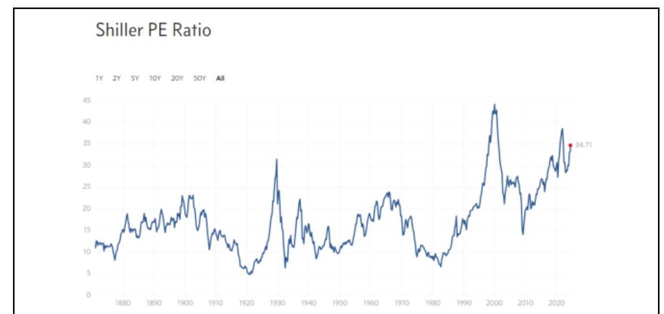
Source: Federal Funds Target Rate, chart by Bloomberg

Was there really a lot of skill involved in the markets' rise from March 2009 onwards? Or were markets just rallying on a huge liquidity glut which is no longer there? While the 2022 drawdown due to higher interest rates has now been well and truly forgotten thanks to the euphoria surrounding AI, is it still unfinished business?

We believe that we are perhaps in the last innings of the secular bull market in US equities and could be facing up to a decade of lost returns at the US equity index level. It took roughly 31 years for the Japanese Nikkei to recover its losses from the 1989 bubble peak. The Nasdaq took a much more modest 14 years to recover from its 2000 peak.

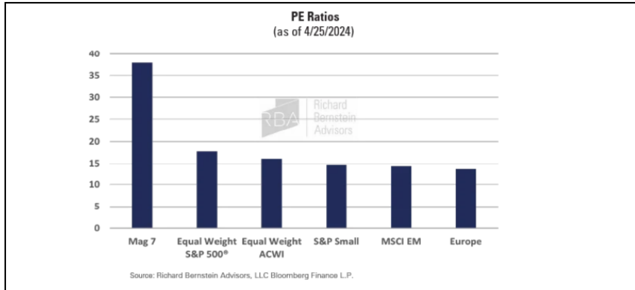
Looking at the 16.07% annualised return of US equities since March 2009 also makes us nervous, knowing that nothing is forever in financial markets and that the average annualised return on the S&P 500 is 10.26% since 1957, while the average annualised return on the original S&P (90 stocks), which was launched in 1928, is 9.90%. Mean reversion could be very painful!

The most recent Bank of America fund manager survey, which found fund managers at their most bullish since November 2021, cash levels at a three-year low and stock allocations at their highest level since January 2022, doesn't have us jumping for joy either. The recent capitulation of long time Wall Street bear Mike Wilson at Morgan Stanley could easily be interpreted as another contrarian indicator. While it is never a great short-term indicator, the Shiller PE ratio (CAPE) has been a good gauge of forward returns over longer time periods. The fact that it is approaching 2022 levels and is already above 1929 levels makes us nervous as well.



Source: Shiller PE Ratio, chart by Bloomberg

The rise of passive investing (now 40% of the market), algorithms and momentum strategies could easily exacerbate any market moves given that no thought is paid to whether you are paying too high a price for a stock. What happens when momentum reverses?

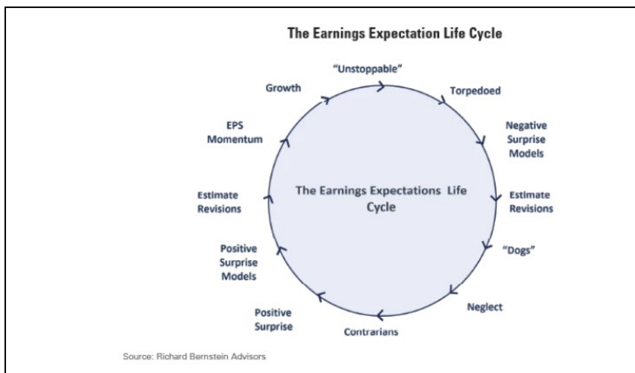


Source: Richard Bernstein Advisors LLC Bloomberg Finance L.P.

So why aren't we excited about bonds?

With interest rates unlikely to come down and no recession on the horizon US bonds look very expensive too, with the added disadvantage that we could at some point have a Minsky moment if investors question the sustainability of US (and other) government debt, which has risen to 122.27% of GDP from 57.77% of GDP in 2000. This equates to a debt per taxpayer of USD 266,952. Governments (in the Western hemisphere) seem addicted to debt, with words like austerity and balanced budgets relegated to the history books.

We believe the best course of action is to hold an extra portion of cash to take advantage of opportunities, be damn careful about the price we pay for an asset and buy in overlooked, unloved areas, focusing on companies that fulfil an economic need.



Source: Richard Bernstein Advisors

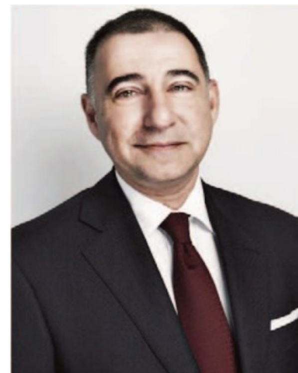
We believe that the vast majority of stocks we own are in the 5 -6 o' clock range, while the overall US equity indices are in the 12 o' clock area.

Europe as a region also provides an area of more modest valuations and, once again, when you drill down through the index levels it is relatively easy to find good companies with mid-single-digit PE ratios. And when you search just a little harder you can also find good companies whose dividend yield is significantly higher than the PE ratio.

With the German economy levelling out and the "club med" countries outperforming (who knew that PIIGS [Portugal, Ireland, Italy, Greece and Spain] could fly?), as well as the likelihood of interest rate cuts, it is almost as good a contrarian trade as Asia ex Japan, which is even more loathed than Europe yet seems to be in a different economic cycle to the rest of the world.

While we are aware that we are very differently positioned to the crowd (we all know what happens to lemmings and sheep), if we are right then we expect to provide you with a decent return whatever happens at the level of US equity indices. A reckoning is due once market participants finally face reality.

We continue to be amazed that in every walk of life people want to negotiate and pay a lower price, whether it is for houses or other assets, realising that in doing so they lower their downside risk while increasing their potential profits. Why then do stock market participants always seem to want to pay top dollar for their purchases?



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