January 2018

The futility of bargain hunting in Harrods

The key question from investors that we have had to answer for quite some time now is, "Isn't the market too expensive now?"

I have always considered myself a market skeptic and this has resulted in me amassing many big-fish stories of "the one that got away." Caution practically guarantees that I will not likely get in on the ground floor on any stock but that same caution also safeguards against being on any floor of a building that collapses.

As the price-earnings (PE) ratio of the market crept up, my skepticism grew until it reached levels unseen since the late 1990s. Surely stocks are expensive, I and many other market observers thought. But if we take a closer look beyond these historical comparisons, a few things come to focus.

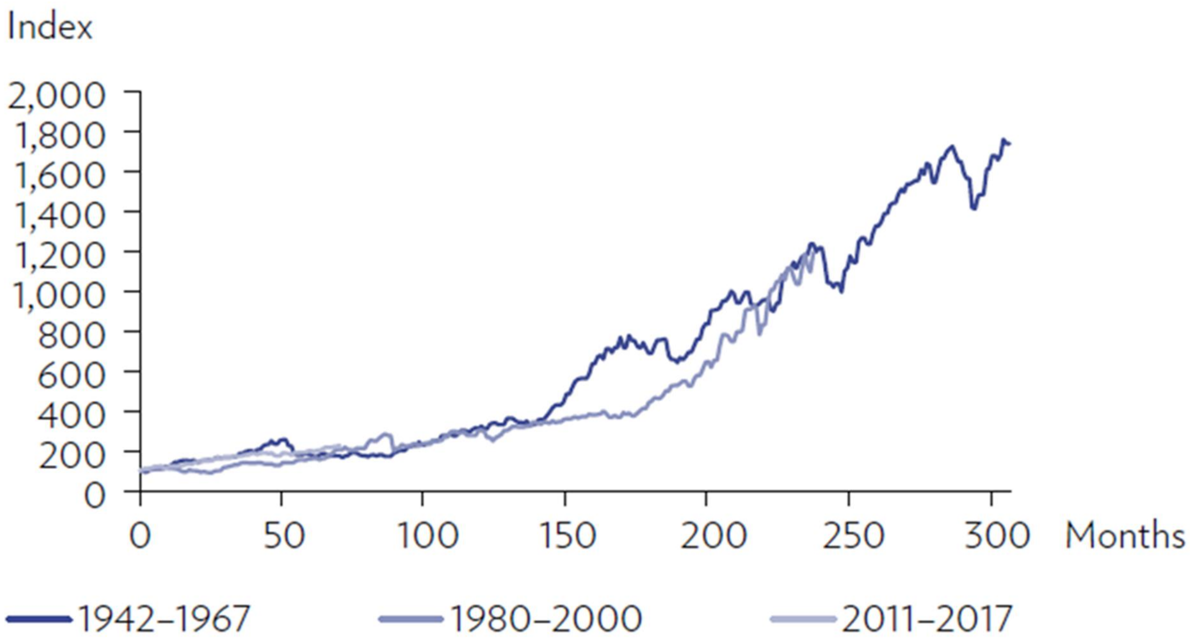
Interest rates are low. Yes they will rise but are likely to stay in the low single digits (in developed markets). This is important because stock prices are fundamentally a company's future earnings discounted against a required return. That required return is comprised of a risk-free rate (think of the 10-year US government bond) plus an equity risk premium that should fairly compensate you for taking money out of your savings account and putting your money at risk in stocks for a long time. That risk-free rate has been dropping over the last 30 years and is still hanging around that bottom. The current price of stocks is justified by this historically low risk-free rate – certainly one of the things we keep an eye on.

Returns have been relatively subdued. Another reason mentioned to justify the notion that the bull market is nearly over is its lengthiness. If we count the time from trough to peak, it would appear that the current bull market is the second-longest period without a single

20% drop in history. However, another way to count this is from PEAK to PEAK. Let me explain: Yes, we can say a bull market starts on the day prices hit rock bottom, say, in Spring 2009. But we can also say a bull market starts only after it has fully recovered back to its previous high. That would be in the Spring of 2013. 2017 aside, this bull market – defined as a period without a significant market correction – has been a long, slow slog and has not produced stellar returns of bull markets past. I think part of the reason is that this bull market came out of the car wreck that was the Global Financial Crisis and the world has been driving slowly with the GFC wreckage visible in the rear-view mirror. That is, like a man who's been burned one too many times.

But it has to end sometime, right? Like a cricket match or a baseball game, nobody's holding a stopwatch to the market. It's been almost eight years since the S&P 500 bottomed out but if you look at the returns *relative to gold*, the stocks/gold ratio bottomed in 2011. *Julius Baer* points out in their chart below how short this current recovery cycle has been compared to the ones started from the previous lows in 1980 and 1942 which lasted 25 and 20 years respectively.

Stock cycle trends using S&P500/gold ratio



Source: Bloomberg, Julius Baer Group

No apparent sign of irrational exuberance. It is comforting to hear a great deal of healthy skepticism about market valuations as it may indicate that the positive sentiment hasn't reached irrational levels. The phrase "irrational complacency" has been thrown about and a great deal of this lack of volatility has been explained by the extraordinary actions of central banks.

Not all markets are expensive. Whilst the S&P500's PE is in the high teens, US energy and financial stocks as a whole have barely inched above their pre-GFC peaks. Elsewhere, Korean stocks trade at 8x earnings. The point is, nobody's pointing a gun at our heads to invest in technology or the US or India or any other stock market that is perceived to be expensive.

An old market veteran once told me that you'll never find great stocks that are cheap. Stocks are cheap for a reason and it's up to us to discern whether those reasons stand up to scrutiny. At the same time, stocks of great companies are often perceived as expensive because of the quality of their earnings and the economic background is benign. For the first time in more than a decade, every major market in the world is in growth mode simultaneously. Are prices high because of excess optimism or because things haven't been this good in so long? Could the market prices be reflective of the higher quality of today's merchandise? Are some markets Harrods and others the weekend flea market? We contend that there's value in both.

There will be bumps along the way. Markets correct. Bear markets happen. The end result of a long market rally is not necessarily a crash. It is no comfort to those who are dependent on their portfolios for their lifestyle support, but for long-term investors, corrections offer a window of opportunity to collect quality at more favourable prices. Bear markets can go on for a long time like in the 1970s. But compare the technological innovation of that time and today. Compare the world's dynamics and demographics of that time and today. Billions of new consumers (with money!) Greater information and a more symmetrical distribution of that information. New spending on health care and transportation and communication and other things that did not even exist in the 1990s.

That future starts now. The prices of the FANGs (Facebook, Amazon, Netscape, Google) and BATs (Baidu, Alibaba, Tencent) may be high in terms of valuation ratios but underlying these prices are terrific fundamentals. These companies (and others such as Microsoft, Disney and Visa) have formidable competitive advantages that they can maintain for years to come. Envision what the world will look like 10 years from now. Chances are high that these companies will remain very much a part of that world. And while you're imagining yourself in that future world, think about names that you are likely to regret not having bought back in 2018. And let's right that wrong.

The recovery has finally hit Main Street. Hindsight being 20/20, it's easy now to conclude that stocks were cheap in March 2009 and that Amazon was cheap at $800 around this time last year. Back then, little did we know how effective the central banks' post-GFC efforts would prove in propping up asset prices. Initially QE served to reflate assets to the benefit of the wealthy who are more invested in these assets. It also resulted in corporations buying back their shares and not much else. The wealthy do not have a high marginal propensity to spend so their increased wealth did not translate immediately to economic activity. And contrary to what some US Republican politicians think, companies won't expand or hire or invest just because they have extra cash. The American household whose wealth is mainly in real estate was pummelled by falling property prices and rising unemployment. It is only now, many years later, that we see the wealth effect translate to higher spending. And with that increased demand from customers, corporations have grown confident of future business prospects and have resumed investing in their businesses for expansion. It's about time! Many companies now report higher revenues (not just higher profits which can be achieved through unsustainable cost-cutting). The chart below shows this business confidence with several countries recording record highs in their respective Purchasing Managers Indexes in 2017:

Global Manufacturing PMI, 2017

	2017											
Country / Region	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
World	52.80	53.00	53.00	52.70	52.60	52.60	52.70	53.20	53.20	53.5	54	54.5
Developed Markets	54.20	54.10	53.90	54.10	54.10	53.90	54.00	54.20	54.60	55.2	55.8	56.3
United States	55.00	54.20	53.30	52.80	52.70	52.00	53.30	52.80	53.10	54.6	53.9	55.1
United Kingdom	55.40	54.60	54.30	57.20	56.40	54.20	55.20	56.70	55.90	56.3	58.2	56.3
Eurozone	55.20	55.40	56.20	56.70	57.00	57.40	56.60	57.40	58.10	58.5	60.1	60.6
Germany	56.40	56.80	58.30	58.20	59.50	59.60	58.10	59.30	60.60	60.6	62.5	63.3
France	53.60	52.20	53.30	55.10	53.80	54.80	54.90	55.80	56.10	56.1	57.7	58.8
Italy	53.00	55.00	55.70	56.20	55.10	55.20	55.10	56.30	56.30	57.8	58.3	57.4
Spain	55.60	54.80	53.90	54.50	55.40	54.70	54.00	52.40	54.30	55.8	56.1	55.8
Netherlands	56.50	58.30	57.80	57.80	57.60	58.60	58.90	59.70	60.00	60.4	62.4	62.2
Ireland	55.50	53.80	53.60	55.00	55.90	56.00	54.60	56.10	55.40	54.4	58.1	59.1
Greece	46.60	47.70	46.70	48.20	49.60	50.50	50.50	52.20	52.80	52.1	52.2	53.1
Canada	53.50	54.70	55.50	55.90	55.10	54.70	55.50	54.60	55.00	54.3	54.4	54.7
Austria	57.30	57.20	56.80	58.10	58.00	60.70	60.00	61.10	59.40	59.4	61.9	64.3
Japan	52.70	53.30	52.40	52.70	53.10	52.40	52.10	52.20	52.90	52.8	53.6	54.2
Emerging Markets	50.80	51.30	51.60	50.90	50.60	50.80	50.90	51.70	51.30	51.2	51.7	52.2
China	51.00	51.70	51.20	50.30	49.60	50.40	51.10	51.60	51.00	51	50.8	51.5
Hong Kong	49.90	49.60	49.90	51.10	50.50	51.10	51.30	49.70	51.20	50.3	50.7	51.5
India	50.40	50.70	52.50	52.50	51.60	50.90	47.90	51.20	51.20	50.3	52.6	54.7
Indonesia	50.40	49.30	50.50	51.20	50.60	49.50	48.60	50.70	50.40	50.1	50.4	49.3
South Korea	49.00	49.20	48.40	49.40	49.20	50.10	49.10	49.90	50.60	50.2	51.2	49.9
Taiwan	55.60	54.50	56.20	54.40	53.10	53.30	53.60	54.30	54.20	53.6	56.3	56.6
Brazil	44.00	46.90	49.60	50.10	52.00	50.50	50.00	50.90	50.90	51.2	53.5	52.4
Mexico	50.80	50.60	51.50	50.70	51.20	52.30	51.20	52.20	52.80	49.2	52.4	51.7
Czech Republic	55.70	57.60	57.50	57.50	56.40	56.40	55.30	54.90	56.60	58.5	58.7	59.8
Egypt	43.30	46.70	45.90	47.40	47.30	47.20	48.60	48.90	47.40	48.4	50.7	48.3
Poland	54.80	54.20	53.50	54.10	52.70	53.10	52.30	52.50	53.70	53.4	54.2	55.0
Russia	54.70	52.50	52.40	50.80	52.40	50.30	52.70	51.60	51.90	51.1	51.5	52.0
Saudi Arabia	56.70	57.00	56.40	56.50	55.30	54.30	55.70	55.80	55.50	55.6	57.5	57.3
South Africa	51.30	50.50	50.70	50.30	50.20	49.00	50.10	49.80	48.50	49.6	48.8	48.4
Turkey	48.70	49.70	52.30	51.70	53.50	54.70	53.60	55.30	53.50	52.8	52.9	54.9

Source: Bloomberg, DoubleLine

We cannot go back to the past but we can keep learning from the past. Most of these lessons are not new but we just have to keep relearning them: Favour companies with great business models with defensible wide moats. Beware the asymmetric reward for taking credit risk. Diversify, diversify, diversify. And take only as much risk as you NEED.

Laissez les bon temps rouler? Stocks may be expensive but that's most likely because we haven't had it so good in a good long while. Will the good times roll? The honest and best answer: We don't know. It absolutely can. Or the proverbial black swan can fly in and shoo away our collective confidence. After all, whilst synchronised global growth, low but steadily rising interest rates and unleashed animal spirits have all conspired to bring us to this Goldilocks moment, one must always be on the lookout for shocks.

Shocks? What shocks? Escalation in North Korea is an outlier and if that does result in a conflagration, a 25% market correction might be the least of our problems at that point. More probable would be unforeseen problems in the flashpoints of the Middle East and Venezuela. These would lead to further geopolitical unease as well as shocks to the price of oil. The Mueller investigation? Probably not. As much as DJT claims credit for the state of the US economy and stock market, the data does not support this. The markets would have and will continue this recovery with or without him and his tweets.

Yes, the risk-free rate will rise. We do expect some sell-off in bonds throughout 2018 but from a longer viewpoint, this is all a long process back to a more "normalised" state where interest rates are neither supportive nor destructive of asset values. We do not favour bonds but the right ones will still produce regular income and play a risk-dampening role in the portfolio. We are increasing optionality within our portfolios to reduce directional risk of stocks and bonds and that will probably hold true for some time to come.

This is why we constantly make sure that our portfolios are well-diversified amongst equity and the other alternatives. This is true for old as well as new clients. If you have missed the Great Rally of 2017, you are certainly not alone. But that's only if 31 December 2017 were the finish line. Our portfolios are running marathons because our clients have long-term investment horizons. Retirements, bequests and other spending plans are years down the road. We cannot guarantee a smooth well-paved road. But we can almost guarantee that many years hence, we will look back and say, "Remember 2018? When we still talked to bank tellers, carried smartphones and owned cars with internal combustion engines? Gee, I wish I invested more back then."