Aviator Update – April 2024
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The boy who cried wolf

The boy who cried wolf is a popular story in the financial markets world. It's a story that's stood the test of time - having its origins in ancient Greece as one of Aesop's Fables.

The story involves a shepherd boy who repeatedly fools villagers into thinking that a wolf is attacking the town's flock of sheep. When an actual wolf appears, the boy calls for help. Thinking it is another false alarm, the boy is ignored by the villagers and the sheep are eaten by the wolf.

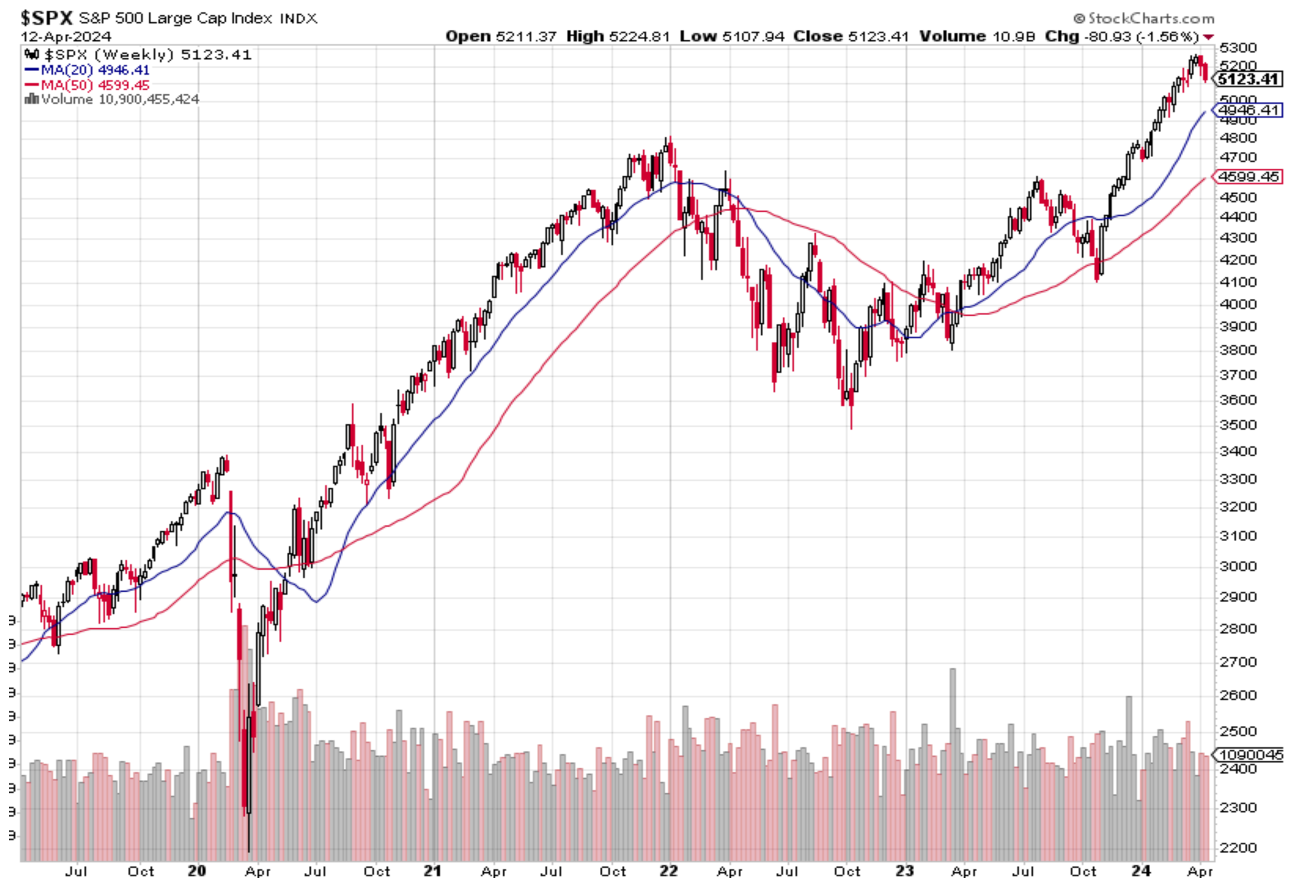
The basic moral to the story is that liars won't ever be believed or trusted, even when they're telling the truth. More modern adaptions and interpretations deliver a broader meaning – when we are alarmed with imaginary dangers, how can we know when we need to guard ourselves against real ones?

If we think about this in relation to the current conditions in the economy and financial markets, the analogy is easy to spot. Let's recall some of the dangers we've been cautioned about over the last few years:

- Respected economists and commentators warned about a "bubble" in Australian residential property…
- Commentators warned about a bursting of the Chinese economic growth model and possibly dire implications – such as an implosion in demand and prices for raw materials…
- We were warned that "quantitative easing" in the U.S. would trigger a collapse in the value of the US dollar and a hyper-inflationary bust…
- We were warned that when Covid stimulus washed through the market, the economy and markets would tank…
- We were warned that there would surely be a recession in the US during 2023…
- We were warned that inflation was just getting started and "hyperinflation" is finally here…
- We were warned that the end of zero interest rate policy, fast and aggressive rate hikes and the end to quantitative easing would bring about a bust…
- We were warned to brace for a massive wave of bank failures and that the several we saw (Silicon Valley Bank, Silvergate and Signature Bank) was the tip of the iceberg.
- We were warned to brace for carnage in the commercial property market – plunging occupancy rates smashing values and leading to a tidal wave of loan defaults.
- We were warned that share market valuations were at historically-extreme levels and there's little scope for further gains.
- We've been warned that we are entering a "blackout period" for corporate share buybacks that will take a major source of buying demand out of the market; and,

- That the "presidential cycle" is against us.
- That seasonal factors are a headwind.
- There are major geopolitical risks.
- Technical indicators (chart pattern) and oscillators are very over-bought.
- Bullish enthusiasm is extreme and flashing a major warning sign, etc etc.

Yet when we look at the market in terms of the US S&P 500, its (largely) just kept going higher:



A popular adage is that the market "climbs a wall of worry". Indeed…

The reality is there's always things to worry about – within financial markets and life in general. The task for all of us is to try and make sense of a situation and decide what action to take (if any at all).

This isn't easy. It takes a certain amount of knowledge and experience to be able to understand what's going on. For example, your doctor might inform you that you have stage-1 extrahepatic cholangiocarcinoma. Should you be worried?

Of course, in cases like that we turn to experts to help us. The same is true for investing. However, investing and economics aren't "science" and many of the "experts" we have to listen to in our industry are…well… perhaps not what we'd really call "experts"…

A troubling aspect of the current market environment is the level of complacency. It feels like little can significantly derail things – the odd down-day is soon followed by a couple of up-days.

Bigger picture, the last few years has taught investors a valuable lesson – even when the market goes down you can rely on it picking itself up and returning to new highs with little delay. This "truth" may have tragic consequences for some investors.

The road ahead

As we try to get a sense of where we're headed, its valuable to begin by looking at where we've been.

When the 2020 Covid pandemic came around, stocks were still enjoying a long bull market, originating in 2009 after the bust that was the Global Financial Crisis. 2020 saw plenty of volatility and then in 2021 we witnessed an impressive bubble. Remember? "SPAC's", "NFT's, "meme stock" frenzies… Within all that, the broad U.S. share market reached valuation extremes never seen before.

2022 saw declines in the order of 30% in the major indices. Of course, the falls were far more eye-watering amongst the silly stuff. The road behind is littered with the carcasses of defunct SPAC's and worthless NFT's.

The economic outlook wasn't great as we headed into 2023 with the majority of economists and pundits suggesting a recession was likely. As seen in the weekly price chart above, the share market was locked in a downtrend.

And then came along ChatGPT. As 2023 progressed, awareness of this amazing new transformative technology increased. This, along with the absence of recession sowed the seeds for another bubble which has blown out of the suds of the previous one. This is the bubble we witness today.

As has been well-documented, the AI ("artificial intelligence") bubble has been quite narrow. Driven by those "magnificent 7" stocks. The first quarter saw some run out of steam – Tesla has fallen around 30% from its highs.

More broadly, 7 out of 12 S&P 500 sectors were positive during the first quarter. 383 of the 500 individual stocks generated a positive return for the quarter. Can we call this "broad-based"? Not really – especially not compared to other periods of extreme speculation.

If speculative enthusiasm isn't as high as during other "bubble" periods, might that imply the market isn't a bubble after all?

Well, that depends on your definition of “bubble”.

For this, let’s turn to the all-knowing resource on everything – Wikipedia. They define a bubble as:

A period when current asset prices greatly exceed their intrinsic valuation, being the valuation that the underlying long-term fundamentals justify.

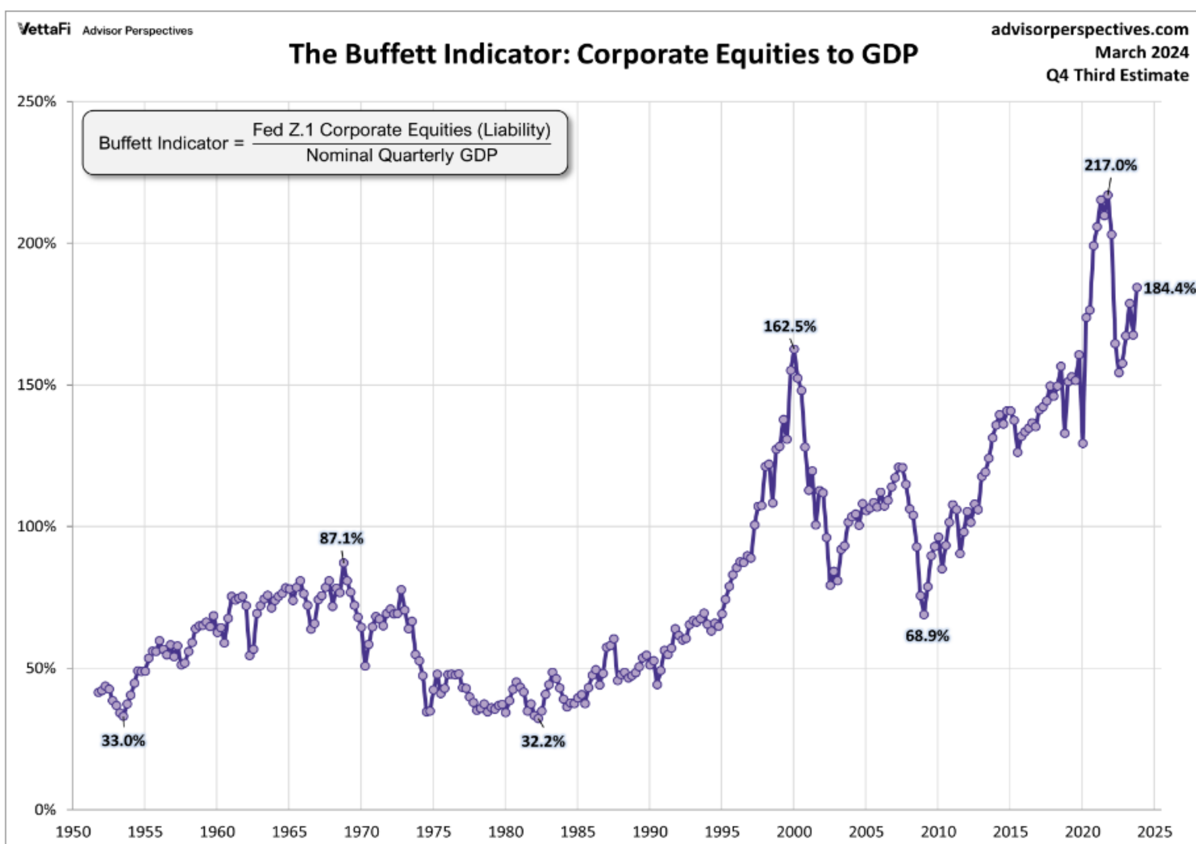
To be fair, a “bubble” is more complex and nuanced that this. Traits such as extreme speculative behaviour and excessively strong price-action are also important ingredients. But extreme valuations are a key ingredient.

Valuation Update:

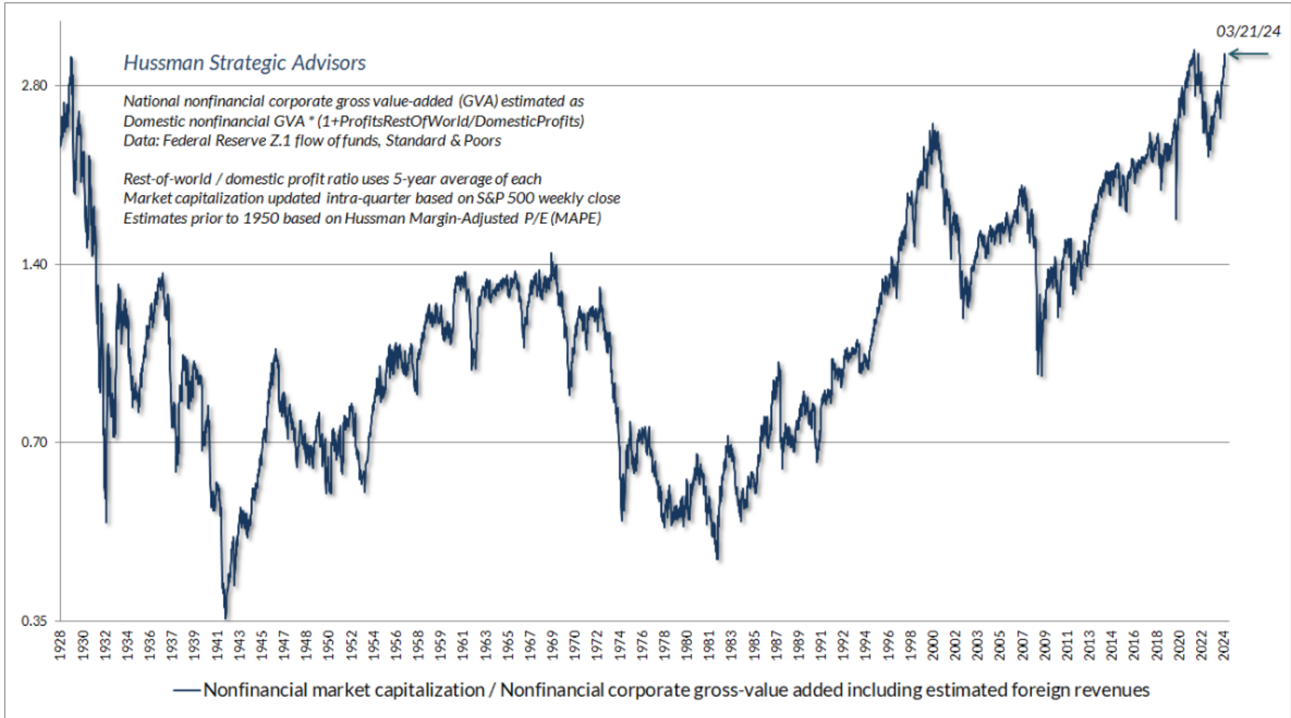
Whichever way you want to slice and dice it, the U.S. share market is extremely richly valued at this point.

The current “Shiller PE” (10 year historical average PE) of around 34 is in the top 1% of historical readings.

How about the “Buffet Indicator” – the highest it’s ever been (except for 2021, which was in part skewed by Covid GDP data):

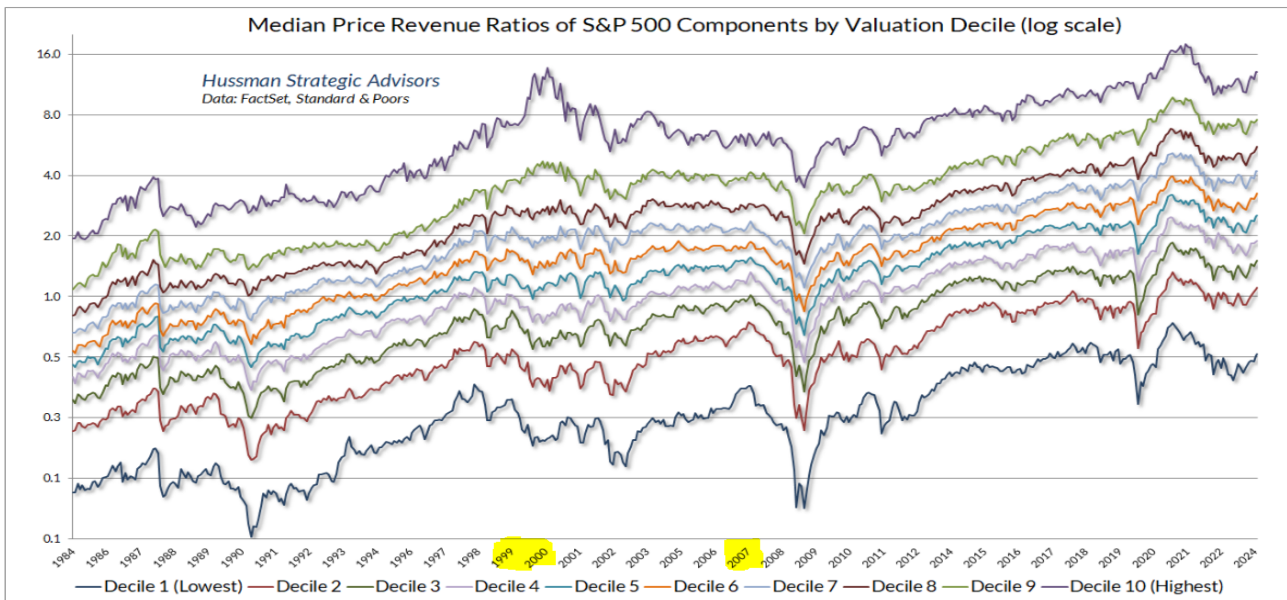


How about Dr Hussman's "market-cap to gross value added" – a metric that has a very high inverse correlation with subsequent market returns:



The chart below from Dr Hussman is interesting. It takes the price-to-revenue ratio of S&P 500 components then ranks them in deciles – the top-50 valuations followed by the next 50 valuations and so forth.

Notice that for every group except for the most richly valued, current valuations sit higher than the 2000 tech bubble and the 2007 market peak. Whilst the recent rally has been driven by a handful of stocks, nobody can say that rich valuations are confined to a small number of stocks:



“Wolf!”

Our broad message has been fairly consistent for some years now. The U.S. share market has been at historically extreme valuations and this makes for a very difficult investment environment. It tells us little about short-term return expectations, however, it is very informative about longer-term return expectations – it is highly likely that when we look back from a point some years into the future, average annual returns through this period will be very modest. This will be due to the market reverting to some degree back towards “average” valuations. Whilst some of this may happen via fundamentals catching up to elevated stock prices, history shows the greater likelihood is a significant market decline.

The U.S. market is the most important in the world because it’s by far the largest market and is domiciled in the largest economy in the world. Whilst other markets can certainly out-perform (and we suspect many will in the years to come), most markets will be caught up in a U.S. decline.

It’s important to emphasise what we haven’t been predicting. Whilst we have certainly commented on some of those dangers cited earlier, our negative outlook isn’t based on anything “bad” happening. It’s simply an observation from studying the history of financial markets – extremely over-valued markets have tended to “revert to mean” eventually. The more over-valued, the greater the potential decline.

Momentum is a powerful thing. It’s the main thing driving the current market environment – and it can go on for a lot longer yet.

But make no mistake – the dangers present in the current market environment are real.

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