MARKET CYCLES

NCMC Investment Club

Book: Mastering the Market Cycle, by Howard Marks

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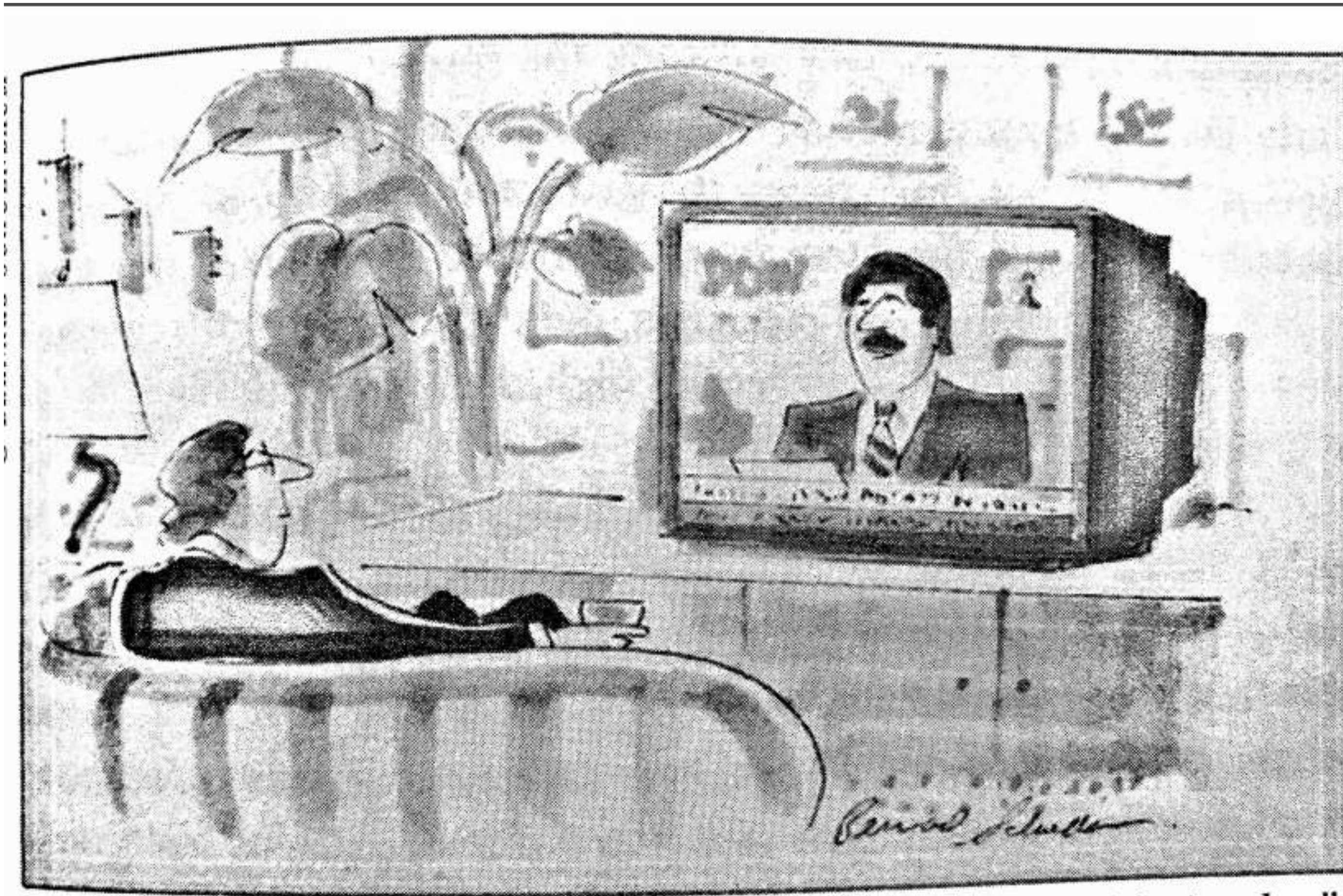
Next meetings: September 16, November 4

Hans Dijs
Marathon Investments, LLC
hansdijs@aol.com (203) 984-4534

Reaching financial success is a marathon, not a sprint.
Slow and steady wins the race.

INVESTORS INTERPRETATIONS ARE DRIVEN BY EMOTIONS



"Everything that was good for the market yesterday is no good for it today."

UNDERSTAND WHERE WE ARE IN THE CYCLE

- Understanding market cycles is one of the most important things in investing. You can benefit if you know where we are in the cycle.
- There are recurring patterns, but because of human psychology and behavior, they are not as regular as the cycles of clock and calendar.
- Investing is not a science and can't be depended on to work the same every time.
- "History doesn't repeat itself, but it does rhyme" – Mark Twain
- We can't know what the 'macro future' has in store for us in terms of things like economies, markets or geopolitics. Very few people can master that, so trying to predict that does not lead to superior performance on a consistent basis.
- In other words, don't try to predict the next recession or market meltdown. More money has been lost by predicting recessions than by the actual recessions themselves.

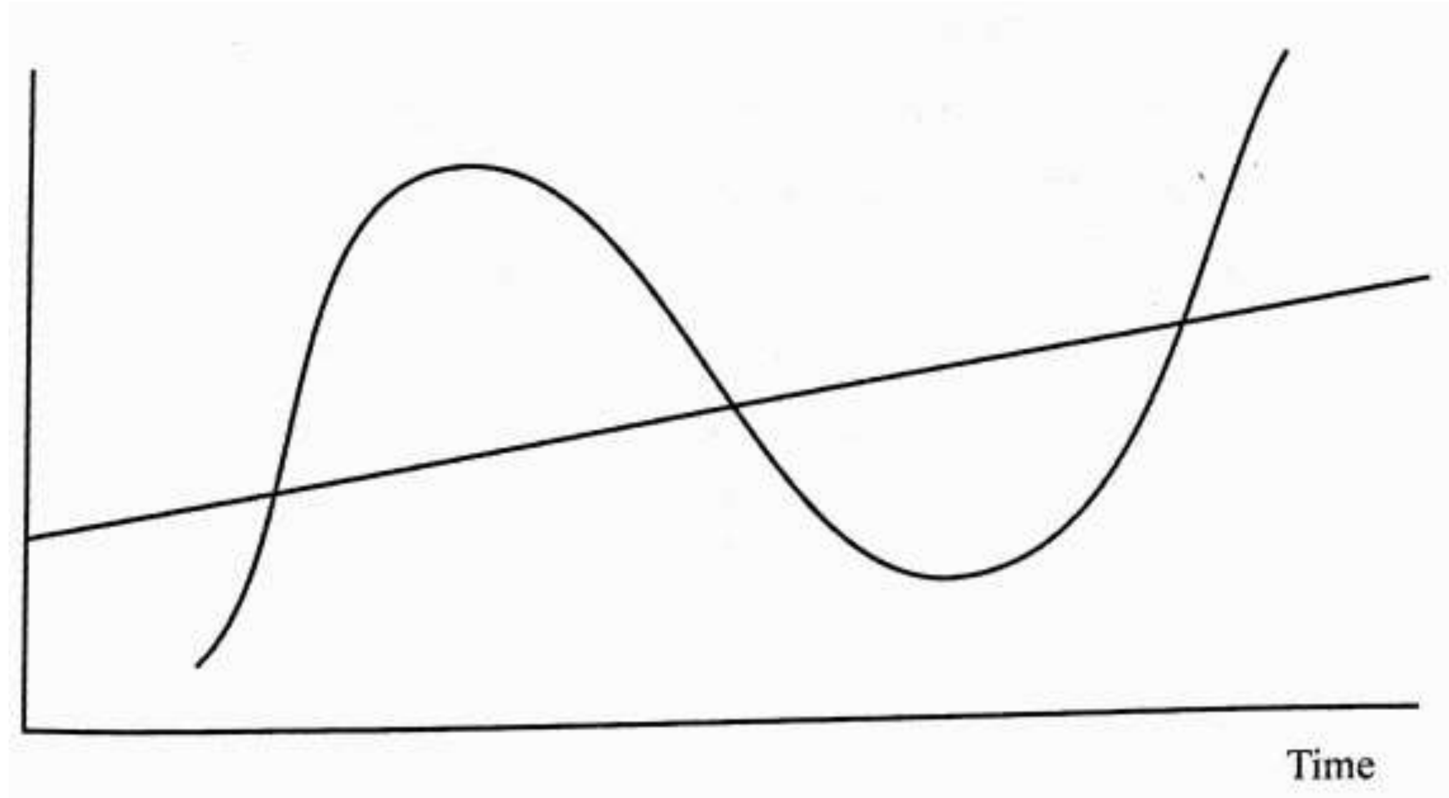
FOCUS ON THE KNOWABLE INSTEAD

- Know more about the fundamentals of industries, companies and securities;
- Be disciplined as to the appropriate price you pay for a security;
- Instead of a macro ‘top down’ approach, favor a ‘bottom up’ investment style. If you can’t find attractively priced individual stocks, then the market is probably overvalued.
- Understand the investment environment we’re in and decide how to position your portfolio for it.
- Should you emphasize defensiveness or aggressiveness? When we’re getting value cheap, we should be aggressive; when we’re getting value expensive, we should pull back.
- Focus on ‘tendencies’ – study the things that might happen or should happen, and how likely they are to happen.
- The future should be viewed not as a single fixed outcome that’s destined to happen, but as a range of possibilities. You can make a probability distribution based on respective likelihood of occurrence.

OPPORTUNITIES FOR INVESTMENT GAINS IMPROVE WHEN:

- The economy and company profits are more likely to swing upward than down;
- Investor psychology is sober rather than buoyant / exuberant;
- Investors are conscious of risk or – even better – overly concerned about risk;
- Market prices haven’t moved too high.

Market Cycle



THE NATURE OF CYCLES

- The events in the life of a cycle should be viewed as each causing the next instead of each being followed by the next.
- Advances are followed by corrections; bull markets by bear markets; but booms and bubbles are followed by much more harmful busts, crashes and panics.
- Thus, everything else being equal, the bigger the boom – and the greater the excesses of the capital markets in the upward direction – the greater the bust.
- The central line constitutes a midpoint around which the cycle oscillates; this is the norm, mean, average or if you wish 'happy medium'. In the economy a secular annual growth rate of say 2%;
- It has a secular trend that's usually upward, so over time and in the long run, economies tend to grow, companies' profits tend to increase and markets tend to rise.
- The extremes of the cycle are thought of as aberrations or excesses to be returned from and generally they are – this is called 'regression to the mean', a powerful tendency.
- A swing back from a high or a low almost never halts at the midpoint regardless of how right the midpoint may be.
- Markets rarely go from 'underpriced' to 'fairly priced' and stop there. Usually the fundamental improvement and rising optimism cause markets to recover further towards 'overpriced'.
- Cycles influence each other, like the economic cycle influences the profit cycle. Cycles don't operate in isolation;

THE NATURE OF CYCLES (2)

- Cycles are inevitable; yes, this time is not different;
- The existence of cycles is heightened by the inability of investors to remember the past;
- Cycles are self-correcting;
- Capitulation at the bottom of the cycle, but also at the top;
- A boom can take years, but the bust that follows may seem like a fast moving freight train: the air goes out of the balloon much faster than it went in.
- Psychology is an essential component in understanding the cycles.

THE LONG TERM ECONOMIC CYCLE

- The output of an economy is the product of hours worked and output per hour;
- Thus, the long-term growth of an economy is determined primarily by fundamental factors like birth rate and the rate of gain in productivity;
- These factors usually change relatively little over time, so the average rate of growth is rather steady over long periods of time;
- The rate of change in the level of productivity is largely viewed a being dictated by technological gains.
- Large productivity gains occurred during: 1) the Industrial Revolution; 2) when Electricity and Automobiles replaced older and less-efficient forms of power and transportation; 3) Computers and 4) Information Age;

- Gains in population and productivity have declined in the U.S., as they have in other developed nations.
- Taken together, these two things suggest GDP will grow more slowly in the U.S. in the coming years than it did in the years following World War II.

SHORT TERM ECONOMIC CYCLES

- Short term economic fluctuations around the long-term growth trend;
- A recession is when economic growth is negative for two quarters in a row in the downward swing;
- Psychology plays a big role; world events can create fear that discourages economic activity;
- The sub-prime mortgage crisis and financial institution meltdown (Lehman Brothers) discouraged consumers from buying, investors from providing capital and companies from building factories and hiring people.
- Economic expectations can be self-fulfilling. If people and companies believe the future will be good, they’ll spend more and invest more … and the future will be good, and vice versa (we nearly saw that last December).
- Another reason for short term variation concerns inventories. Additions to and reductions in inventories often lead to short-term ups and downs in economic output.

WHY IS ECONOMIC FORECASTING NOT WORTH IT

- Most economic forecasts consist of extrapolations of current levels and long-term trends;
- These forecasts usually turn out to be correct, but are not of much use as they are already reflected in the market prices.
- The forecasts that are potentially valuable are those that correctly foresee deviation from recent levels and long-term trends, but there is one catch:
- Since major deviations from trend (a) incur infrequently and (b) are hard to correctly predict, most unconventional and non-extrapolation forecasts turn out to be incorrect;
- John Kenneth Galbraith: “We have two classes of forecasters: those who don’t know – and those who don’t know they don’t know.
- Also political: hardly anyone predicted a Brexit in June 2016 and a Trump win later that year.

GOVERNMENT INVOLVEMENT WITH THE ECONOMIC CYCLE

- Extreme economic cyclicality is considered undesirable. Too much strength can kindle inflation and too much weakness can companies' profit to fall and can cost people their jobs;
- It is part of the job of central bankers and Treasury officials to manage cycles with counter-cyclical measures (lag effects);
- Most central bankers have two jobs: to limit inflation, which requires restraining the growth of the economy, and to support employment, which calls for stimulation of economic growth;
- Their dual responsibilities are in opposition to each other and requires a delicate balancing act;
- Monetary tools to slowdown economic growth include reducing the money supply, raising interest rates and selling securities.
- Governments' main tools for managing the economic cycle are fiscal (taxing and spending);

THE CYCLE IN PROFITS

- Annual growth in U.S. GDP almost always falls between 5% and minus 2%. Profits rise and fall much more than the economy as a whole; Stock prices even more;
- In the long run, stocks should provide returns in line with the sum of their dividends plus the trend line growth in corporate profits, or something in the mid-to-high single digits;
- In other words, at the end of the day: **IT IS PROFITABILITY THAT COUNTS!!!**
- When stocks return much more than that for awhile, that return is likely to prove to have been excessive;
- The economic cycle has a profound effect on some companies' sales but less on others.
- Sales of industrial and 'big ticket' durable goods companies are directly responsive to the economic cycle while, on the other hand, everyday necessities like food, beverages and medicine aren't highly responsive to the economic cycle.
- Largely because of differences in operating and financial leverage, a given percentage change in sales has a much greater impact on profits for some companies than others.
- Operating leverage is higher for companies for whom a larger percentage of costs are fixed and lower for the ones whose costs are more variable;
- Operating leverage and financial leverage are great for companies when the economy does well and sales rise, and vice versa;

THE CYCLE OF INVESTOR PSYCHOLOGY

- Swings in emotion / psychology strongly influence the economic and profit cycles, and they play a big part in causing ups and downs in the investment world;
- Swings

- between euphoria and depression

- between celebrating positive developments and obsessing over negatives

- between stocks being overpriced and underpriced

- between greed and fear – ‘buy before you miss out’ versus ‘sell before it goes to zero’

- between optimism and pessimism

- between risk tolerance and risk aversion

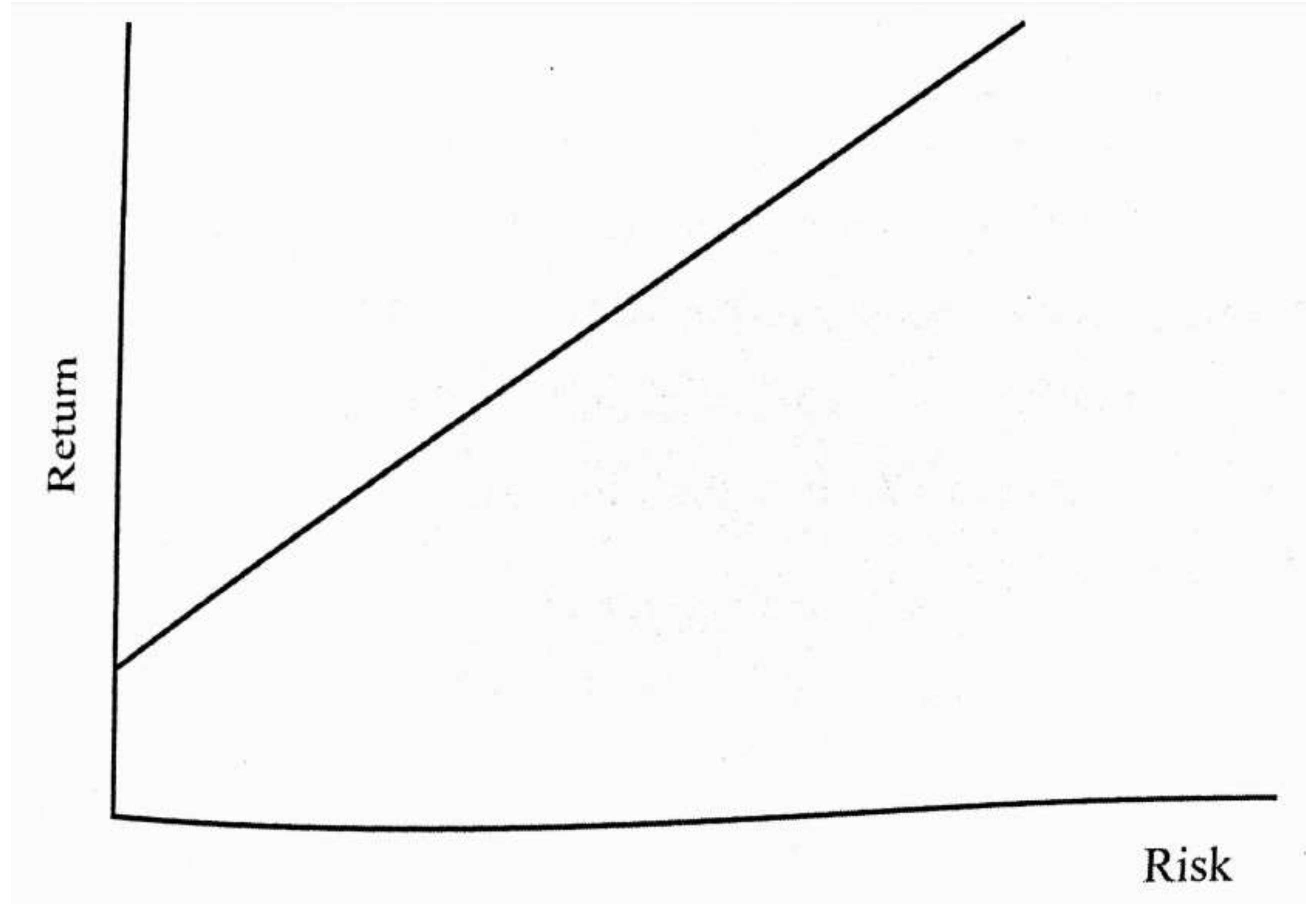
- between credence and skepticism

- between urgency to buy and panic to sell

When markets have been rising for awhile, we see all of the elements listed first. And when the market has been declining, we see all of the elements listed second; rarely do we see a blend of the two sets.

In the real world, things generally fluctuate between ‘pretty good’ and ‘not so hot’. But in the world of investing, perception often swings from ‘flawless’ to ‘hopeless’ – going from one extreme to the other and hardly spending anytime at the ‘happy medium’.

RISK – RETURN



RISK

- The line shows up and to the right: there is a positive relationship between risk and return;
- Some people think risk is the likelihood of losing money;
- Others think risk is the volatility of asset prices or returns;
- I lean heavily to the first definition. Risk is the likelihood of permanent capital loss;
- Uncertainty and risk are inescapable in investing;

THE CYCLE IN ATTITUDES TOWARD RISK

- Investing consists of dealing with an uncertain future, which creates risk, because of the possibility of a bad outcome;
- The rational investor is risk-averse at all times, but also on the lookout for opportunities for potential return that more than compensates for risk;
- ‘Risk premium’ is the incremental expected return for the incremental risk;
- In good times, the slope of the curve is flat – risk tolerance is high and people take on more risk given potential meager returns;
- In bad times, the slope is steep – people are very reluctant to take on risk, but potential returns are very high;
- The greatest source of investment risk is when asset prices attain excessively high levels that can’t be justified on the basis of fundamentals. These prices are reached when risk aversion and caution evaporate and risk tolerance and optimism take over.

HIGH RISK TOLERANCE BEFORE THE GLOBAL FINANCIAL CRISIS OF 2007-08

- In the years 2005-07, the environment was very risk tolerant;
- Government policies supported an expansion of home ownership, which meant inclusion of people who historically couldn’t afford to buy homes at a time when home prices were soaring;
- The Fed pushed interest rates down, causing the demand for higher yielding instruments, such as mortgage backed securities, to increase;
- Rising trend among banks to make mortgage loans, package them and sell them; Rating agencies provided high (AAA) credit ratings, despite a lot of junk in it;
- Lending standards declined on the basis of extrapolation of low historic mortgage default rates;
- Sub-prime mortgages were issued without proof of income or employment;
- No banker could decline to participate for fear of losing market share;
- Bankers are like surfers, trying to catch the next big wave, without knowing what’s behind;
- Protective laws and regulations were relaxed; such as the Glass-Steagall Act; the elimination of the uptick rule; and the rules that limited banks’ leverage;

FROM EXCESSIVE RISK TOLERANCE TO EXCESSIVE RISK AVERSION

- The consequences included massive mortgage defaults and home repossessions; collapsing home prices; collapsing stock and bond markets, drying up of credit availability, and bankruptcies of a number of banks.
- In March 2009, at the bottom of the stock market, pessimism and risk aversion were extreme;
- It would have paid off tremendously if you would have been a contrarian then, leaning against the wind. The slightest turn for the better would result in appreciation.
- In short, excessive risk tolerance contributes to the creation of danger, and the swing to excessive risk aversion depresses markets, creating some of the greatest buying opportunities;
- The time to buy is when there is blood on the streets – Baron de Rothschild
- Investors are most willing to buy when they should be most cautious, and most reluctant to buy when they should be most aggressive.

THE CREDIT CYCLE

- Changes in the availability of capital or credit are one of the biggest influences on economies, companies and markets.
- This cycle is even more excessive then the other ones we discussed.
- The credit window opens wide in good times, but slams shut when times turn sour;
- Banks are very willing to lend you money when you don’t need it and vice versa;
- The best bargain opportunities in the stock market arise during the slammed-shut phase of the credit cycle;

WHY IS THE CREDIT MARKET IMPORTANT?

- First, capital or credit is an essential component in the productive process, thus the ability of companies to grow usually depends on the availability of incremental capital;
- Second, capital must be available in order for maturing debt to be refinanced (rolling over); Many companies borrow short to invest long, so they keep rolling over their debt; If the credit cycle turns negative, the mismatch (between LT assets and ST liabilities) is often the cause of financial meltdowns;
- Third, financial institutions (banks) rely heavily on credit markets. What happens when there is a run on the bank, when all depositors demand their money back? If there's no access to the credit market, that bank may fail;
- Fourth, the credit market gives off signals that have great psychological impact. Difficult conditions can cause the credit market to close.
- Pay attention to credit spreads! Wider spreads, more risk.
- Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on

TOP AND BOTTOM OF THE MARKET CYCLE

- Market top: Maximum (optimistic) psychology, maximum availability of credit, maximum asset price, minimum potential return and maximum risk all are reached at the same time, and usually these extremes coincide with the last bout of buying.
- Market bottom: The nadir of psychology, a total inability to access credit, minimum asset price, maximum potential return and minimum risk all coincide at the bottom, when the last optimist throws in the towel.