ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

> ***I am learning all the time. The tombstone will be my diploma.***
> *Eartha Kitt*

Friday, 12 June 2020

In this week's Investment Insight

One day, maybe…
The Dow Jones Industrial Average ("DJIA") more than tripled in value in the 5 years running up to the October 1987 stock market crash. By the time Black Monday occurred resulting in falls of over 20% in the DJIA and the S&P 500, the stock market was overvalued on most measures. While programmatic trading algorithms were generally blamed for causing the crash, the reality is that the conditions were becoming increasingly ripe in the runup. The February 1987 Louvre Accord had replaced the Plaza Accord, with the objective of stabilising G5 exchange rates around a new balance of trade. The US Federal Reserve had tightened monetary policy to protect against the slide in the US dollar, which resulted in a big fall in US money supply during the first three quarters of 1987. This had the predictable tightening effect on the US economy, further exaggerating the differential between "fair value" and current prices of US stocks. Shortly afterwards the Fed Chairman Alan Greenspan, not long in the job at the time, began a policy that fundamentally changed the way stock market (the mechanism through with investors' collective (and at any point in time, marginal) views are expressed) reacts. No longer would bad news for the real economy necessarily translate into bad news for the stock market. More than three decades later, might the "old way" make a comeback? One day, maybe, and it if it happens it probably won't be pretty. In The Inside Track we explore this in more detail.

Finding value in value
The defeated strategies of "value" traders, like crumpled chits, litter the virtual floors of stock exchanges. The result is the widest disparity ever, apart from a brief spell shortly before the dot.com bubble burst, between valuations of growth and value stocks. According to GMO, while value will have it's day in the sun, not all value looks valuable at the moment. In Pic of the Week we take a look.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance.

The Inside Track: One day, maybe...

For a longish while now, dating back to Alan Greenspan's support for markets after the 1987 stock market crash, the prevailing wind has been one where everyone knows you don't sell on bad news. Yet one day, according to Jonathan Ruffer, founder and Chairman of Ruffer LLP, the wind will change, and bad news in the real world will be bad news for asset values once more. These are a few extracts from his recent letter. If you would like to read the full text, please email research@aria-capital.ie.

First, why have the markets recovered [since the coronavirus selloff in February and March this year]? The classically correct answer is that interest rates have come down, both at short and long duration – future profits in the stock market are discounted at a lower rate than before; they are therefore worth more than they were. This, of course, seems to assume that the profits will reappear.

Alan Greenspan, chair of the US Federal Reserve, began the policy of supplying the market with funds whenever it had a headache. It is a policy executed over three decades without even a pause for a coffee break…Since then, investors have come to see that bad news is the precursor of Fed-gifted good news – and only the patsies sell the bad news.

The relationship between growth stocks and their opposite (known as value…) is at an extreme. This momentum versus value decision in portfolios is tactical – it is a view on the markets, not a view on the real world…Events following the 2008 crash have benefitted the few...There is a reckoning coming. Taxation at higher levels will help reduce the monumental debt pile a little, but that may be almost beside the point – for many, it will be a visceral pleasure to observe.

Why is inflation worth considering now? The answer is that the monetarists (who, bless them, have been wrong for 20 years) are soon to be right, too. One of the few economic theories which has stood the test of time is that money value will be determined by multiplying two things: the amount of money in the system, and its velocity (how often money changes hands).

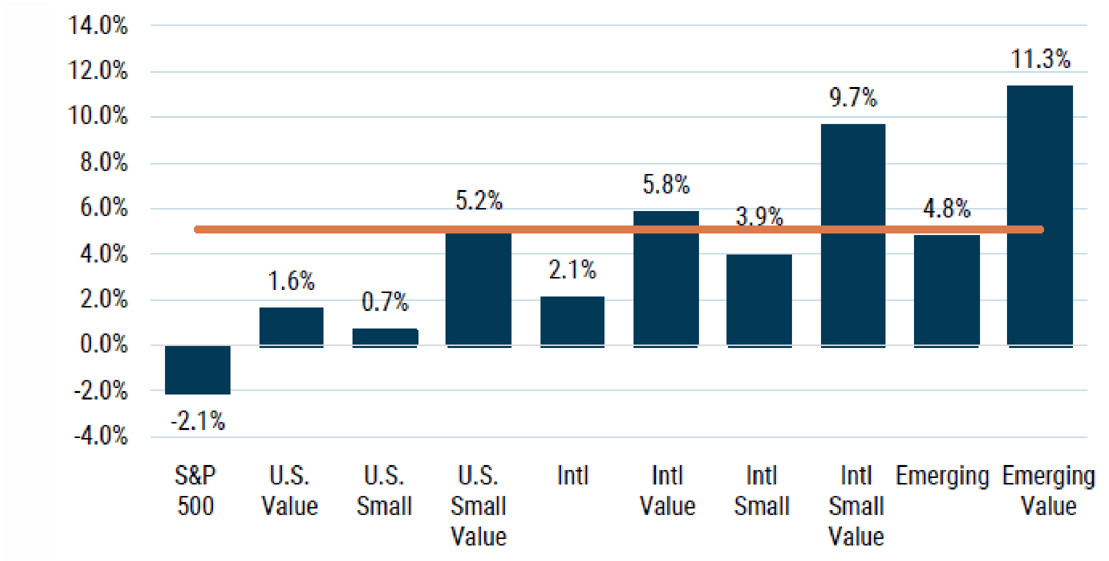
After 2008, quantitative easing meant there was a lot of money around, but it went to those with no propensity to spend – much went into financial engineering, especially in the United States, where the market has, unsurprisingly, outperformed for a decade.

[Now,] falling profits, a re-energised workforce calling for its rights, a shortage of prosperity to start paying down debts – it all adds up, in our view, to a re-run of Britain and much of Europe in the 1970s…When there's not enough money, it's either austerity, or more money is created. Last time round it was austerity, and up went asset values – this time, the authorities will strive to keep prosperity alive, and will, in so doing, create a great deal of money. This is a world where it's difficult to preserve the value of savings. The economic climate and the politics combine towards redistribution.

Pic of the Week: Finding value in value

On some metrics, many stock markets are priced for an almost perfect outcome (read *imminent availability of an effective vaccine, a strong v-shaped recovery and consignment of coronavirus to the annals of medical history while meriting barely a mention in economic almanacs*) to the coronavirus pandemic. If this rosy result doesn't transpire, a(nother) correction may well take place, particularly in the US. This is one of the scenarios according to GMO, and echoing some of Jonathan Ruffer's thoughts summarised in *The Inside Track*, in which value might offer a safer haven than growth.

Not all parts of the value universe stand up to a value assessment though, given the rapidity of the post 23-March pickup in stocks. GMO's analysis suggests that non-US value stocks and global small cap value are still priced to give a fair return or better in a bad economic scenario, but now neither US large value nor broad developed markets outside of the US are priced to deliver anything particularly close to a "fair" return. In fact, the only group outside of the value style at all which is priced to deliver a "fair" return in a bad economic scenario is emerging markets. That is not due to an assumption that emerging markets will avoid a fundamental hit in such an event. It is simply that they are trading at much lower valuations, which leaves significant room for normalised earnings to fall while still providing a good return to shareholders. Emerging market value stocks are far cheaper still, and today seem priced to offer a double-digit expected return in a poor coronavirus outcome scenario. Relying on indices or passive investments, however, is not the way to lean into this space...there are major contrasts across the emerging market spectrum between those poorly and well-positioned for the coronavirus pandemic, so selection is key.



Newswire

...on Monday
Oil prices rise after major producers agreed to extend a deal on record output cuts to the end of July.

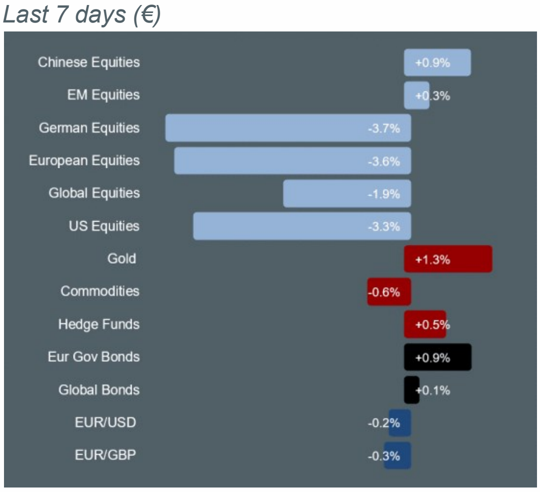
...on Tuesday
The Nasdaq 100 closes at an all-time high.

...on Wednesday
US Federal Reserve Chairman Jerome Powell refers to the economic impact of Covid-19 as "the biggest economic shock, in the US and the world, really, in living memory".

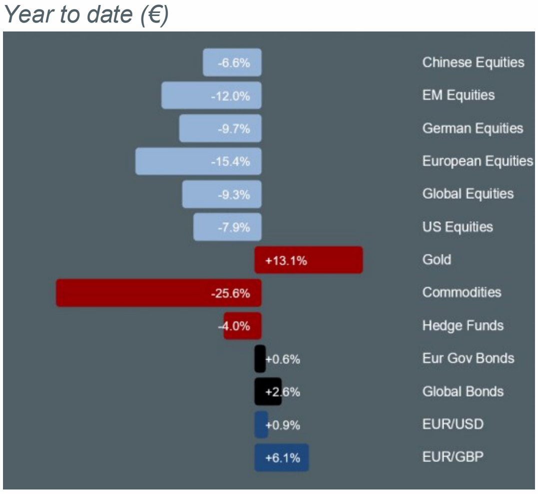
...on Thursday
Stocks suffer the largest one day decline in over 2 months following the bleak picture painted by the US Federal Reserve yesterday and the emergence of a second wave of Covid-19 cases in some US states.

Market View

Last 7 days (€)



Year to date (€)



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