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There is no crystal ball

Deon Gouws - CIO, Credo Wealth - 18 January 2016

Barely halfway through January, and already it feels like a tumultuous year in global markets. Just in the first five trading days of the month, for example, US stock indices declined by some 6%, thereby registering their worst first week of the year since records began. Seven days later, another record: year-to-date, the market is now down 8% - the worst two week start in history.

Markets across the board have been affected; none more so than China where circuit-breakers triggered a suspension in trading on two consecutive days in the first week of the year, following 7% falls in the country's main index. Soon after, the circuit-breaker system itself was suspended.

Volatility continues.

Further fuel has been added to the fire with strategists and analysts publishing bearish outlook pieces. In particular, last week's "Sell Everything" note by Andrew Roberts (head of European Economics at Royal Bank of Scotland) has attracted a lot of attention. According to the note, the only financial asset that Roberts would buy, is high quality government bonds, "which are cheap", according to him (even though it is hard to find any sovereign in the UK or continental Europe that yields anything at present, with the exception of longer dated bonds). Roberts ends off his overview with a warning: "In a crowded hall, exit doors are small. Risks are high."

It is perhaps even more concerning that someone like Andrew Roberts is of course not alone in being bearish: every day seems to bring another pessimistic commentator to the fore, calling for a (further) stock market correction, expecting financial Armageddon.

George Soros, for example, recently said that he foresees a crisis in global markets which "echoes 2008". Jeff Gundlach, founder of Doubleline Capital, has been quoted as saying that both stocks and bonds face an "ugly situation" in 2016. There are other examples; if one reads the newspapers, it would appear that there are bears coming out of the woods on a daily basis.

What to do in the face of all this scaremongering? And who will be proven right?

One of the first things to bear in mind, is that no-one really knows exactly how markets will play out; there is not one investor or strategist out there who has perfect foresight.

This last point was eloquently illustrated in a recent article by Tim Harford (author of inter alia The Undercover Economist) focusing on Phil McNulty, chief football writer for the BBC. In December 2015, McNulty offered his predictions for the rest of the English Premier League season – the kind of thing that pundits do all the time.

As a starting point, Harford first reminds us of McNulty's most recent set of forecasts, a short four months earlier (when the current season started). At the time, the BBC's man predicted previous league champions Chelsea to come out on top again, and that Leicester would be relegated at the end of the season - an outcome which seemed totally reasonable at the time but which is now inconceivable, with Chelsea clinging onto 14th position, and Leicester (joint) top of the league after round 22 of the competition.

Why on earth should we therefore care about McNulty's updated set of predictions, Harford rightly asks?

Harford then continues to analyse our fixation on forecasting. One of the reasons that we keep on trying to see into the future, he postulates, is that forecasts "offer us a lazy way to understand a complex world… it's a simple way to convey a fleeting sense of understanding". As Harford rightly concludes: "The forecast will probably be wrong. But at the instant it is consumed, it gratifies."

Tim Harford's insights apply not only to sports punditry, they are valid in all walks of life, including financial markets. When considering Andrew Roberts and his "Sell Everything" prognosis, for example, it is perhaps worthwhile to note that the same analyst has been predicting disaster consistently for at least the past five years. In June 2010, for example, he was quoted as saying: "We cannot stress enough how strongly we believe that a cliff-edge may be around the corner, for the global banking system (particularly in Europe) and for the global economy. Think the unthinkable."

As pointed out in The Spectator at the end of last week, "the unthinkable in that case turned out to be that, contrary to the Cassandras' warning of a double dip recession, it didn't happen". Furthermore, if one had listened to the RBS analyst in 2010 and sold out of share portfolios, you would be licking your wounds: equity markets have risen by approximately 100% since then (even taking into account the recent sell-off).

Will Andrew Roberts be proven wrong again? Stephen Koukoulas, managing director of Canberra based macroeconomic advisory firm Market Economics, certainly thinks so; in fact Koukoulas has put his money where his mouth is, offering Andrew Roberts an AUD10,000 bet that markets would end the year higher, not lower (based on 11 specified measures). To date the bet has apparently not yet been accepted by Roberts.

And what about George Soros? And Jeff Gundlach? These individuals may indeed have made some exceptional calls in the past, and they're certainly very rich and famous today, but that doesn't mean they are good forecasters: they have both made countless predictions in the last few years which have simply been wrong (at worst) or extremely early (at best)... I guess time will tell.

No doubt a lot of people will, however, keep on following some of these gurus and their prognostications. As JK Galbraith famously said: "There's a certain part of the contented majority who love anybody who is worth a billion dollars."

Another perma-bear who has built up a rather loyal following and who deserves a mention, is Albert Edwards, employed by SocGen as an "alternative strategist" (whatever that means). He and his colleague Andrew Lapthorne recently made a presentation to an audience of some 900 people in London, the topic of a Financial Times article last week under the heading "Doom mongers have their day in the sun as markets turn". The same article describes the views put forward by Edwards and Lapthorne as "a useful counterpoint, a way to jolt the brain out of day-to-day immersion in spreadsheets and company filings". And, as the article closes off, Lapthorne acknowledges he has a curious job and he is quoted as saying: "We're paid very well if we're completely and utterly wrong".

It should be stressed that I am NOT trying to fall into the trap of making my own predictions here (by suggesting that the individuals referred to above will necessarily be wrong in their bearish pronouncements). All I am saying is that there is nobody in the world who has a crystal ball, no matter how rich and famous he or she is.

It is of course true that the market has experienced a start to the year which is unprecedented, and as a consequence it is totally understandable that many people will react with apprehension if not trepidation when they look at their portfolios and try to come to grips with overall valuations that are lower than a few weeks ago. But, as Howard Marks (founder and co-chairman of Oaktree Capital) said in his most recent memo to clients (quoting Ben Graham): "the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously."

By the way, in the same memo, Howard Marks also addresses the very point made by George Soros, namely the risk of a potential crisis echoing that of 2008 (as mentioned above). Marks concludes that, in his view at least, such an outcome "isn't in the cards", inter alia due to the fact that leverage in the private sector has been largely reduced in the intervening period.

Who knows exactly what the market has in store for the rest of the year... As mentioned before, the 8% decline in the first two weeks is an all-time record, but it's interesting to note that after the second worst start in history (i.e. minus 6.6% in the first two weeks of 2009), the market actually yielded a positive return amounting to no less than 32.5% over the rest of the 2009 calendar year.

Regardless of financial market conditions, there will always be opportunities for astute market participants to find quality assets at reasonable valuations. In fact, one can argue that some market weakness is of course healthy, as it leads to a number of attractive buying opportunities. Contrast this with an environment where most securities are "priced for perfection"... the signs of which have been around for some time now (which is why we have consistently urged clients to have low expectations in all interactions over the last couple of years).

In his "Sell Everything" note, Andrew Roberts warns us that the exit doors are small. My response would be that it shouldn't matter... speaking for myself, I'm not going anywhere in a hurry. It's been proven time and time again that the most rational approach is to stay invested with a focus on the long term, rather than panicking at the bottom and missing out on the next upswing as a consequence.

In closing, I take heart from a line in a recent article by Morgan Housel who writes for the Motley Fool... I could not say it better myself: "The past wasn't as good as you remember, the present isn't as bad as you think, and the future will be better than you anticipate." ■