Absolute Return Partners

The Absolute Return Letter

April 2020

Five Lessons from History

"We have a government that borrows $4 billion a day. We have a government that owes trillions of dollars in debt, half of that to foreigners, most of that to Chinese investors. Not only is it extreme. It's insane and it's unsustainable."

Marco Rubio

Lesson #3: Unsustainable things can last longer than you anticipate.

Unsustainability

The theme in this month's Absolute Return Letter is *unsustainability* and I will share with you one or two classic examples of events/incidents that were, to the naked eye, entirely unsustainable. As Warren Buffett once said: *"Only when the tide goes out do you discover who's been swimming naked"*. The tide has now turned, and it is obvious that many equity investors were indeed swimming around naked. In these columns, I have repeatedly argued that equity valuations, particularly US equity valuations, were uncomfortably high and that, sooner or later, *something* would happen that would bring equities back down to earth again.

I did not predict the Coronavirus (nobody did) but, following ten years of rising valuations, even my dog would have told you that equity markets were in dangerous territory and *very* sensitive to bad news. As far as the virus is concerned, I hope you are well and that your personal life and your business isn't overly affected. I suspect that this outbreak will be with us for many weeks (months?) to come, so I am preparing to stay indoors until at least early June and would encourage you to do the same.

Before moving on, allow me to deal with one particular issue which will undoubtedly be raised by one or two of our American readers: If US equities were so overvalued, how come that, at least so far, supposedly cheaper European equities have fallen more than supposedly more expensive US equities?

There are two reasons for that. First and foremost, most of Europe is further into the disease cycle than the US is. More Europeans have died (so far), resulting in a higher fear factor on this side of the Atlantic, i.e. the impact on risk assets has been bigger. Secondly, European equity markets are less liquid, i.e. the selling pressure has had a bigger impact on prices in Europe than in the US.

Before we come out on the other side of this crisis, more likely than not, the day will arrive when European equities begin to outperform US equities, just like Chinese equities have outperformed equities from the rest of the world in recent weeks. Enough about Covid-19.

Lesson #3

Let me open this month's letter with an extensive quote from Morgan Housel's *Five Lessons from History*:

> "There's a long history of military leaders following a logic that goes like this: *"The enemy is outnumbered. They are out-gunned. We are gaining ground each day. Their morale will soon break and, accepting reality, they will surrender."*
>
> "And then that outnumbered, out-gunned enemy keeps fighting, and fighting, and fighting. Sometimes to the last man.
>
> "A rational person might look at this and say, *"Why are they still fighting? It's unsustainable, and they have to know it."*
>
> "But wars often aren't governed by spreadsheets and clean reasoning. During the Vietnam War, Ho Chi Minh put it bluntly: "*You will kill ten of us, and we will kill one of you, but it is you who will tire first."*
>
> "Identifying that something is unsustainable does not provide much information on when that thing will stop. To tie this into the last lesson: Knowing there will be a reversion to the mean does not mean you will know when things will revert. Unsustainable things can sustain for a long time." [Emphasis mine.]

The first time I learned that lesson was when, in the second half of the 1980s, all the fancy theories from my days at university in Copenhagen proved pretty useless when investing in Japan. For years, Japanese equities defied all logic, and the only fools were those of us who didn't participate in the extraordinary rally because we found the market too expensive. The fact that we were eventually proven right was poor consolation at the time.

The five biggest US bull markets since the Great Depression

If we define bull and bear markets the conventional way – i.e. when prices rise/fall by more than 20% – the five biggest US equity bull markets since the Great Depression are (in chronological order) as indicated in Exhibit 1 below.

Name of bull market	*Starting*	*No of Months*	*Rise*
Great Depression Recovery	June 1932	57	+325%
Post War Boom	June 1949	86	+266%
Reaganomics	August 1982	60	+229%
Roaring 90s	October 1990	113	+417%
GFC Recovery	March 2009	129	+376%

Exhibit 1: The Five Biggest US equity bull markets since 1927
Source: CNN, Absolute Return Partners proprietary research

The Great Depression Recovery was kickstarted by President Roosevelt when, in 1932, he unleashed a massive federal spending programme to get the US economy going again in the midst of the Great Depression.

The Post-War Boom after World War II was a period of rapidly rising prosperity in the US with many families buying their first car. President Eisenhower had come home from the war in Europe and told Congress about this wonderful thing called autobahns. Consequently, the interstate highway system was established, and productivity benefitted.

Reaganomics ruled in the 1980s after Ronald Reagan had come to power and Fed Chairman Volcker had managed to tame out-of-control inflation. What followed was one of the biggest bull markets of the last 100 years.

The Roaring 90s came about as the result of two separate developments – the end of the cold and the early days of the digital revolution. As a consequence, we enjoyed almost ten years of virtually uninterrupted bull times.

The GFC recovery may not be the biggest bull market of all time but it was certainly the most durable, lasting almost 11 years. The GFC Recovery rally is sometimes also referred to as the Everything rally as pretty much all risk assets rose substantially in value between March 2009 and earlier this year when the Coronavirus ended the good times.

Common characteristics of major bull markets

The five bull markets just referred to have, with one exception, two characteristics in common. All five bull markets were established in the aftermath of a major crisis – (i) the Great Depression that followed the 1929 Wall Street collapse, (ii) World War II, (iii) the oil crises in the 1970s that led to runaway inflation, (iv) the recession that followed the collapse on Wall Street in 1987 and (v) the depression that followed the GFC in 2007-08.

Secondly, none of the five crises died from old age but (mostly) from policy mistakes. Only one of the five big bull markets did not come to an end as a result of some sort of policy mistake and that is the most recent one which ended when the Coronavirus, in addition to threatening human life, began to do immense damage to economic fundamentals. How that story will end remains to be seen.

The DNA of the Japanese boom & bust

> *"[…] the prevailing expectations in Japan in the late 1980s were that the country was entering a new era of economic development, reflecting optimistic expectations for economic growth."*

With those words, Shigenori Shiratsuka of the Bank for International Settlements begins his analysis of the Japanese asset price bubble in the late 1980s (you can find the whole paper here). In the quote above, if you replace "Japan" with "the United States of America" and replace "1980s" with "2010s", am I the only one in with a distinct sense of déjà vu?

As you can see from Exhibit 2 below, the asset bubble in Japan in the late 1980s, the so-called Heisei boom, was extraordinarily powerful. Between 1985 and 1990, both Japanese equities and Japanese urban land prices were up 20-40% *every year*. And after the first setback in 1990, equities, but not urban land prices, enjoyed several more good years until investors finally realised in the late 1990s that the party was over.

Exhibit 2: Japan Nikkei 225 stock market index, 1965-2020
Source: *https://tradingeconomics.com/japan/stock-market*

One factor particular to the Heisei bubble of the late 1980s was the behaviour of inflation (Exhibit 3). Other than asset price inflation, which was out of control for a few years, inflation was actually exceptionally well behaved – a factor that only fuelled further enthusiasm amongst Japanese investors. What does that remind you of?

When the first wave of selling pressure hit Japan in 1990, the prevailing view was that it was a cyclically driven sell-off, and that everything would return to 'normal'. You may recall that large parts of the world were in recession around that time. However, as the decline in asset prices continued into the second half of the 1990s (Exhibit 4), investors began to ask serious questions. The rest of the world was booming, as we began to enjoy the benefits of the digital revolution. Why not Japan? What was wrong?

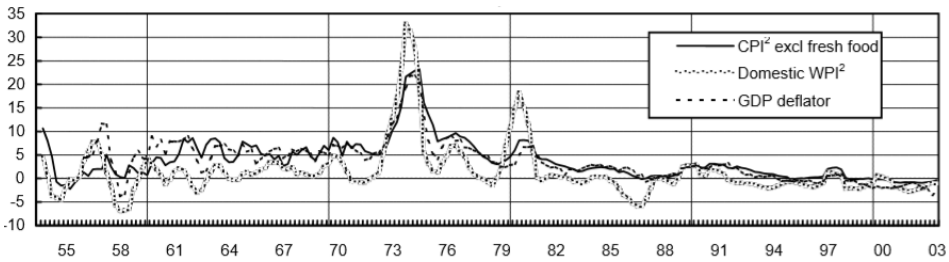

Exhibit 3: General prices in Japan in the second half of the 20th century
Source: Bank for International Settlements (BIS paper No 21)

A very important lesson learned from the Heisei bubble in Japan in the 1980s is that monetary policy does not work very well when the financial system carries problems stemming from the bursting of a bubble. We have managed to convince ourselves that pretty much any problem can be fixed with a dose of monetary policy these days, but the Japanese lesson should have taught us that monetary policy cannot fix absolutely everything. I hope policy makers have taken note of that, but I am not convinced.

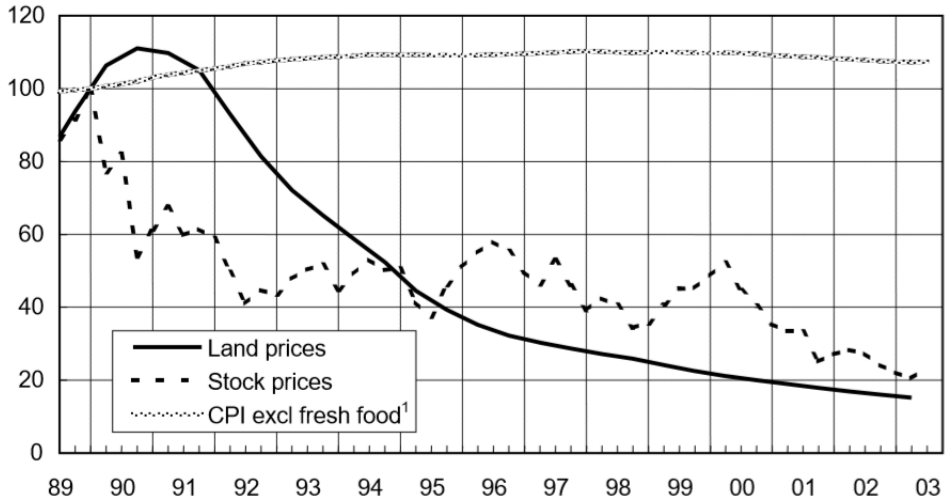

Exhibit 4: Japanese asset price deflation in 1990s and early 2000s
Source: Bank for International Settlements (BIS paper No 21)

Bubbles that have burst in my lifetime

Although the Japanese equity bubble of the late 1980s was the first bubble I was confronted with after joining the financial industry in 1984, it hasn't been the only one I have experienced in my 35+ years in the industry.

I joined Goldman Sachs in 1989, and I still remember the happy days of the 1990s when we took an almost endless number of companies public. The one I remember the best of them all was a US company called Netscape Communication, which we took public in 1995. Netscape's claim to fame was something called a web browser. I am not sure many of us understood how dramatically the web browser would change the world – I certainly didn't – but the appetite for the IPO was huge, in fact so big that our clients only got a tiny fraction of what they had asked for. Despite of that, they still made a boatload of money.

Netscape's IPO was an early indication of what was soon to come – what is now known as the dotcom bubble. Between January 1995 and March 2000, any listed company that had *anything* to do with the internet rallied. The Nasdaq index, the home of most dotcom companies, went up about 400% during that period. Shortly before the bubble finally burst, the P/E of the Nasdaq index reached 200, making the Japanese bubble a few years earlier look like a mere appetiser for the real thing.

Now, fast forward to the mid-2000s, and we had the next big bubble on our hands. Between 2002 and 2006, US house prices had rallied so much that strong signs of unsustainability were creeping in – sub-prime borrowers had too easy access to capital and condo "flipping" became standard practice; even mortgage fraud was rampant. By 2007, the mood had changed

profoundly and, by 2009, the average US house had lost one-third of its value. Even now, more than a decade later, some US house owners are still under water.

This bubble is often referred to as the US housing bubble and, whilst it is correct that it all started with the rally in the US housing market, one could argue that pretty much all risk assets rallied in the years leading up to the crisis in 2007-09. The dotcom bubble had burst only a few years earlier, and many investors continued to have a humongous appetite for risk. Presumably, they could still remember from the late 1990s how easy it was to make a profit!

The bursting of the US housing bubble quickly turned into the so-called Global Financial Crisis (GFC). As if the crisis in the US wasn't serious enough, a major crisis in Greece unfolded only a couple of years later, turning what was up to that point mostly a US housing crisis into a global financial crisis.

Having learned a lesson or two from the Greenspan era (remember the Greenspan put?), the Federal Reserve Bank decided that an archetypical unwinding of a bubble is so *yesterday*. Hence they decided that the party could be reinvigorated by applying a decent dose of QE, which has since become standard practice amongst central banks. I note that QE has had little impact on economic activity but big impact on how risk assets perform. Adding to that, QE has also increased the gap between the rich and the poor in society, what has led to a rise in the populist agenda amongst our political leaders.

Is the US wealth bubble bursting?

The liberal use of QE in the post-GFC era combined with only modest inflationary pressure established yet another everything rally with most risk assets performing rather well in the years following the GFC. That said, one asset class stands out and that is equity technology, particularly US equity technology.

There is one simple reason why that bubble could also be bursting as we speak, although investors and commentators alike are busy stating that everything will be fine once we get out of the iron grip of the Coronavirus, and that is the current ratio of wealth-to-GDP. If you have followed my writings for a while, you'll be aware that total wealth in society *cannot* grow faster than nominal GDP over the long-term, and that every country has a well-defined mean value in terms of the wealth-to-GDP ratio. In the US, that mean value is 380%. In other words, when the actual wealth-to-GDP ratio deviates too much from 380%, you know that the ratio will mean revert at some point. You just don't when.

Exhibit 5: US wealth-to-GDP ratio through 2Q2019
Source: Wall Street Journal (The Daily Shot)

Following one of the biggest bull markets of all time, US wealth is now 530% of US GDP (Exhibit 5). We therefore know that, at some point, US wealth will likely take a major hit. In principle, the long-term mean value (380%) could also be re-established if the numerator were to grow more slowly that the denominator for a number of years. Given how massively the

two numbers are out of sync, that would take forever, though, so the more likely solution is for the numerator (wealth) to fall about 30%.

The wealth statistics being published by the Federal Reserve Bank are published with almost a quarter's delay, so we do not know yet how much damage the coronavirus outbreak has done to US wealth already; hence my earlier comment that the bubble may already be bursting.

So, what do we know? We know that:

1. the biggest contributors to private wealth are (i) property, (ii) pension savings and (iii) equity holdings, either listed or privately held (mostly family-owned businesses);
2. pension funds hold massive amounts of all three, i.e. property, equities and bonds are the most exposed to a decline in wealth;
3. considering how leveraged they are, governments cannot afford for interest rates to rise much, i.e. they will do everything in their power to keep a lid on interest rates;
4. irrespective of that, interest rates will most likely stay relatively low anyway as there are some very powerful, structural reasons why inflation will remain subdued for many years to come.

For those four reasons, property and equities are the two asset classes most exposed to a decline in wealth, and that is the case worldwide, although the US is more exposed to this risk factor than other countries, as US wealth is more out of sync with US GDP than is the case elsewhere.

What does lesson #3 tell us?

Going back to lesson #3, *Unsustainable things can last longer than you anticipate*, how can we incorporate that lesson into my thinking around mean-reversion of wealth-to-GDP? One lesson I learned in the late 1980s, when Japanese equities were defying all logic for years, was the need to participate in the rally regardless, even if valuations were ridiculous. Clients demanded it, and the boss expected it.

The academics amongst us don't use the terminology I have used in this letter. They call it *accelerated price increase* and *reversal* instead of boom (bubble) and bust. That an increase in the stock price is accelerated simply means that the percentage return on your investment is increasing over time. In a famous paper from 2015 (see here), Roger Ibbotson and James Xiong found that accelerated stock price increase is "a strong contributor to poor future performance", as accelerated returns increase the probability of a reversal. Importantly, Ibbotson and Xiong concluded that their findings work both at the individual stock level and at the aggregate market level.

This implies that a long-only strategy in a powerful bull market can be suicidal – at least financially – as you never know when the good times are over. The cost of protection (through put options or otherwise) may cause you to underperform a little bit but not enough to lose your job. And the protection will ensure you still have a job when all wheels eventually come off.

Lesson #4

Subject to how the coronavirus crisis will affect financial markets (and my personal circumstances) over the next four weeks, I plan to come back next month with lesson #4:

> *"Progress happens too slowly for people to notice; setbacks happen too fast for people to ignore."*

… which reminds me of the second of the six megatrends that we have identified – Changing Demographics. I am constantly confronted with the view that demographics are changing so slowly that we do not need to pay much attention day-to-day, which is a viewpoint that I wholeheartedly disagree with, but therein lies the opportunity. More about that next month.

Niels C. Jensen

7 April 2020

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