LeoVest

AIO Quarterly: Déjà Vu of a Bubble Era

By Peter Ahluwalia

- *Bubble Warning: Beware the Euphoria in U.S. Markets*
- *Inflation and Debt: The Hidden Threats to Stability*
- *An alternative Christmas*

'The market is a pendulum that forever swings between unsustainable optimism, which makes stocks too expensive, and unjustified pessimism, which makes them too cheap. The intelligent investor is a realist who sells to optimists and buys from pessimists'.
– Benjamin Graham

Back to the future

I remember the 1990's like yesterday.

Life seemed like a dream but in hindsight it was a mirage.

It was the post-cold war decade with the rise of the USA as the sole superpower. It also saw the introduction of the series Friends and the movie franchise Wayne` s world. After a slow start in the early 90` s markets certainly did party on!

It was the era when city traders got large cash bonuses and set up restaurants to explore their creative talents (many failed miserably). We also saw the rise of two new demographic subsets – the Yuppie and the Dinky (dual income no kids) who often had matching BMW` s or if they were really successful matching Porsche 911` s. It was also the era of power dressing for both men and women and a time when people regularly spent over £50,000 on lunches at the best restaurants. Of course much of this joie de vivre was down to stock market investment, mainly in what subsequently turned out to be bubble stocks. Whenever extra money was needed, it was taken from people's portfolios, which seemed to miraculously increase in value every day. By late 1999 despite being ever the optimist I really felt that things had got out of hand and issued words of caution to my colleagues. Of course given the easy gains they were making on a regular basis this either fell upon deaf ears or was met with ridicule or comments that I was out of touch with the new era.

It was also during this period of time that famous hedge fund managers such Julian Robertson were forced to close their funds and turn them into family offices due to vast redemptions as their performance temporarily had not kept up with the market.

There were also various uncomplimentary articles speculating that Warren Buffett was too old, had lost his touch and was unable to adapt to the new paradigm that was unfolding in front of us.

my youthful foolishness I blamed it on the over hype of the Millennium which could only disappoint given the ludicrous build up.

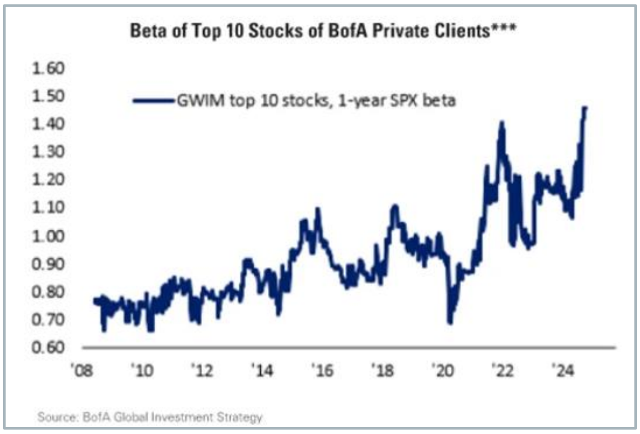
I also remember clearly the very uncomfortable conversations my colleagues on the discretionary portfolio management team were having with their clients trying to explain how their substantial portfolios had seemingly evaporated into thin air overnight.

Decades later with hindsight it is easy to see that I was living through my first ever financial bubble. It has been said that financial markets enter periods of euphoria or bubbles every 20 years or so. Part of the rationale for this is that it gives time for investors involved in the previous bubbles to nurse their wounds (which are always deep) and also to experience some amnesia. It also allows time for a new generation of investors to emerge who of course always know better and are much more 'au fait' with the latest technology which will of course change everything.

As the secular bull market in US stocks reaches its 16th year, we hit the 54th record high of the year for the S&P500 and Bitcoin exceeds USD 100,0000 we are pretty sure which way the pendulum is swinging.

We believe investors in certain parts of the market should be afraid- very afraid.

In 2009 investors were scared with stock ownership at 39% and average Beta of 0.75. Today stock ownership is 63% and Beta is 1.45. Investors have thrown caution to the wind.



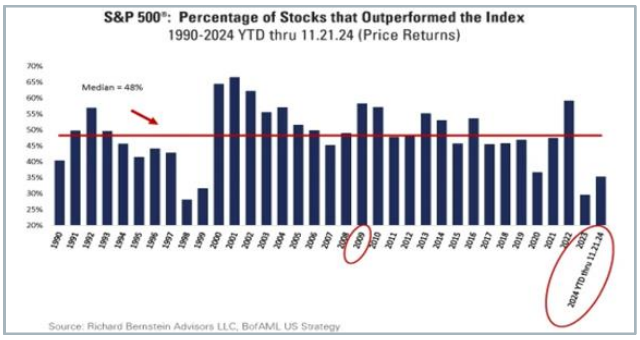
An alternative Christmas tale

As we approach the traditional year end festive season we feel rather like Ebenezer Scrooge crying out 'bar humbug'

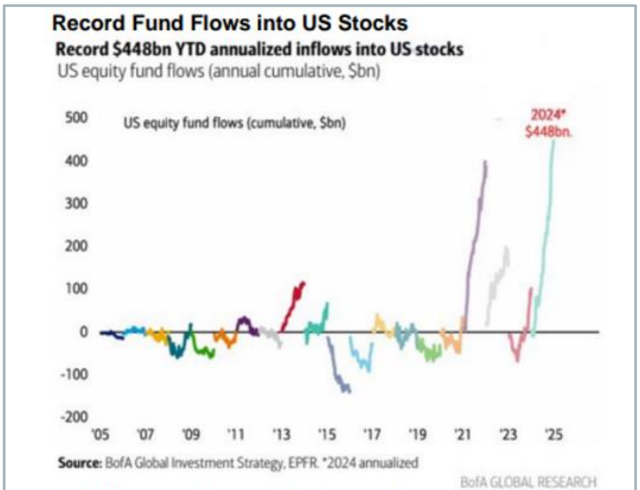
As investors gorge on their daily market gains without even a 'please Sir can I have some more' (Oliver Twist). We see other similarities between Dicken's novels and Victorian society.

Many chasing things at the moment are likely to end up in the Victorian equivalent of the poor house.

Narrow stock leadership is never a good sign



Nobody really knows the exact cause of the market crash of 1929, but many feel one of the major causes was a reckless overconfidence by investors which led to an asset bubble which eventually burst as is the fate of all bubbles.



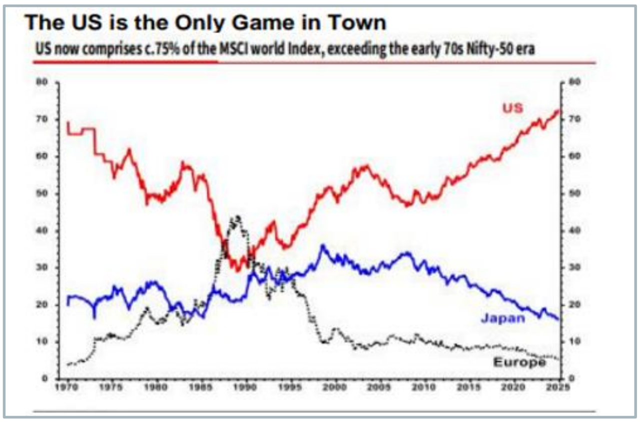
Fund flows into US stocks this year have exceeded all prior levels.

I believe that I am witnessing the 2nd large asset bubble of my career and probably the most dangerous (I desperately hope to witness a couple more before I hang up my boots).

We are I believe close to the point in time that we will see the end of the secular bull market in US stocks that began 16 years ago.

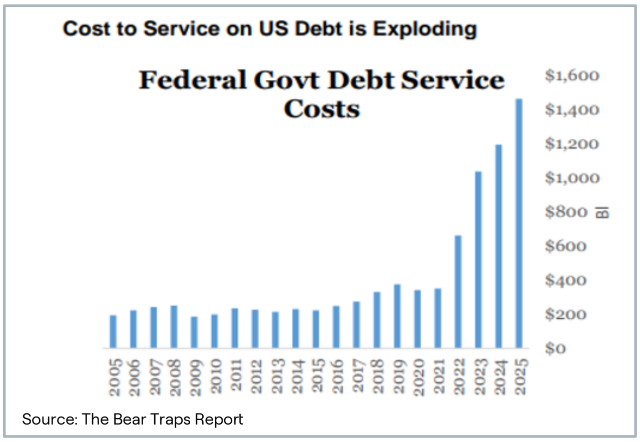
What is perhaps even more worrying than the dot.com bubble of the 2000` s is that any stock that is providing an element of steady growth has been significantly bid up- just look at Costco on a PE of over 50x.

The mass hypnosis and euphoria of this particular bubble seems to be way more widespread than the dot.com bubble and this makes it eminently more dangerous.



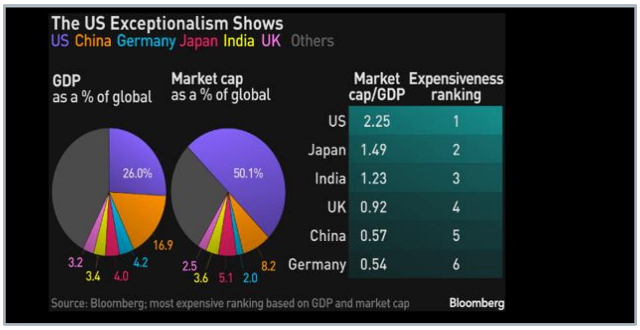
Source: The Bear Traps Report

The US deficit is already a problem but is only likely to get worse with tax cut giveaways

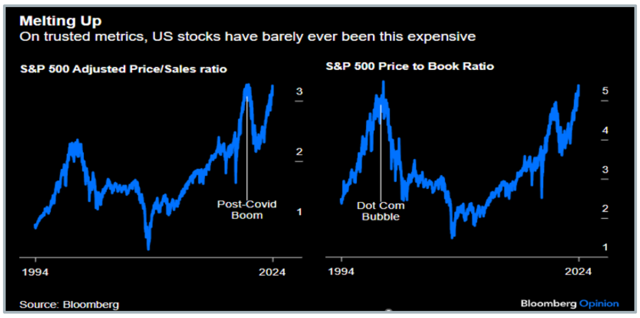


Leverage is one of the key themes to every asset bubble.

Rational valuation measures such as the Buffett indicator (how big the stockmarket is compared to a country's GDP) are flashing bright red. It therefore comes as no surprise that Mr Buffett holds his largest cash pile ever and is too scared to even buy back his own stock!



Whilst inflation in the USA has been edging down recent developments like blanket tariffs, tightening immigration, and tax cuts are all inflationary. This is without taking into account recent pay developments – Boeing machinists and dock workers just received a multi-year payout deal averaging near 9% per annum.



I really struggle to see how the magic 2% inflation target will be reached and it is more likely that the US economy has inflation running at 3.5-5%.

This in turn means that longer dated US bonds yields are seriously mispriced and the 10-year yield could easily move to 5% or more.

Whilst we are in the midst of US election euphoria it should be remembered that sometimes you are just dealt a bum hand

We remain unfashionably underweight US equities especially the most popular names, overweight cash and short dated quality bonds.

Opportunities within the equity space still remain in unfashionable markets like Asia (including China and also in Europe including the UK).

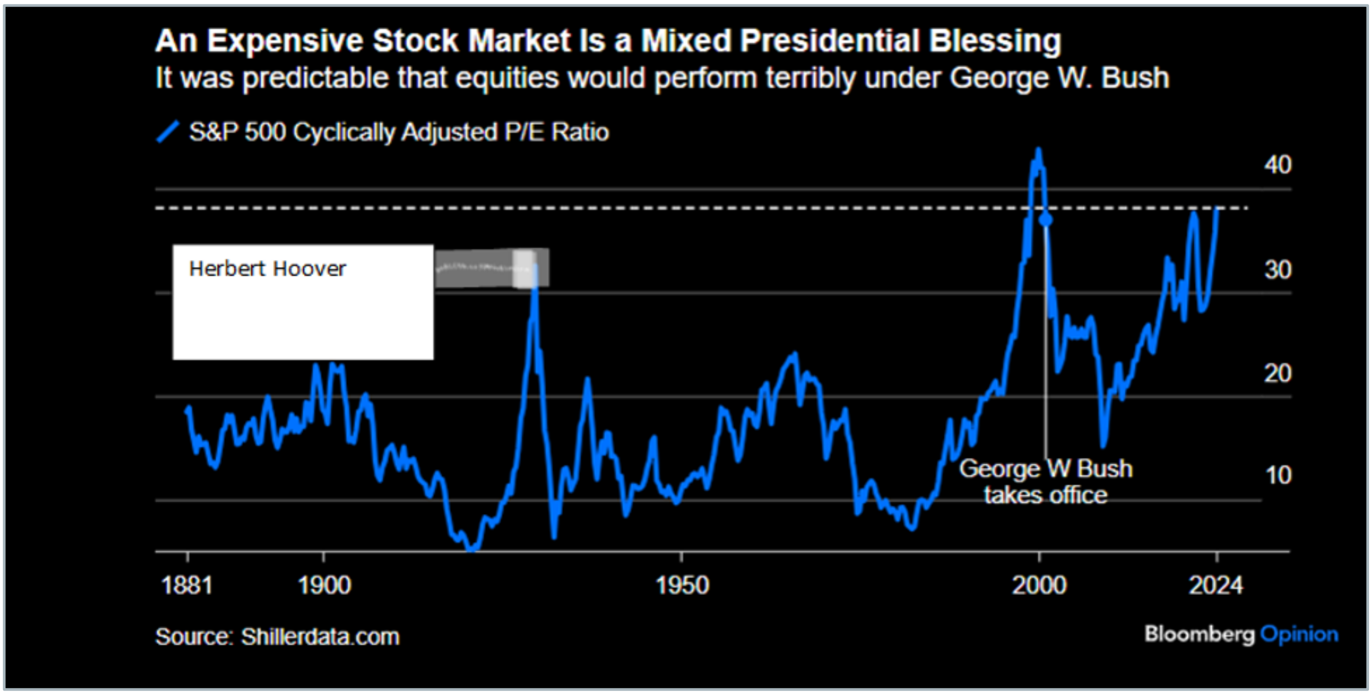
The question we always ask ourselves before investing into an area that we believe is mispriced is why is it so, are the problems temporary and what is the timeline.

Some of the best values we find are in the auto and parts sector where the industry seriously misjudged the appetite for EVs but this in the process of being fixed fast and with the average age of a car in Europe and the US at 13 years plus the demand is there when they have the right products.

From a country perspective we find bargains in the UK where the population seems to have a heavy dose of buyer` s remorse following the new Labour Government which has led to what we believe are bargains in the multinational space.

France which is going through a political crisis (the businesses are doing just fine and the average French household is saving 18% of their income) offers us a plethora of opportunities.

We are convinced that this is the right course of action to not just preserve your wealth but also enhance it in the years ahead.



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