Step Back and Take a Deep Breath

“You don’t want too much fear in a market, because people will be blinded to some very good buying opportunities. You don’t want too much complacency because people will be blinded to some risk.”

– Ron Chernow

It has been about three weeks since Donald Trump was sworn in as the 45th President of the United States and now would be a good time for many of us, regardless of political leanings, to step back and take a deep breath from either the euphoria or misery driving our emotional states. As an ex-bond trader, I learned early on in my career that my daily performance was neither as good nor as bad as whatever feelings I had swirling around my head at the time. Giving in to the emotional highs and lows was a quick way to increase stress and usually led to impulsive decisions that ultimately subtracted from returns.

I do not plan on opining here, as to whether I believe the Trump administration’s policies will or will not work. Some things make sense to me while others do not. We will see. Many people will choose to focus on President Trump’s brash leadership style, distasteful comments, and seemingly volatile approach to governing. I will try not to do that. My intent is to judge the President’s and therefore our country’s success or failure based on the results. If the results
are good then we will want more of whatever is being dished out, if the results are poor then adjustments will be necessary.

Our financial markets on the other hand have been unambiguously euphoric since the election was called in Mr. Trump’s favor. From November 8th through February 9th the S&P 500 index climbed +7.9% while 30-year treasury bond yields increased from 2.62% to 3.01%, equating to an approximate price loss of -7.7% (data provided by Wall Street Journal), as investors focused on the potential future benefits of tax cuts, deregulation, and proposed infrastructure spending. But what if the market is already fully priced for much of this optimism? Or, what if many of the Trump administration’s proposals prove too difficult to pass or enact? I cannot see the future, but I think it would be sensible for investors to temper their expectations given the market’s recent move.

I’ve said it before but I’ll say it again. Japan is a good example of what happens when a government fighting entrenched demographic trends attempts to modify its economic trajectory, by relying on either monetary or fiscal policy. Per data provided by the St. Louis Federal Reserve Bank, the Japanese stock market as measured by the Nikkei 225 index peaked on Jan 2, 1990 at 38,915, 10-year Japanese government bond yields peaked in April shortly after at 8.03%, while their government debt/gdp ratio during the same year stood at 67%. Fast forward to February 9, 2017 and the Nikkei 225 index stands significantly lower at 18,907, 10-year Japanese government bonds yield only 0.08% while their government debt/gdp ratio as of Dec 31, 2014 has increased to a whopping 249%. What effect did both monetary and fiscal stimulus have on real GDP growth? From 1990 thru 2014 there were short term spurts of growth here and there but this quickly wore off. Crunching data provided by The World Bank, I found that Japan’s real GDP grew on average by only 1.18% annually over this same period. It would be safe to say that the measures taken over the past 26 years did not work as intended.

Now it is not clear to me that we are in the same boat as Japan, however there are undeniable demographic similarities across the entire developed world, and so it is probably not a coincidence that to some extent we all seem to be fighting the same boogie man – lower growth. We may or may not be turning Japanese, but some skepticism in regards to asset pricing would probably be prudent.

As an advisor and investment manager to clients, I have been communicating that we should prepare for much higher market volatility going forward. Frankly, many well-known investment managers have come to the same conclusion. One such person is the value investor and hedge fund manager Seth Klarman who described investing under a Trump regime in a recent client letter quoted by The New York Times writer Andrew Ross Sorkin (hat tip to J. Freeman for passing along). “The big picture for investors is this: Trump is high volatility, and investors generally abhor volatility and shun uncertainty,” he wrote. “Not only is Trump shockingly unpredictable, he’s apparently deliberately so; he says it’s part of his plan.”

Investing under a Trump regime means the probability of extreme outcomes over short time horizons has likely increased. Statisticians use the term kurtosis when describing this probability distribution phenomenon, while financial analysts use the term fat tails. Regardless of how one chooses to describe this, I believe the chances of very good or very bad investing outcomes over the short term has probably increased and investors should be pricing this in.

To be compensated for increased uncertainty, buyers of assets would rationally look to pay a discount. In theory, this makes sticking with an investment portfolio easier as market volatility increases. There are times to ramp up risk exposure and there are times to dial it back. Today, stock market sentiment by one measure is at a bullish extreme per the chart below (Figure 1) which could be a warning sign for near term returns.
Over a long time horizon by no means am I negative on the market. Fast forward a year or more into the future and I see higher valuations for both equities and gold prices, while I believe bond yields will likely remain low. Nevertheless, market complacency has me concerned over the short-term, which may increase the chances that investors mistakenly buy high and sell low. Constructing and sticking with a thoughtful asset allocation plan is more important now than ever.

Sincerely,

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