



Holland Macro Views

The Pendulum Swings

With stock markets and US presidential political ineptitude both at new all-time highs it seems right to take stock. Equity markets were first driven higher by the arbitrage of predictable cash flows and how deep they looked vs. bonds. More recently the new economy winners (FANGs) and ETFs have driven continued rises in levels and optimism. While we see value in some special situations and neglected sectors, we also note how relaxed many investors seem with the cult of equity investing again. As a result we wonder whether we shouldn't be thinking a little harder about how the three cycles we have previously identified might pan out: Political, Economic and Market cycles.

Many commentators/investors have worried about markets and their valuations for years. However from the likes of Buffett and Templeton we learnt that calling market levels is a mugs game. We have learnt to:

1. Pay more attention to sentiment than the state of the economy, and
2. Know what we are looking for
3. Fish where other people are not

These approaches we feel are more important than ever to use at more elevated market levels.

Sentiment not economic forecasting

A few years back we devoured Anthony Bolton's book. From a 'how to analyse a company in detail' it maybe told us little new. However, from the perspective of how to think about portfolio structuring and market and economic cycles we thought it a wonderful read. Ever since when thinking about economics and markets the following passage comes to mind:

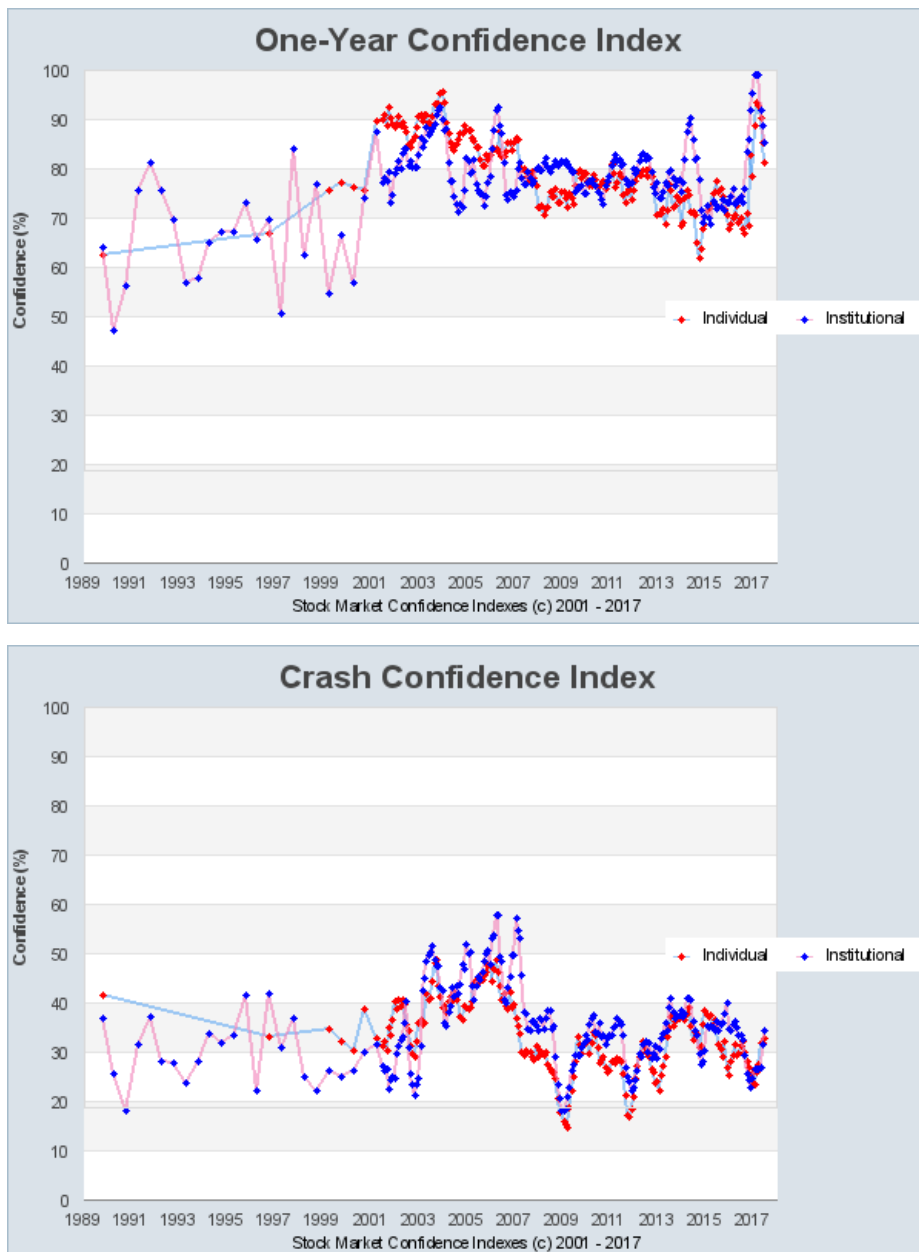
*"When evaluating the market outlook there are three things that I particularly focus on – and one that I don't consider. The one thing that I don't look at is the economic outlook, as this invariably looks great at tops and horrible at bottoms. In my experience, economic views won't help you time markets correctly. The three factors that I do look at are: the historical patterns of bull and bear markets, i.e., for how long and how far have we have fallen in a bear market, when the length of time and the quantum of the rise or fall are high relative to history the odds of change of trend increase significantly; I then look at indicators of investor sentiment and behaviour – indicators such as the put/call ratio, advisor sentiment, breadth, volatility, mutual fund cash positions and hedge fund gross and net exposure etc. When these indicate extreme optimism or pessimism it normally pays to bet against them." Anthony Bolton, *Investing Against the Tide*, 2009*

With that in the back of our mind we occasionally take a peek at an indicator we have found very useful at market extremes – 'The Shiller 'Market Confidence' and 'Crash Confidence' indices'.

Over large swathes of time these charts tell investors very little, but occasionally the sentiment expressed by those being surveyed stands out. We note that in the Crash Confidence survey the most extreme reading on it ever (i.e. the point at which most people thought there was a high likelihood of stock market crash) was in March 2009. In the years after that date many looked for reasons not to believe in equities focusing on economies and money printing etc. But the Shiller index rang the bell telling us that at that point just too much negative sentiment was already discounted.

Today these readings are interesting as the following charts show. They are maybe not as extreme as other peaks/troughs, but they do tell a picture of far greater confidence in the US market than has been expressed for some time.

Fig.1.The Shiller Market Confidence and Crash Confidence indices



Source: The Yale School of Management

Two other sources we look to as good market barometers are Howard Marks and Grant’s Interest Rate Observer. We have been avid readers of both for a maybe 17 years now. Whilst no commentator is ever always ‘right’ they both importantly ask the right questions and do so at

the right times. For those that do not either read Howard Marks' letters frequently or perhaps have missed his most recent letter – we recommend it most highly. The link to it is below¹.

Nine Bells a-ringing

We will not try to summarise this letter for it is extensive and wide ranging in its commentary of current market conditions and the risks they now carry – we agree with almost every word. Below are nine factors that Marks suggest are currently present in the credit and equity markets that would normally herald a boom or bubble – see Page 4 of the report for the commentary on each:

1. A benign environment
2. A grain of Truth
3. Early success
4. More money than ideas
5. Willing suspension of belief
6. Rejection of Valuation norms
7. The pursuit of the new
8. The virtuous circle
9. Fear of Missing out (of 'FOMO' as my wife calls it)


As we write this we are reading that Uber is to raise \$1bn at its past high valuation of c.\$70bn but each investor gets a chance to invest 10x as much at a lower (undisclosed) valuation. The whole process designed to say we are still worth X, even if we can't raise money at anywhere near that price...desperate stuff.

The pendulum swings

Howard Marks for the uninitiated is a credit investor with excellent pedigree of returns largely achieved by taking a cautious approach to absolute value and by only investing when a high margin of safety is offered. It is from Mr Marks that we first found this slide of market cycles below. It plays an important role in how we think about market cycles.

Fig.2. The Human Side of Investing

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Human Failings

- The swing of the pendulum
 - The three stages of a bull market:
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 - The three stages of a bear market:
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"What the wise man does in the beginning, the fool does in the end."

Source: Howard Marks-Oaktree Capital Management presentation

¹ <https://www.oaktreecapital.com/docs/default-source/memos/there-they-go-again-again.pdf>

Looking at it over the last five years told us to worry less than the bears feared as the pendulum had not to fully swing. Reflecting again today many people seem to now think ‘things will get better forever’. Thus the market cycle feels far more extended.

Seeking Grey Haired Guidance

Our second grey-haired touchstone is Jim Grant of Interest Rate Observer. Again we recommend the most recent Grant’s piece. It makes a couple of interest points:

That the combined Short Interest in Facebook, Amazon and Google, i.e. the fastest rising drivers of the stock markets new higher level equates to a mere 1% of their shares outstanding. This compares with a 4% short interest in the market as a whole. Simply put all it seems are believers now as to the continued success of these business models justifying ever high share ratings.

Do we respect and see these companies’ dominance? Yes. But we also know that investment markets have cycles – rarely straight lines of growth. Diageo’s business activities have changed very little over the last 20 years, so why was it offered at a 15x PE in 2011, 14x in 2006 and yet trades on 24x today? The answer is different market cycles of sentiment and the discounting of cashflows off of different interest rates. If interest rates stay low and growth low, then today’s premium may be correct, but this is far from guaranteed to be the case.

Cash attitudes

Jim Grant also made a great point about cash balances and how different types of investors have different attitudes to them today. He quoted the great book ‘Margin of Safety’ by Seth Klarman.

“Relative-performance-orientated investors will typically choose to be fully invested at all times since cash balances would like cause them to lag behind a rising market. Cash affords flexibility, for it can quickly be channelled into other investment outlets with minimal transaction costs.” – **Seth Klarman- Margin of Safety**

We simply could not agree more and feel that many clients when they reflect on the train on the way home away from their day job might be more than happy to have a decent sum of cash in their SIPP or ISA, while at the same time their fund is maybe 98% invested. Professionally almost all investors are today judged on a relative benchmarks, as result they are driven to lower cash levels post strong markets. Margin of safety investing suggests the opposite should occur.

Economic forecasting = Crystal ball gazing

The minute we or anyone else start opining on economic forecasts rather than focusing on company analysis we are, in truth, little more than fortune tellers, peering hard to see what the tea leaves tell us.

“Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.” – **Buffett**

As such it is maybe instructive to at least know what our palm reading pedigree looks like. For full disclosure, we attach a piece we wrote twelve months ago (*What would Ranieri (or Billy Beane) do?*). In it we asserted that for all our belief in the compounding power of franchise investing, its success had now run a long way, especially when compared to the underlying growth in the intrinsic value of the same companies.

We noted that companies like Unilever’s shares were up double the rate of their profits growth in the last 10 years. And that on such starting multiples of 23x as opposed to 13x a repeat of the last 10 years’ returns was just neither possible nor likely. Those that enjoy a good car crash will

be delighted to witness how wrong we were as Unilever has added a further 20% appreciation in the subsequent 12 months!

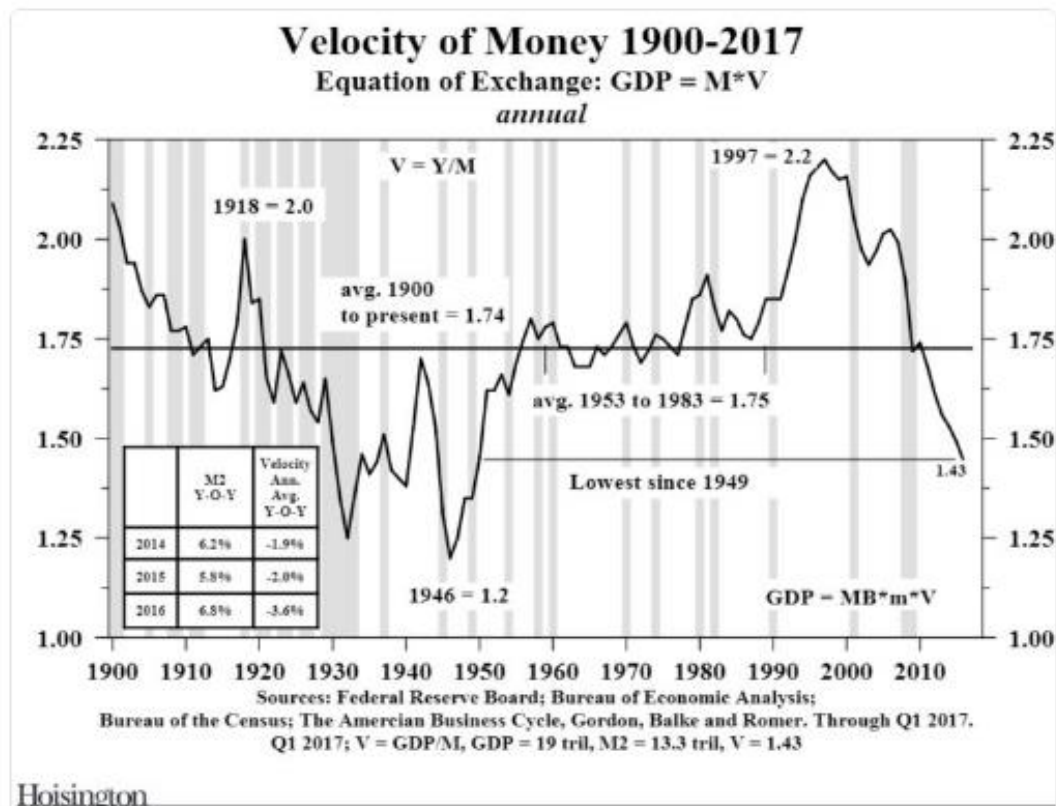
However, what we also observed in that price was that there was real value in some more obscure parts of the stock market. We highlighted hated sectors, troubled franchises and a few other deep value ideas. Pleasingly on this idea we were more ‘on point’ with a few of the special situations we highlight performing very nicely since.

Economic outlook/Velcoity of Money vs. Own Goals

We have been (and broadly remain) optimistic about prospects for Global and US growth due to what we still assess as a depressed current starting point. However, we admit to now being more fearful that Trump’s ego and his lack of understanding of the real economic drivers can get in the way of the necessary stimulus/policy actions that we hoped could drive faster growth rates.

Key to this belief was/is our view on the importance of animal spirits (or for the economics grads – velocity of money). We described our view of this in an earlier piece but in short we feel the combined situation of an already recovering US economy boosted by pro-business measures could result in a recovery of this all-important metric. Such a recovery would help to answer the oft repeated bearish economic commentary of “*how in the future can we grow faster than today if interest rates will be higher?*” Our answer to that is “*for many many decades we managed to do just that*”. All were terrified of very low interest rates – now all are terrified to lose them. A recovery in the velocity of money (aka Animal Spirits) would be powerful and far reaching in its implications – almost all of which will be positive. For now we concede that we see the chart the same as you do – i.e. no uplift yet.

Fig.3. The Velocity of Money



Source: Hoisington Management

At the time of Trump’s appointment, we were encouraged by the business orientation of his appointments and policies. Almost a year on, and with a danger that the right policies will not

get passed and business confidence in the administration falling – we must accept that our assessment was/is too optimistic.

The good news is the resilience against such inept leadership that the US economy is demonstrating (so far). During the credit crunch we wrote about whether capitalism would survive or whether the populists would demand a more socialist approach as ultra-free markets had proved their failings. We repeat a quote from a Detroit worker made redundant in 2010: *“the unions have destroyed this town”*.

At the time we found this amazing and felt it talked to the survival of American Capitalism. The amazing multi-decade growth story that is the US economy is seemingly built inside the DNA of almost all of its inhabitants: work hard, build businesses and wealth. This dynamism seems to be intact. We have no doubt that today great management of the economy with the right policies enacted soon would help the US move to faster growth via the creation of better animal spirits.

However, assuming current inept political leadership continues, one of two things might happen. Either we have a more of the same with the economy carrying on despite Trump and his team failings or we end up with a political stalemate with even business friendly Republicans refusing to pass bills so as to thwart a lame-duck of a president. Under this latter scenario maybe business and consumers worry and have less confidence or maybe they carry on regardless. We don't know.

A study of the Roman Empire and its comparison with the US is fascinating – although perhaps alarming. It shows that whenever there was trouble in Rome the troops were sent off to war. Their victorious homecoming rallying those at home to temporarily forget their local troubles. Such a route is, of course possible – maybe even made more likely the longer the domestic tit-for-tat of politics continues. We hope for progress on tax and regulatory reform and think they could have knock-on benefits, but we accept the risks inherent of a market discounting such an outcome that might not ultimately arrive.

What is an investor to do?

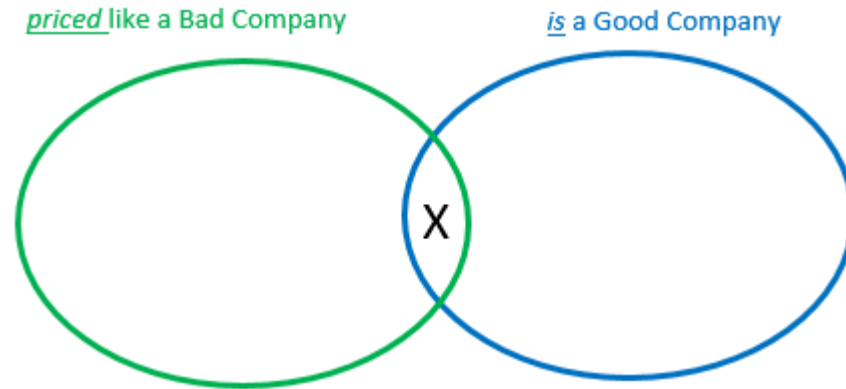
This all brings us to the thorny question of what is a developed market investor to do with their capital at a time when assets seem to offer little value and sentiment looks a little rosy. The answer we think depends a little on your remit.

At an asset allocation level (Property, Bonds, Equity) we see little opportunity and in some cases plenty of risk. We are also inclined to agree with Klarman that at a time like this the value of cash is vastly under-rated even if it makes a 0% return. Additionally, if needing to own say 40-50 US or UK mid/large cap stocks we would struggle to fill the second half of that list and the first half might have a number of obscure companies few readers would have heard of. That said, we do think there are pockets of value and they are similar to those that we presented last year.

What do we do all day?

Our approach has always been and remains absolute return and margin of safety focused. Ideally, we look for compounding machines but are most keen to buy them when others lose faith.

The following Venn diagram shows our approach visually.



Source: Holland Advisors

Today in the UK examples of 'X' might be **Sport Direct, Howdens, Lloyds, Next or Dominos Pizza**. All enjoy depressed valuations due to the headwinds they are seen to be facing.

Additionally, we enjoy deploying John Templeton approach as well as Munger's i.e. looking to invest when there is metaphorical blood in the streets, particularly if we sense we are closer to the bottom of the capital cycle. Having this string to our bow has been useful in the past year and we believe it should continue to be the case. As the quality, Franchise and ETF mandates all chase the predictability they seek they cast off large swathes of the stock-market as "uninvestable" seemingly almost at any price.

This approach took us profitably to Greece (**Eurobank** + one other) and for a long time has helped us see the value in the **US (and UK) banking sectors** that many others ignore. This sectors undervaluation, we think, remains compelling not least as it also brings a partial insurance policy if higher interest rates materialise. Other sectors we are interested in using this approach are Autos and now Shipping. When deep negativity is discounted, a small improvement in fortunes can change a market price quite considerably (see **Fiat** for details). **General Motors** (with a PE of 5x and very well rated new electric car) still intrigues us. We are also actively looking at some new ideas in these and related sectors.

Reflections on Margin of Safety

All the points above make us reflect that today's margin of safety for investment in many asset classes is poor. Even though we think we are being offered value in the niche opportunities we are finding we must accept than many come with a little uncertainty or a little more debt than we ideally like. For all of our effort to read the political and economic tea leaves we are minded to do as per Bolton's comments at the start of this piece: concentrate on the sentiment measures currently visible in markets. Looking at these as we have and with help from Howard Marks and Robert Shiller gives us a reason to be more prudent.

A few years ago, we wrote a few pieces that talked of three distinct cycles. These being the **Economic Cycle**, the **Political Cycle** and the **Market** (i.e. stock market) **Cycle**. We observed that whilst sometimes they can be interlinked often they move independently. We observe a consistency that has existed for as long as we can remember. That our news channels obsess about the political cycle, that many great business minds are obsessed with forecasting the economic cycle (usually with little accuracy). But the market cycle is often forgotten by investors and yet we think it is the most important one for them to understand. The greats (Buffett, Bolton, Marks, Templeton) understand this point very very clearly.

"Be fearful when other are greedy and greedy when other are fearful" – **Buffett**

We watch the news like you do and the daily political to's and fro's. We also try our hand at economic forecasting with about as much success as anyone else. But today it is the market cycle that we think is extended and offers us little in the way of Margin of Safety in our investments. A change in this cycle may just bring a rotation out of momentum areas and into the value we see in banks/other depressed areas. Arguably this would happen if growth and interest rates were higher and bonds lower. Alternatively, a wider correction in investor bullish sentiment could occur.

We conclude that the prudent thing to do is to perhaps raise the bar required for investments a notch or two. If as a result only a small number of ideas get over and the result is a larger cash pile – so be it. If enterprising investors looking under more stones can find enough uncorrelated value to deploy a greater amount of cash then good luck to them.

All we know is that the investment world has moved on a great deal since we wrote ‘*Holland Views - ‘Met any bulls lately? – October 2011’*. At that time we concluded many were finding reasons to be fearful (Martin Wolf was saying the only option was helicopter money drops!). As Marks’ brilliant market cycle slide shows we think that pendulum has swung quite some way in the other direction now.

Fig.4. The Human Side of Investing

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“What the wise man does in the beginning, the fool does in the end.” ¹²

Source: Howard Marks-Oaktree Capital Management presentation

Please do read Howard Marks letter via this link. (It is far better and more widespread that our piece you have just read – we recommend it very highly):

<https://www.oaktreecapital.com/docs/default-source/memos/there-they-go-again-again.pdf>

Andrew & Mark

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