What is the market saying?

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Yesterday, a journalist asked me to interpret recent market action for his readers. His remit: give me a few quotes, and tell me what it means in the short term. As instructed, I proceeded to give him a few of the former; but admitted that I could not help with the latter. I'm not sure what the article will say, and given its focus on the short term, I'm not sure it matters. It did, however, cause me to reflect on the recent bullish market action. Here are my thoughts:

Right now, the market is looking through the economic wreckage caused by governments’ reaction to the virus. The market is saying - we are getting back to normal a lot quicker than consensus believes. It's saying Covid-19 is not much worse than the seasonal flu, and human beings, being the smart social animals they are, will look through the mass hysteria and quickly revert back to normal behavior. Whether we believe this to be true or not is not relevant. This is what the rising market seems to be saying.

Our response to this is relevant, however.

If the market is right, and the reality is that this virus is not much worse than the flu, much of the resulting positive outcomes are now already in the price. Why? Equity indices globally are now at or above their levels of last year. It's as if the last 3 months never happened. Last year, markets were seen as being fairly fully priced, with limited upside potential. Ratings were high, on earnings which were elevated after a period of economic expansion that had lasted for almost a decade.

If the expectation around upside was limited then, it should probably be even more muted right now - as lock downs of varying intensity have undoubtedly caused some economic damage in the short term - even if we get back to normal in 3 months’ time.

The alternative is that the market is wrong, and that the response to the virus has caused permanent economic damage. In this case, there is substantial downside in markets. If markets were fully priced at the end of 2019, and earnings are now going to be substantially worse than expected, should we not reasonably expect a substantial negative adjustment?

But before we panic, it's good to remember that markets represent the collective wisdom, and are therefore not often wrong.
As always, the truth probably lies somewhere in the middle - somewhere in between a truly disastrous outcome and something that’s just a bit disappointing. So despite the present ebullient mood of the market, the environment calls for caution, and at least a modicum of defensiveness.

Having said that, being too cautious is probably also not right. There are still opportunities. Where to look for them? Many are saying that changing behavioural patterns are the place to look. More Zoom, less office space.

Such analysis strikes one as being simplistic and premature at this stage. It’s too early for firm conclusions. If there are new behavioral patterns that will emerge, they will take a lot more time to develop and become ingrained. I am sure there will be some changes, but they will only really be identifiable after the fact. And some of them will be quite surprising. Remember 9/11? It changed some behavior - mostly in terms of security at airports - but within a year, more people were flying than ever before. And taller buildings were being planned and built.

Humans are social animals, and do not take kindly to isolation and distancing.

There are two changes that have taken place, and that should be recognised in any sensible, forward-looking investment strategy:
- Trust in governments and other authorities has declined markedly since the onset of the coronavirus.
- The various lockdown regulations globally have caused severe economic stress. In recognition of this, governments have implemented unprecedented levels of monetary and fiscal stimulus. MMT (Modern Monetary Theory), regarded as outlandish a few months ago, have now become mainstream policy, by stealth.

Broadly speaking, low trust environments equate to low multiple environments. High levels of valuation are unlikely to be sustained.

As for the stimulus measures that have been put in place - there is a famous saying that goes "Don't fight the Fed". Not fighting the Fed means going with the flow, going with momentum.

Portfolios should recognise these changes, and implement appropriate strategies. However, on the face of it, the effects of these changes call for opposing strategies. One argues for low exposure to market risk; the other for high. How does one square the circle?

Sensible positioning could be a combination of higher than average cash holdings (to counter valuation risk) and broad exposure to undervalued assets - emerging market stocks and currencies, small cap stocks, value situations – to take advantage of global stimulus measures. In the short term at least, it looks like these are the assets that are starting to pick up the market leadership baton.

And remember to make some room for the one asset that is no-one else's liability - the less you trust your counterparties, the more valuable such an asset becomes. Yes, this means some exposure to gold is warranted.

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