Source: http://www.zoptiontrader.com/trading-options-cash/

October 2019

Seasonal Reflections

Financial markets in the grip of

TINA [There Is No Alternative]
&
FOMO [Fear Of Missing Out]

https://app.hedgeye.com/insights/77636-cartoon-of-the-day-stampede?type=cartoons

Quote(s) of the Month:

"Family offices, the advisers that invest the wealth of the super-rich, are preparing for a downturn in financial markets as concerns mount of a looming recession." (Source: Financial Times, see: https://on.ft.com/2kM3Ot7)

"A growing number of investors are paying for the privilege of parting with their money. Even at the height of the Great Financial Crisis, this would have been unthinkable. There is something vaguely troubling when the unthinkable becomes routine." (Claudio Borio, Head of monetary and economic department at BIS, as quoted in Almost Daily Grants, issue 9/24: Banks for nothing, see: https://www.grantspub.com/resources/commentary.cfm)

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Dear Reader,

We have entered the often-tumultuous autumn season in global financial markets, and the world outside my office window looks appropriately cool, cloudy and grey at the time of writing this.

However, when looking at global equity and risk asset markets one cannot help but being puzzled by the obvious summer high they are still enjoying. – In my humble opinion it appears that investors have finally completely detached from the real world and the fundamental news flow it has been delivering over the past couple of weeks. But I guess it is only me…

FTSE Global 100 (USD), Source: www.investing.com

Or maybe not. Amid financial markets firmly in the grips of **TINA** (There Is No Alternative – for taking equity and risk asset exposure, that is) and **FOMO** (Fear Of Missing Out – on even more stellar gains, of course), it seems that family offices are batten down the hatches. That at least is what the first Quote of the Month above suggests. This news comes courtesy of UBS and Campden Wealth, who in a survey of 360 family offices found 55% expect a global recession before the end of 2020.
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We at Incrementum are no family office. And yet we also regard ourselves responsible and prudent stewards of our investors' hard-earned capital. And thus as manager of the **Incrementum All Seasons Fund (IASF),** with its absolute return driven approach that aims to expand the purchasing power of invested assets across the market cycle, I am extremely mindful (in line with Investment Lesson No. 1; for more details please refer to the appendix section) of the economic cycle and its influence on the financial market cycle. And as co-investor in the fund (following Investment Lesson No. 7), I realize that there are times when it is preferrable to sell early and risk foregoing gains than playing for the fences.

The same FT article also states that *"Family offices have been navigating volatile markets and this is reflected in disappointing returns across most asset classes."* - This is also a quote that resonates, because although I am satisfied with IASF performance under my guidance so far, my cautious attitude over the past few years has had investors' miss out on opportunities. But as all investment decisions are made under (varying degrees of) uncertainty, one must not be guided by the obviousness of hindsight as far as a manager's performance is concerned. I firmly believe that the uniqueness of the times we live in justifies rather more caution than less, even if this led to smaller rewards over the past couple of years.

In my humble opinion, investors – as was typical in any bull market I have lived through in my 30+ years of investing experience – always follow the trend. And the longer it lasts, the more recency bias they suffer, resulting in the headline gracing symptom of FOMO. Therefore, brace yourself, as what I am about to say many readers may find preposterous or even ridiculous.

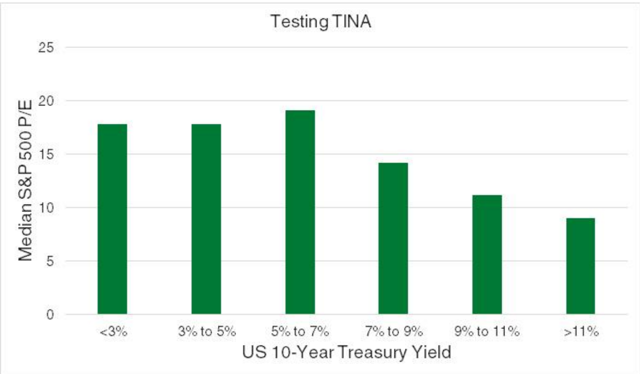
MSCI All Countries World Index (USD); Source: Reuters

I recall the hype during the tech bubble at the turn of the century, when few investors foresaw a >50% decline in the MSCI AC World Index. – And yet it happened. Likewise, there were even fewer who expected the market to fall from the heights of the pre-GFC bubble in 2007 (which was 22% above the tech-bubble peak), all the way back to the 2003 bear-market lows, marking a 60% decline. – And yet it happened again! – Why should a similar sized correction now be impossible or even improbable?

The point I am trying to make is that personally I would not at all be surprised if we experienced a stock market correction that was in the same vicinity of the previous two (anywhere from 50% to 60%). The general argument against this is usually that there are so many investors who have to earn a yield (and thus TINA rules), which is why the family office study shows that *"Alternative investments, such as private equity, hedge funds and real estate, already account for about 40 per cent of the average family office portfolio, a significantly higher share than among public pension funds."*

This is of course hardly unique for this stage of the cycle. As mentioned above, the willingness among (even experienced) investors to assume risk tends to rise disproportionate to the length of the bull market cycle. Similarly, readers who have gone through the last one (or two) full cycles may remember how hard it is to buy near the bottom of the cycle and how conservative one's risk appetite can become.

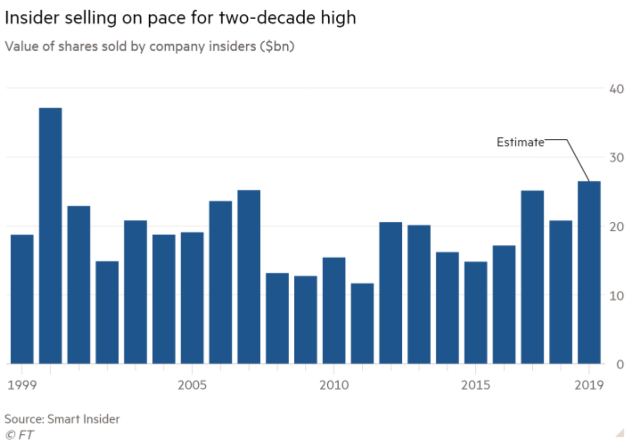
The other argument usually made is that low / zero / negative interest rates justify higher valuations of equities and other risk assets, as the discounting factor for future cashflows is lower (and thus mathematically net present values higher). However, if one agrees that in the long-term corporate profit growth is a function of real economic plus productivity growth, and low interest rates are the result of below average economic growth, this also means that lower profit growth is in the cards, which does hardly justify higher valuations.



Source: https://www.manning-napier.com/insights/blogs/markets-and-economy/there-is-no-alternative

An empirical test validates this argument at least partially, as can be seen in the chart. Comparing 10-year US Treasury yield levels with then prevailing median S&P500 PE ratios shows that equity valuations were the lowest when interest rates were in double-digit territory, and with their decline have been rising. But *"The historical evidence suggests that falling interest rates cease to boost stock valuations once rates fall below approximately 5%. The relationship starts to flip, and lower rates become associated with incrementally cheaper stocks."*

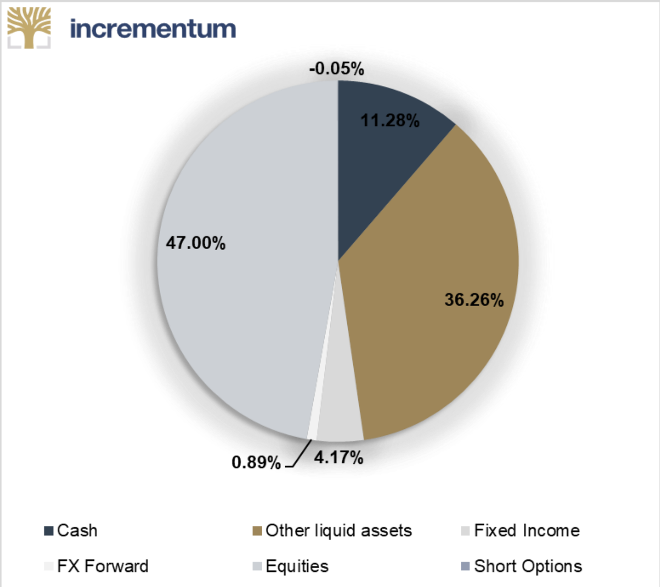
These arguments of course leave out the cyclical element of both the economic and corporate profit development, which has equity and credit markets in tow and commonly fluctuating violently as less rosy scenarios are priced in. This seems not lost on (US) corporate insiders, who through mid-September have sold an annualized USD 26bn of stock, which if realized would mark the most active year since the tech-bubble peak of 2000. I guess these guys can hardly believe their luck… (Chart source: https://www.ft.com/content/d95e12a6-dbed-11e9-8f9b-77216ebe1f17)



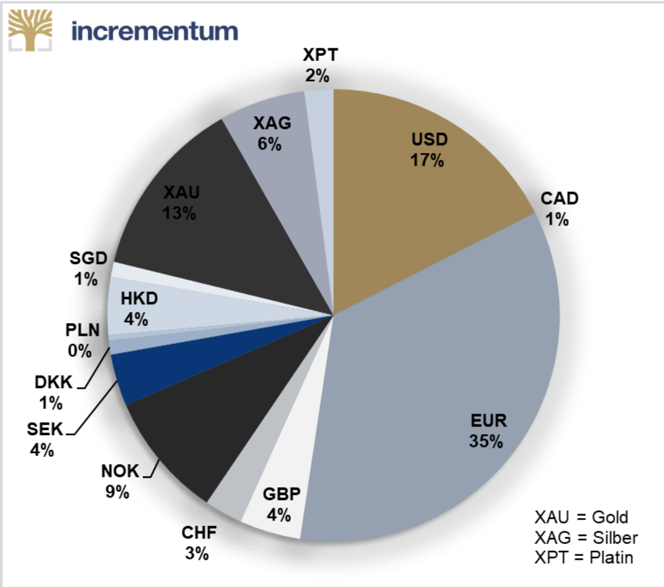
IASF – September Review and Comments

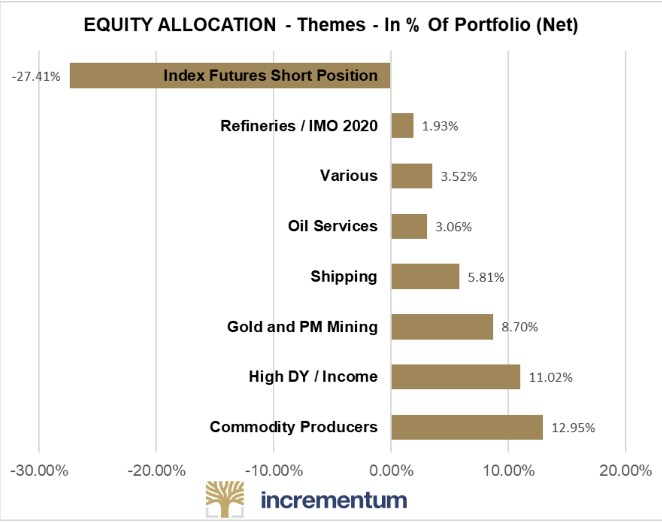
Slowdown or nearing recession signs have been plentiful in recent months, and I will not bore you with details. But as usual I would like to use this section to put **IASF** activities in September into context:

Asset Allocation



Currency Allocation



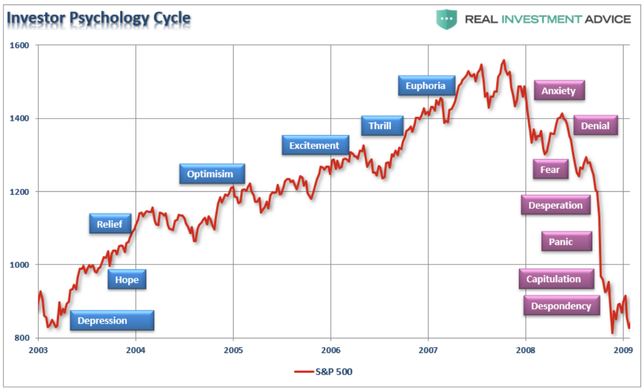


Despite rising markets in September, **IASF**'s gross equity allocation was cut by 4.1% amid profit-taking. Bigger changes were also made on the FX side, where we increased the USD hedge at below 1.10. The remaining USD exposure is 17% (from 24%), which however consists mainly of commodity and other USD based businesses like shipping and refineries, often listed in other currencies (e.g. CAD, EUR, JPY, etc). If the USD weakens their share prices should do well and likely overcompensating any FX related weakness. Meanwhile, **IASF**'s precious metals exposure (physically backed ETCs and miners) now amounts to 21%.

Another notable change compared to last month is the fact that **IASF** has become more defensive in its positioning, as it increased its S&P500 short futures position by another 50%, raising its equity short exposure to 27%, and thus further reducing net long exposure to 19%. This is further protected by long-dated (Jan2020) S&P-Put options, which amount to another 7.5% underlying exposure, leaving net equity exposure at around 12%. I regard this as entirely appropriate in light of the seasonally weak late 3rd / early 4th quarter period we have entered, and of course plentiful worrying fundamental news.

In Closing

Let me finish with two more pictures that perhaps do speak louder than a thousand words…



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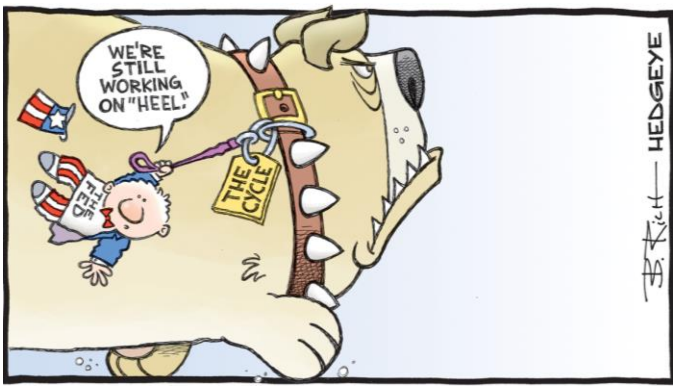

https://app.hedgeye.com/insights/77053-cartoon-of-the-day-beware-of-dog?type=cartoons

The investor psychology cycle chart – though typified – should act as a reminder to readers / investors that equity markets tend to go up the stairs but down by elevator. And the latter is typically a painful process, where few manage to get off on time. And the other is yet another excellent Hedgeye cartoon, serving as yet another reminder that the Fed (and other central banks) have regularly failed to arrest both the downward economic and related financial assets price cycle, and I personally have zero hope that it will be different this time.

This is why I personally (and we as a firm) continue to remain bullish on gold and its precious metals peers. How the general mood towards gold is shifting can best be exemplified by legendary emerging market investor Mark Mobius, who urged investors in an August 19 Bloomberg interview to buy gold at any level, and specifically physical gold, promoting a 10% allocation as appropriate. (Source: https://www.youtube.com/watch?v=DgLGIqhpwsA) – When that idea goes mainstream, IASF investors will sit rather pretty. Family offices are apparently catching up already: *"The appeal of gold has also risen with a net 12 per cent expecting to increase their allocation to the precious metal next year."* (Source: above quoted FT article, see: https://on.ft.com/2kM3Ot7)

That is hardly surprising amid around USD 15tr in negative yielding bonds around the world. In this respect I can only whole-heartedly agree with Claudio Borio in the other opening quote that *there is something vaguely troubling when the unthinkable becomes routine*. – Amen!

Greetings from Schaan, Liechtenstein!

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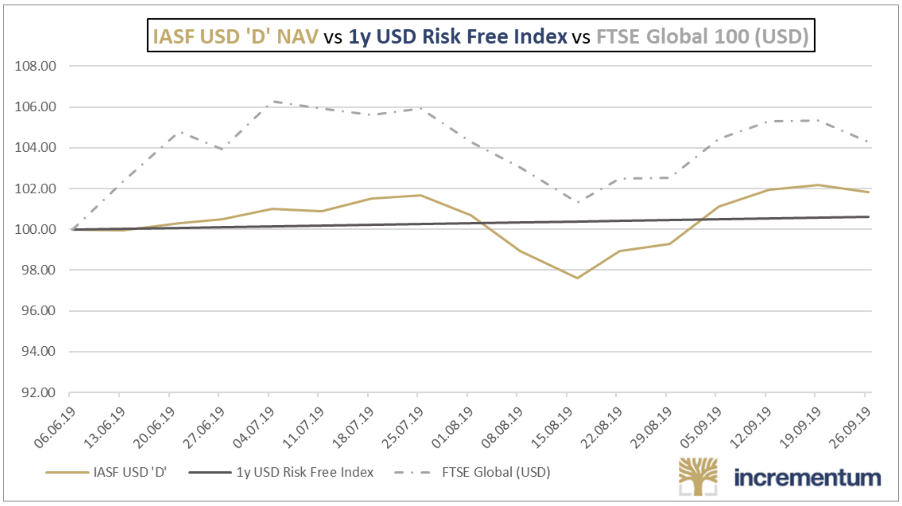
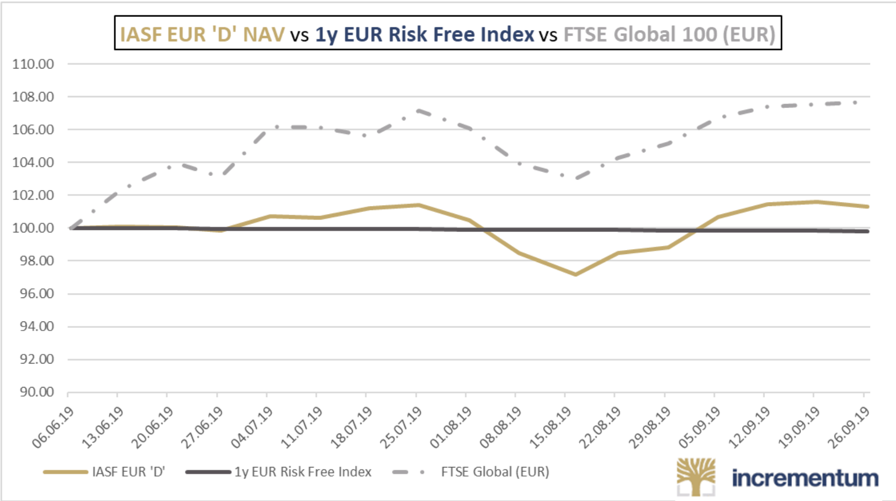
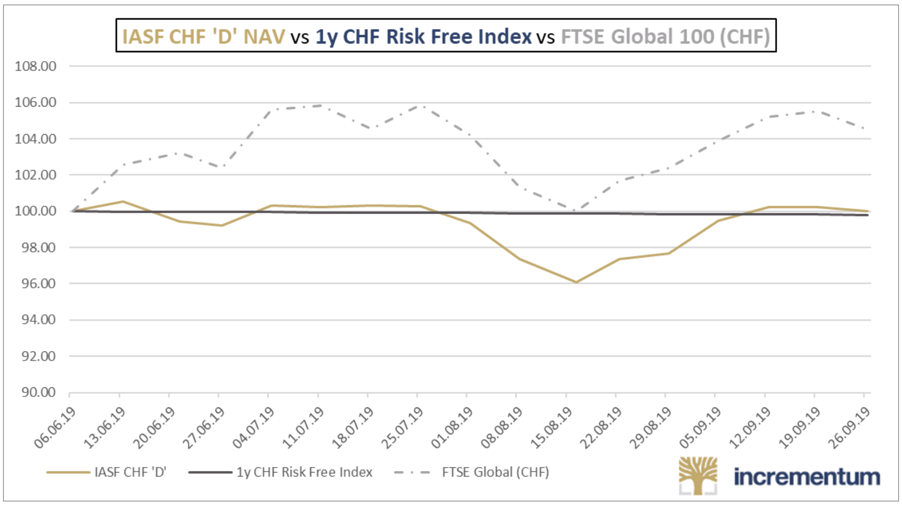
Appendix *







* Graphs display NAV of IASF 'D' shares as of last valuation date (**26Sep2019**), compared to the respective risk-free 1y-government yield as well as the FTSE Global 100 Index in respective currency as a proxy for overall equity market performance, from the start of the investment period (6Jun2019) on an indexed basis.

IASF PM Shaped By 8 Investment Lessons

1. Capital markets, like the economy, are inherently cyclical in nature, and you must always know where you are in the cycle, while not hesitating to "Be fearful when others are greedy and greedy when others are fearful." (Quote: Warren Buffett)
2. Prices paid determine future returns, i.e. the higher valuations are, the lower future return expectations must be (and vice versa), which is the essence of value investing.
3. Capital preservation is the conditio sine qua non, and a consistent and long-term investment strategy is more important than short-term momentum chasing.
4. As a result you must always know when you trade, or when you invest.
5. The most basic and effective risk management tools are proper diversification and the ability to hold cash.
6. Hard assets are preferable to intangibles, distributions to accruals.
7. Look for the incentives: True alignment of interest works in investors' favor.
8. There is no magic formula for successful investing: Consider both macro- and micro-economic issues, be diligent, flexible, patient, keep an open mind, and realize that investing will always remain more of an art rather than a science.

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