ATLAS
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Does it still pay to an optimist and a risk taker?

1. Is the bull market supercycle for stocks and bonds ending?

Bill Gross was called the 'Bond King', and for good reason. After all he was the billionaire co-founder of Pacific Investment Management Co. (Pimco), running it for 4 decades with some of the best long-term investing track records, and was the face of the bond market with television appearances almost every day. His bonus alone in 2013 was a staggering $290m.

Yet even he was wary of calling himself a great investor. He would not label Warren Buffet or George Soros kings either, saying that all of them presided over a bull market supercycle for stocks and bonds. He said, "since the early 1970s when the dollar was released from gold and credit began its incredible...total return journey to the present day, an investor that took marginal risk, levered it wisely and was conveniently sheltered from periodic bouts of deleveraging or asset withdrawals could…(be) rewarded…*Perhaps, however, it was the epoch that made the man as opposed to the man that made the epoch.*"

Since 2013 however, he has warned repeatedly that the bull market supercycle for stocks and bonds is approaching an end, and his focus has been trying to see when the tide will be turning, where the tipping point is, and have called the market top many times. In fact, besides Gross, not a day has passed by without some analyst joining the chorus of voices in sounding the death knell for the bull market. For example, I am getting increasingly inured to such headlines: "How the pieces are falling into place for another global financial crisis".

Gross and many other prominent investors have not been able to call the market top for the past many years. I think the issue here is that unlike physics, where we can observe events without affecting the outcome, the mere act of observing the financial markets would affect the outcome. I think Gross and other analysts are right in saying maybe a train wreck is happening in slow motion or that the bull cycle will simply end with a whimper—that is, if things are 'allowed to run its course.' But things never run their course without intervention.

A super intervention happened in 1971, that heralded the start of the bull market supercycle that Gross spoke of. President Nixon announced to the world that the United States would no longer officially trade dollars for gold, in a move known as the Nixon Shock. Before that the world used to be on a type of gold standard known as the Bretton Woods Agreement. With the untethering of the dollar from gold, we moved to a world of fiat money, where money is not backed by a physical commodity. I believe there were probably mixed reactions then and the move was pronounced a 'shock'. Even today academics have called on the major economies to go back to the gold standard. Nevertheless, rightly or wrongly, fast forward 40 years later, the truth is that we see many happy people holding assets (property, stocks, bonds, etc) that have risen multiple-folds. Some have said we have been "*enjoying* a new era of human history".

At that time, unemployment had risen to 6%, and Nixon said he was "not about to be a hero" on inflation at the expense of unemployment. He believed that easy monetary policy could reduce unemployment in the short run and knew that presidents have a hard time getting re-elected when unemployment is high. Nixon said, "I've never seen anybody beaten on inflation in the United States. I've seen many people beaten on unemployment." When Nixon took office, unemployment was only 3.4%, but after the recession in 1969–1970, unemployment rose to 6%. It became clear what he planned to do: he would print money if that meant jobs.

Back to our timeline, four decades later. The S&P 500 sits at an all time high. Is it all gloom and doom now — will the market crash? Does it still pay to an optimist and a risk taker "as opposed to a more conservative Scrooge McDuck"?

Gross pointed out that epochs (as he called this current bull market supercycle) 'can and likely will outlast' even the legendary investors. In other words, it is not impossible for a supercycle to last beyond a lifetime.

Chart 1 shows the S&P 500 from 1930 onwards. Actually if we just look at the chart casually, from 1955 onwards it would appear we would have spent a lot of time sitting at all time highs! This is simply because the stock market has been on an upward trend over the long term.

LGT Research thinks that S&P 500 is now emerging from the narrowest two-year sideways pattern since mid-1990s. They have this to say:

"Despite the occasional volatility outbursts, the S&P 500 has been trading within an exceptionally narrow range in historical terms over the past two years. Such a prolonged sideways pattern last occurred in the two years through December 1994 — which was also during which US monetary policy was shifting from easing to tightening. The Fed had begun to raise rates in March 1994, after cutting them by 675 basis points between 1989 and 1992. Once investors realized that the tightening would not hurt the economy and earnings, equity prices soared, and we had the great dot-com boom."

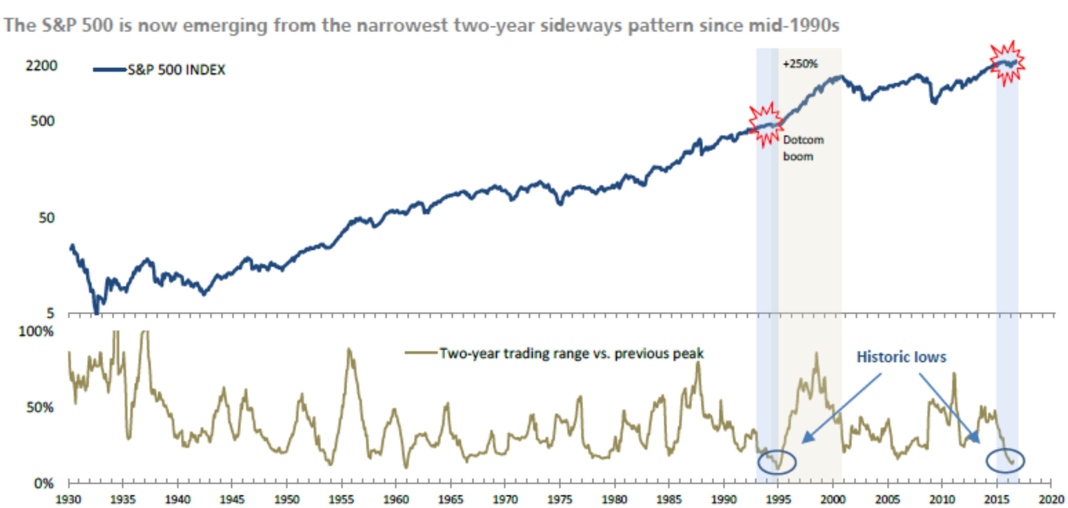

Chart 1: The S&P 500 from 1930 onwards. Source: LGT Research

Not only that, while the S&P 500 has tripled since the lows made in March 2009, investors have thus far refused to participate in the rally. See Chart 2, where the USD value traded appeared to remained mired at the post-crisis levels. Therefore the current bull market has sometimes been labeled as the most unloved in decades, and that should provide support for prices.

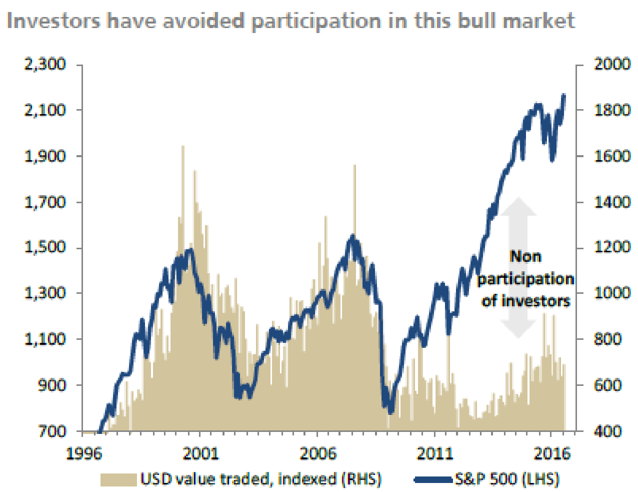

Chart 2: The S&P 500 (left axis) has tripled in value since March 2009, but the valued traded (right axis) has not really recovered since the crisis. Source: LGT Research

The Bank of America Merrill Lynch monthly fund manager survey corroborates with this phenomenon, which shows that cash levels in the June 2016 reading the highest since November 2001.

Therefore, I think there is reason for optimism. I think it is not unreasonable for the bull market to extend further.

2. Meanwhile, in the short run, what would August bring?

It was in August 1971 that Nixon sprung the shocking news. Is August going to be a volatile month? Things always seem to happen in August: The Russian financial crisis of 1998 happened in August—the S&P 500 plunged 14.4% for the month. S&P downgraded U.S. credit rating in August 2011, sending the index down 5.4% for the month. Of course, we would not forget that the S&P 500 fell 6.0% in August last year as China stock market was routed. Curiously, most the big gains (e.g. more than 5%) in August since 1971 were chalked up in the 1980s.

Based on historical data, we do appear to be entering one of the more volatile months of the year. Chart 3 is a box plot that examine the monthly gross returns (i.e. include dividends) of the S&P 500 from September 1971 to June 2016. The rectangle represents the 25th and 75th percentiles of the distribution of returns, while the line inside the rectangle represents the 50th percentile (or the median). The whiskers represent the outer ends* of the distributions and the dots represent 'outlier' returns.

August has the second widest interquartile range of 6.5% (from -3.1% to +3.3%), just behind January (6.8%). The median return for August is +0.8%. This is the same if we look at the range of the whiskers, with August having a range of 21.18% (from –9.0% to +12.1%), taking second place after January (-8.4% to +13.5%).

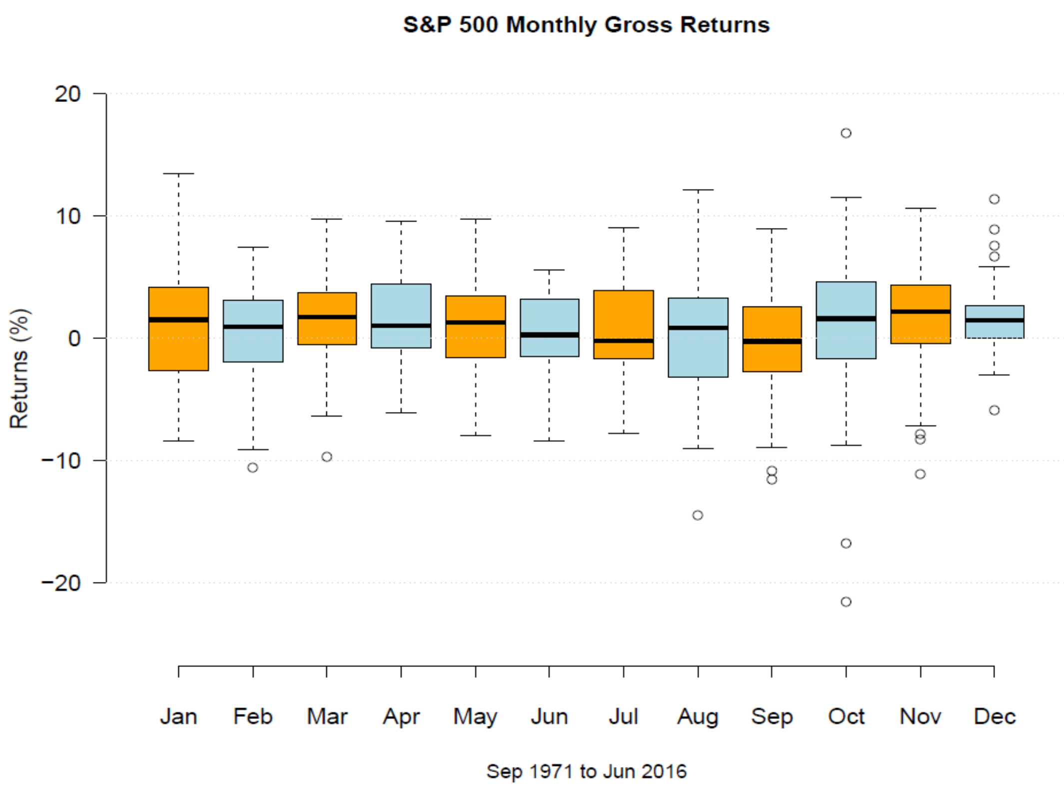

Chart 3: Box plot of monthly gross returns of the S&P 500 from Sep 1971 to Jun 2016

Data Sources:
- Bloomberg
- LGT Beacon 07202016
- PIMCO Investment Outlook April 2013

* Technically speaking, the whiskers extend to data points that are less than 1.5 x IQR away from 1st/3rdquartile. The IQR is the interquartile range, which is the difference between the 1st and 3rd quartile.

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