Taking Stock

“Thank you sir, may I have another?”

Martin Conlon, Head of Australian Equities

Forecasting is a tough game. Trying to assimilate seemingly endless data points into a coherent view of the future (at a company, industry and country level) is far more challenging than it seems. As far as our efforts are concerned, the past year or so has been our most frustrating ever. Delineating why things have gone so awry is challenging. We are trying.

Philip Tetlock, in his book ‘Superforecasting’, which chronicles a multi-year experiment aimed at determining whether superior levels of skill are achievable in forecasting, provides some fascinating insights into the thought processes and methods adopted by ‘superforecasters’; those that consistently beat the crowd. Some are fairly obvious. They tend to be methodical, analytical and collect information from a variety of sources. They are unlikely to be relying on emotive predictions from CNBC presenters. In examining things from every angle, they invariably start by trying to establish rough probability of an outcome, the ‘base rate’. For example, if we are trying to forecast the likelihood of Australia’s Prime Minister changing in the next 2 years, we might establish rough probabilities by looking at how many changes there have been over the last 100 years. If the answer was 25 and the average Prime Minister lasted 4 years, this would give us a ‘base rate’ of a 50% chance of change in the next 2 years. Tetlock labels this the ‘outside view’. Superforecasters then seek to refine this view by approaching things from other angles; looking for information which might assist in refining this view to a greater degree of accuracy. For example: How recently has the PM changed? How long till the next election? What are the polls saying about the incumbent? These factors, aiming to improve the accuracy of the base rate, are known as the ‘inside view’. Assessing a broad range of sources, ensuring disparity of views, avoiding ‘group think’, ensuring objectivity of data and a host of other factors are important in improving forecast accuracy. This type of framework and discipline should be intuitively appealing for those of us seeking to improve our own efforts.

The ‘outside view’ in stock market terms is complex. Interest rates, economic growth, human behaviour, liquidity (the amount of money actually inducing price changes), valuation levels and a myriad of other variables, play a part. In looking at most of these drivers from a longer term perspective, one thing is obvious. Almost all are at extremes when considered in a long term context. Interest rates have never been lower, economic growth is moribund nearly everywhere, asset prices are high, debt levels are extremely high and market liquidity has generally been deteriorating. Absent any other information, this would suggest it unwise to assign an unusually high probability to the extension of these extremes. However, with markets totally in the thrall of central bankers, this is exactly the current situation. Referring to an amazingly narrow and inaccurate set of variables (inflation, growth) and consisting of participants almost certainly likely to be suffering from ‘group think’ (similarly theoretical and academically inclined backgrounds), central bankers and interest rates remain the only game in town for investors. Every incremental sign of economic weakness incites a chorus of demand for further monetary stimulation. Witness the farcical response to major bank interest rate increases during the month. After APRA raised concerns on deteriorating lending standards, forcing banks to raise additional equity to mitigate risk in the system, banks decided that shareholders should be fully insulated against this cost and increased mortgage rates to borrowers. Raising price is usually an easier solution than improving efficiency and one that investors usually embrace. A raft of commentators immediately call for the RBA to cut interest rates such that the cost of maintaining high teen return on equity levels for shareholders is shouldered by depositors. What happened to improving lending standards? Price moves in banks, Westpac (+6.2%), CBA (+5.5%), ANZ (+0.5%) and NAB (+0.6%), suggest investors remain comfortable the RBA and APRA will remain close allies.
The extremes evident in the variables referred to above are substantially an outcome of delivering the same response to the same data but expecting a different outcome. In simplistic terms, the real economy has gone nowhere whilst global balance sheets grow ever larger. We have a far more voluminous pool of assets matched by a far more voluminous pool of liabilities balanced on an ever smaller interest rate. Given the real economy must support this balance sheet (and isn’t growing), ever lower interest rates are the only way it avoids implosion. A return to normality in this era of extremes is impossible without a change in the relative size of the financial versus real economy. Either the real economy must grow massively without financial asset prices moving in tandem or balance sheets must shrink to again match the real economy. The inter-relationships are all too often ignored when forecasts are made without understanding the ‘outside view’. I don’t want to be the harbinger of bad news, but growth in superannuation assets is necessarily tied to investment in the real economy to drive revenues. Growth rates cannot perpetually diverge and on the current path the number will not be a high single digit!

Developing the ‘outside view’ on industries within the economy raises further cause for concern. Political ineptitude in driving efficiency in sectors not subject to traditional market based competition (healthcare, infrastructure, utilities), those with artificial regulatory support (financials) or those funded directly by government, ensures that profits and returns must be driven down in the remainder of the economy. As these sectors grow in size relative to the economy, the ‘tax’ on other sectors for inefficiency and waste in the system will quickly become unsustainable. A cursory examination of reported returns on equity across sectors highlights the divergence. Whilst healthcare, financials and most defensive industrial sectors remain buoyant, resources, energy, retailers and most cyclical industrials are both far lower and under greater pressure. As is the case for interest rates and debt levels, valuations around book value for resource and energy companies and more than triple this level for defensive industrial counterparts indicate the extent to which investors are prepared to capitalise this trend and its exacerbation. The differentials are wider than almost any period we can find in the past four decades. Focusing on traditional measures such as price earnings ratios, rather than more durable measures of implied returns such as price to book ratios can be highly misleading in this environment. In terms of weight within stock market indices, almost every perceived interest rate sensitive sector (financials, healthcare, utilities) is at or near highs, whilst cyclical sectors (resources, energy, retail, industrials) are near lows (see below chart). We’re almost positive most have not thought through the consequences.
This landscape of outsized moves in balance sheets (value of investments) versus incomes goes some way to rationalising price moves which anecdotally, seem to us absurd. Declining liquidity is allowing ever smaller amounts of money to drive price changes. Ever more of this money is hostage to data driven processes (doubtless supported by intensive back-testing) which dictate that every piece of good news should be bought and every piece of bad news sold. Even fundamental investment processes reflexively respond to this environment by placing ever more weight on incremental news. Believe us when we say that it doesn’t get any easier to sell Transurban (+5.0%) to buy some more Alumina (-3.6%) when one chart looks like a five year stairway to heaven whilst the other is a touch more satanic. It brings to mind the image of the Omega fraternity house initiation in John Belushi’s ‘Animal House’: “Thank you sir, may I have another?” Examples are plentiful. This month, Domino’s Pizza (+16.2%) announcing an acquisition of 90 new stores in France for $50m saw the addition of $500m in additional equity value over the next couple of days. For Blackmores (+14.9%), a sales improvement of $16m over the previous quarter driven by Chinese purchase of vitamins for resale in China drove the stock more than $400m higher for the month (after gains of more than $2bn in the past year). At the other end of the spectrum, Santos (+46.7%) saw a month of sharp rebound after extinguishing some $6bn in market capitalisation over the past year. Over-reaction seems rife.

**Outlook**

Aided and abetted by an interest rate environment which encourages rampant speculation over organic investment, the landscape continues to degenerate into a correlated global trade on interest rates. Successful investment strategies continue to necessitate the purchase of stocks that look like bonds or those using cheap money to fuel acquisition driven growth using all-time low interest rates at a time of elevated asset prices. If I see another commentary on when the Fed will move from making money virtually free to marginally more than virtually free, I think I’ll puke. A perspective which encompasses more than the narrowest views on inflation, employment and growth, and a dogmatic belief in the power of interest rates to cure all ills, leads to decidedly different conclusions. Merger and acquisition activity, now at 2007 levels, continues to escalate as cheap debt encourages the exchange of the same assets at ever higher prices, elevating balance sheet instability. Households continue on the same path in real estate markets. The insidious reflexive behaviour which sees any threat to already parlous global balance sheets met with an implicit guarantee to use ‘whatever it takes’ to propel them higher again, continues to escalate this environment of extremes and elevate risk.

The ‘outside view’ leaves us according a very low probability to the maintenance of these extremes in the longer term. De-leveraging cannot occur without policies that address current imbalances rather than exacerbating them. Unfortunately, the ‘inside view’ leaves limited cause for optimism, as signs of central bankers broadening their view and taking a walk in the real world are sparse. Our predilection for common-sense and the stark lack of evidence supporting the sustainability of these economic and industry extremes leave us unwilling to pick up pennies in front of steamrollers. In the short-term this involves the proverbial Omega fraternity spanking and being prepared to respond, “Thank you sir, may I have another?”

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