The Investment Zeitgeist

Zeitgeist – noun [s] – the general set of ideas, beliefs, feelings etc. that is typical of a particular period in history.

Cambridge English Dictionary

The Investment Zeitgeist – Every decade, there is a "theme" that captures the zeitgeist and turns into an investment mania. It was gold in the 1970s, Japan in the 1980s, Nasdaq in the 1990s, and China & Commodities in the 2000s.

Stray-refelctions.com 13th February 2020

Introduction

In recent years I have become obsessed with the concept of the "Investment Zeitgeist" after studying different "Manias, Panics, and Crashes"[1]. The idea of the repeating cycle that ends in disaster before a new prosperous period is ushered in is fascinating, as is the role that human nature plays in making sure that history continues to rhyme.

The cause of a certain market or asset class rising can be varied as we outlined in our recent Investment Committee Notes, but the result is that investor interest is piqued and momentum builds in a self-reinforcing cycle making the investment rise to sometimes almost unbelievable levels.

Understanding where we are in long-term and short-term cycles is crucial to our investment decision making process; this is something that we need to improve on, as whilst we have consistently picked up on when market conditions are getting carried away and caution is required, we haven't always picked up on new trends as quickly – something that I hope we can address moving forwards.

My view is that the Investment Zeitgeist is not just confined to the big moves in history that are mentioned above, it can also get involved in short term opportunistic activities. So, before we get into the detail of 2022 and where we feel we are heading let's have a look at it in action!

Long Term Action

The Technology Bubble had its origins in the 1980's as the home computer become more affordable and readily available.

Whilst initially there was only so much that households could achieve with this new technology (my ZX Spectrum certainly didn't do much more than provide me with the chance to play "Match Day") it would be the advent of the internet that would have a spectacular impact on Technology Stocks.

[1] Manias, Panics, and Crashes: A History of Financial Crises, is now in its 7th edition after first being published in 1978 it is regularly updated to cover new bubbles.

In 1991 there was **one** website, by 1998 there was **3.18 million**, by 2001 there was **29.25 million**[2] .The growth of the internet and the narrative of this new technology sent the Nasdaq into orbit with investors desperate not to miss out on the next new company that came to the stock market regardless of any real analysis - if they were shares in a Tech Company that was enough. This became a true speculative mania, a modern-day version of Tulip Bulb, as can be seen in the returns below.

Date	**Nasdaq Index**	**Return from 1991**
1991	139	
1995	371	167%
1998	1104	695%
2000 Peak	2956	2030%

However, when the Zeitgeist has done its job of getting everyone hooked on its latest theme the momentum quietly starts to slip away, institutional investors notice it first and the price falls back as they sell suckering in the poor individuals who are scared of missing out again and can't help but think that if stocks were a buy at $100 and its $85 now it must be a bargain!

The reality though is the bubble is starting to burst and everyone starts looking at fundamentals, asking whether these investments are worth the astronomical prices that they have reached.

Scott McNealy was the CEO of Sun Microsystems, one of the darlings of that bubble. At its peak his stock hit valuation of ten-times revenues. A couple of years afterward he had this to say about that time (via Bloomberg):

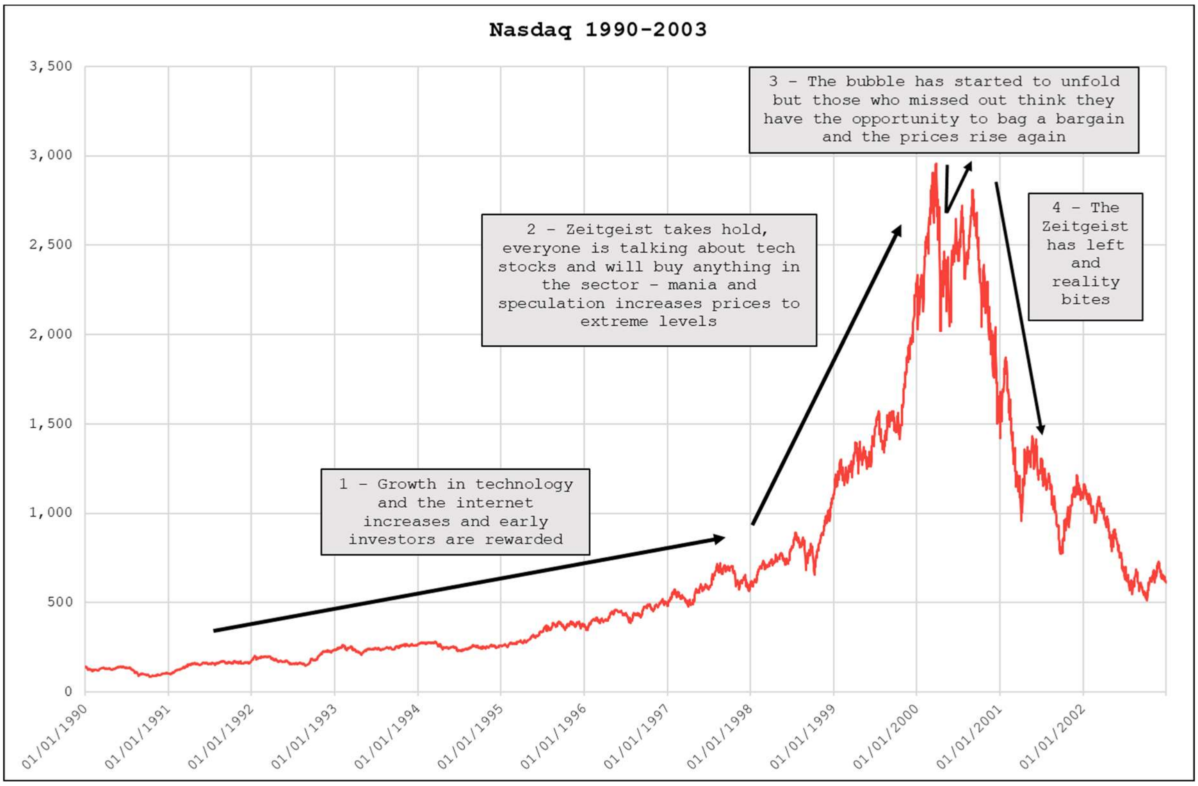
At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees.

That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?[3]

Often the peak in the mania coincides with onset of poor economic data or recession and interestingly investment frauds! The reality is that the Investment Zeitgeist has changed its mind, everyone wants to sell so the rush to the exits starts and the bubble collapses, and the Zeitgeist is already on the lookout for something new that no one else is interested in and we start the process again.

[2] https://absolute.digital/magazine/seo/the-growth-of-the-internet-from-1990-to-2019/
[3] The Felder Report "What Were You Thinking?" 26th October 2017

The graph below shows the stages of the mania for the Tech Bubble, taking the narrative of the new technology and making it the only thing that you should invest in. In the last few years of the 20th Century many experienced and well-respected Investment Managers lost their jobs for refusing to invest in Tech! Ultimately, they would be proved correct.



Short Term Action

Whilst I did consider looking at Bitcoin – particularly given its recent trials and tribulations following the collapse of the FTX Exchange – a far better example is "Meme Stocks"[4]. In the height of the Covid-19 pandemic the story of GameStop in the US highlighted how animal spirits took over and helped by social media the stock went to a price that simply wasn't justified.

GameStop was a struggling firm that had been looking for a buyer for some time, posting financial losses and heavily shorted by hedge funds it looked like a complete basket case. Yet through low-cost investment platforms retail investors were able to bid up the price by over **1500%** in two weeks as social media coverage took off with high profile people such as Elon Musk started Tweeting about it.

The idea of Meme Stocks may well have been short lived with Investors.Com [5] reporting in January 2022 that the twenty-five most widely traded Meme Stocks had last $117 billion in a month.

Whilst this was a bit of a side show to the broader investment market its significance is how easily investors can become hooked on a new trend or narrative, particularly with the help of social media.

[4] A meme stock is a stock that gains popularity among retail investors through social media.
[5] https://www.investors.com/etfs-and-funds/sectors/sp500-meme-stock-crash-costs-speculators-48-9-billion/

What's Around the Corner?

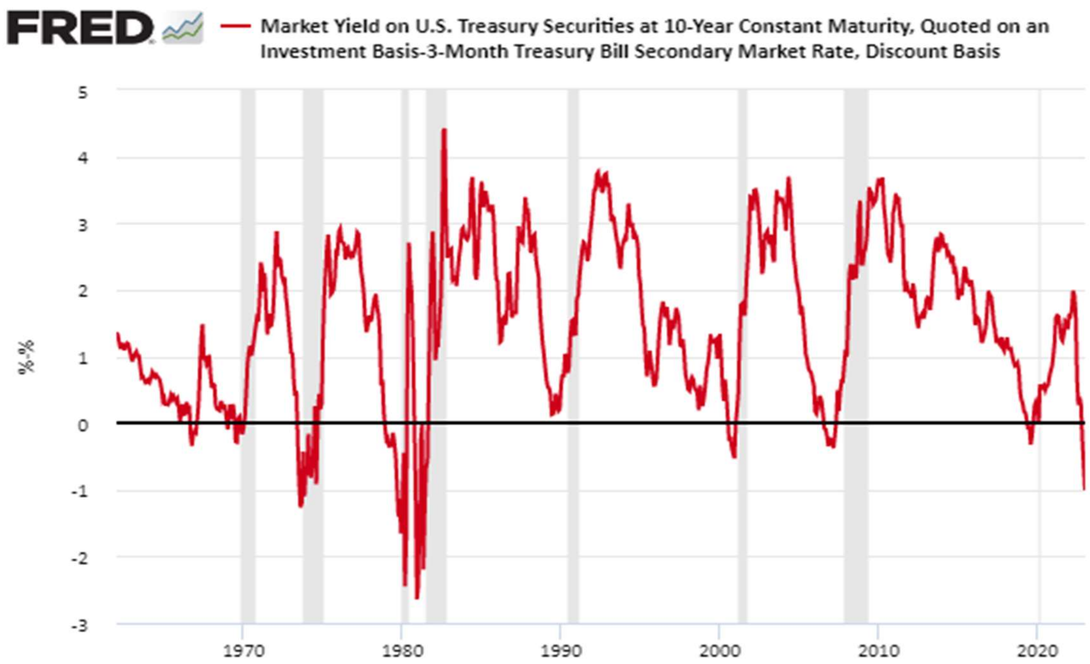
Well, we have theories, but then again anything is possible!

The Zeitgeist has been at work in the long term since, the Great Financial Crisis, so around fifteen years. In that time investors have become addicted to the concept that Central Banks will keep interest rates pinned to the floor and inject cash into the economy at the first sign of trouble. The result was what GMO describe as a "Super Bubble"[6] that has seen all types of asset class rise.

In there we have also seen a major short-term trend as COVID-19 pushed everyone towards online and virtual technology because of lockdowns; firms such as Zoom and Peloton prospered along with the well-established Tech giants Facebook, Amazon, Apple, Netflix, Google. This helped to push the US Stock Market much higher than its peers.

Last year all that changed as Central Banks started tightening monetary policy and as a result major stock and bond markets posted negative returns with commodities the only profitable investment.

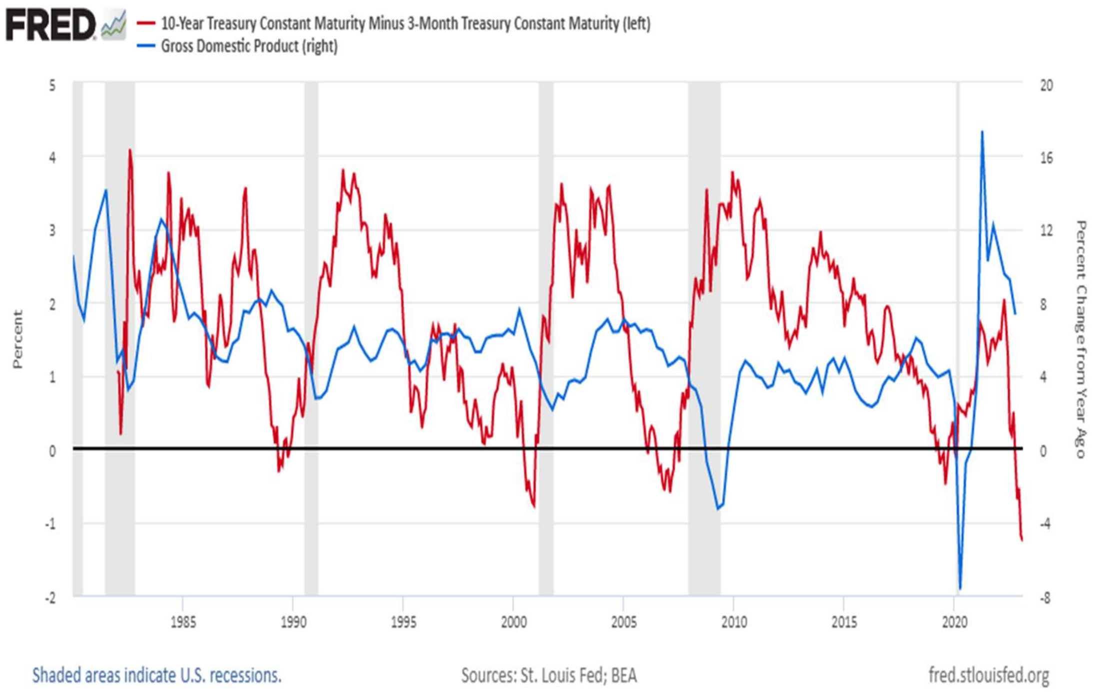
Despite ending the year in negative territory stock markets enjoyed several double-digit rallies; these though were short-lived and only offered some short-term relief. This is representative of the period we highlighted in the Tech Bubble, where investors continually think that they are seeing a bargain. Historical facts though do not support this, and it is rare for market declines to reach their low when interest rates are still rising, and never end before the onset of recession – which now seems odds on. The graph from the US St Louis Fed below shows when the difference in yield between 10 Year and 3 Month Treasury Bonds turns negatives a recession (grey lines) has always followed when this indicator starts to rise[7].



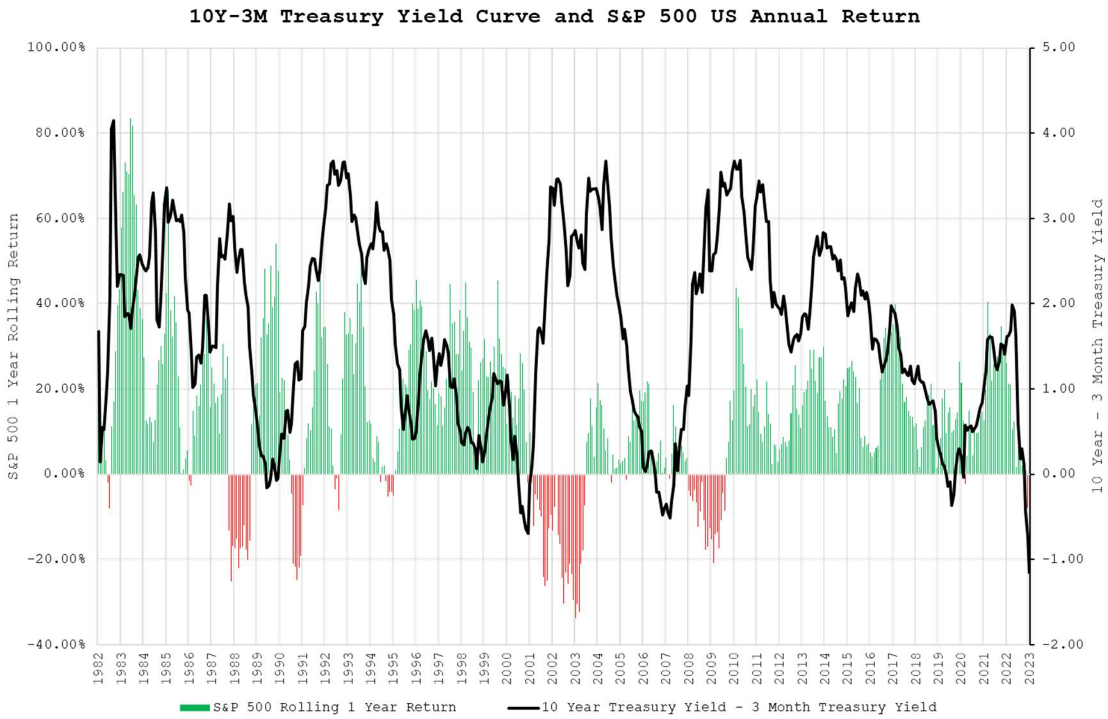
Source: Board of Governors of the Federal Reserve System (US)

[6] GMO Entering The Super Bubbles Final Act 31st August 2022
[7] St Louis Fed Fred Economic Data

The importance of this graph is shown when you overlay the annual change in GDP for the US; declines in this indicator are invariably followed by falling GDP Growth.



This is also important for the Stock Market as you can see below[8] when the yield curve is falling than the annual rolling return from the S&P 500 also declines – the worrying thing is that the more negative the yield curve the more negative the stock market and the we are now lower than ever!



[8] Data from St Louis Fred Economic Data and Morningstar

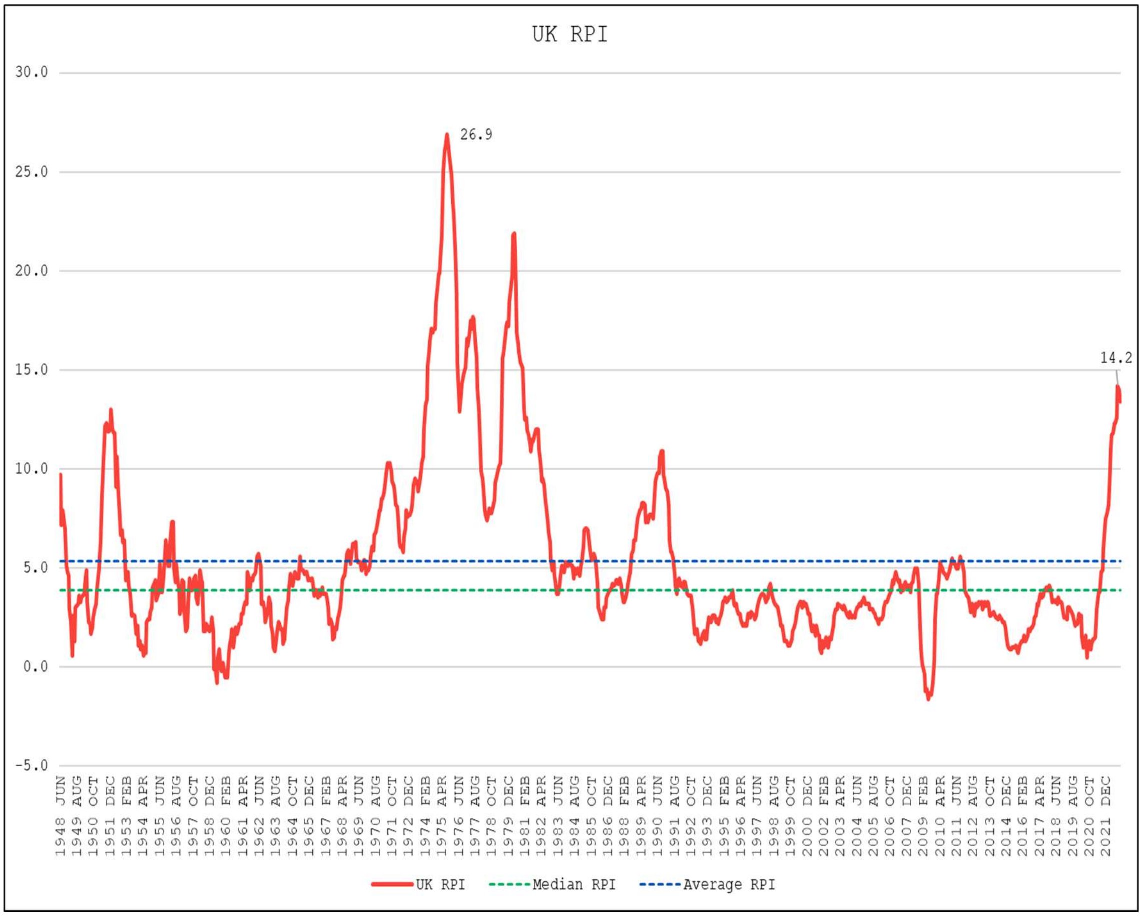
We use the US as a good example due to the availability of data and the fact that it remains the dominant financial economy (for the moment) and other countries and markets tend to follow suit.

So, conditions look set for stock markets to decline, but for them to hit rock bottom we will need to see a recession declared and possibly falling interest rates; this would also likely (hopefully) be accompanied by a decline in inflation. If not, we face the grim prospect of "Stagflation" where inflation remains high and growth collapses into a recession.

It may seem strange to think of a recession when inflation is so high, but perhaps we have got carried away with the narrative and talk that remains focused on rising prices and what asset to hold to protect the real value of your capital?

Whilst inflation may not be going away completely in a hurry (there are many long-term factors such as demographics, energy transition and deglobalisation that could mean it will remain higher than recent years), in the near term there is a *chance* that we could have hit a peak.

The graph below shows how rare it is in the UK to see inflation at current levels; it been above 14% for only around 7% of occasions since 1948. RPI is also well above its median and average levels and we have become conditioned to think that inflation will continue to rise forever - neglecting the fact that its unusual and not the norm to be this high.



Several factors suggest that in the short term at least we could see inflation start to fall in the UK and in other nations: -

- Covid Supply Chain issues are being solved,
- Inflation expectations are falling,
- The price of energy is lower, Oil is 26% lower and Natural Gas 70% lower than at their peaks in 2022,
- The base effect will start to disappear[9],
- Central Banks may be at the peak of raising interest rates,
- Wage growth, one of the key drivers of inflation is falling in the US; the rest of the Developed World may follow a similar pattern,
- The probability of recession is high, which would be deflationary.

If we do see a recession, in the US and globally, then this is likely to lead to higher unemployment and probably lower wage pressures that are a key driver of long term inflation. Central Banks would also need to stop raising interest rates, and even possibly lower rates to support the economy.

Should this scenario play out then the short-term assets to hold would be Long Dated Nominal Government Bonds and Gold; interestingly US Treasuries are one of the most "shorted" positions by retail investors in the US (an excellent contrarian indicator). At the same time a recession would likely bring stocks to a bear market low and set them up for significantly better potential returns in the long run. If this happens the Investment Zeitgeist of the last fifteen years will change and find a new narrative that will attract investors; the trick will be to consider what this could be.

With globalisation reversing and geo-political tensions it seems unlikely that there will an opening of new markets to capitalism, and whilst there is always a chance of new technological breakthroughs, one idea worth looking at could be commodities.

- Commodity prices are as cheap relative to the US Stock Market as they ever have been since 1920. The graph over the page shows how undervalued they are historically compared to US equities[10].
- Post any recession a recovery would increase demand for commodities as spending increases.
- Commodity producing firms (particularly in the energy sector) have been underinvesting for many years, discouraged by Governments and high taxation, meaning that they have a lower capacity for production in the future to cope with increased demand.
- Commodities have been weaponised; sanctions meant to impose economic pain on Russia after their invasion of the Ukraine reduced the supply of energy to the rest of the World increasing costs. It seems that this is unlikely to be reversed anytime soon adding to price pressure.
- The US Dollar is at a multi-year as the US led the way in raising interest rates; as commodities are (for the moment) traded in US Dollars when the Dollar price is high it keeps a lid on commodity prices. A falling Dollar would be good for economic activity as it is

[9] The base effect relates to inflation in the corresponding period of the previous year, if the inflation rate was too low in the corresponding period of the previous year, even a smaller rise in the Price Index will arithmetically give a high rate of inflation.
[10] The Felder Report A Generational Opportunity In Commodities, Part Tres

cheaper for Countries to buy commodities creating a tailwind for the asset class.

This gives us a reasonably clear path for investment strategy moving through 2023; although we will have to be flexible and adapt to conditions.

- In the short term we expect cash, US Treasuries and Gold to perform well as we move through 2023 and possibly into recession.
- Over the long-term we feel that a combination of general commodities alongside energy & resources stocks is a reasonable position given their years of under-performance – although this will come with volatility and ultimately may not really pay off until after a recession.
- If stock markets decline we will have an opportunity to buy these assets at considerably lower prices meaning that they will provide stronger long term returns.
- To reduce the risk that of being wrong we maintain a sizeable allocation to tried and trusted Multi-Asset and Trend following funds that provide a reasonable rate of return without sacrificing their goal of capital preservation.

In Conclusion….

Throughout market history there has always been themes and narratives that have dominated current thinking and pushed the price of the assets associated with the story to unsustainable levels – The Investment Zeitgeist.

In the late 1990's the Tech Bubble was the prime example; whilst the internet would become a dominant new technology the scramble to buy anything Tech related without reasonable due diligence created a huge speculative bubble that ultimately burst spectacularly.

We can also see short term trends and momentum do spectacular things; the "Meme Stocks" were one the most obvious examples. The nature of COVID lockdowns, the penetration of social media into our social fabric and the availability of low-cost investment platforms allowed retail investors to push a stock up 1,500% and squeeze the Hedge Fund short sellers. The popularity though seems to have disappeared along with $117bln.

The Investment Zeitgeist of the last fifteen years has created an "everything bubble" with the many of asset classes regularly reaching new highs. During last year Central Banks raising interest rates to fight inflation had a negative impact on risk assets; however, the declines in the stock market seem more like a bear market rally than a generational buying opportunity.

Based on historically accurate indicators a recession appears to be extremely likely, particularly in the US, and we would expect other global economies to follow. This event, coupled with a peak in interest rates and a bursting of the everything bubble in risk assets would create a buying opportunity.

Hopefully Stagflation can be avoided and recession brings down inflation to more manageable levels, but long-term trends and World events are likely to keep inflation higher than we have been used to in the last decade.

Lower inflation would allow Central Banks to respond and try to stimulate economic recovery by lower interest rates; this would have a positive impact on Fixed Interest Securities (such as Gilts and US Treasuries) and Gold.

A subsequent recovery from recession, coupled with other factors such as a potentially weaker US Dollar would provide a huge boost to commodity prices that remain at a significant discount to the stock market relative to history.

We will need to keep a close eye on developments, but the Investment Zeitgeist is definitely on the look out for a new narrative and if this does turn out to be commodities history tells us that the results should be extremely positive.