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Quantitative & Strategy

Cam Hui, CFA
cam@pennock@ideahub.com

June 26, 2017

WHAT YOU DON'T SEE AT MARKET BOTTOMS

Highlights

It is said that while bottoms are events, tops are processes. Translated, markets bottom out when panic sets in, and therefore they can be more easily identifiable. By contrast, market tops form when a series of conditions come together, but not necessarily all at the same time.

We have stated that while we don't believe the stock market has made its final cyclical top, we are in the late stages of a bull market (see *Four Steps, Where's the Stumble?*). Nevertheless, psychology is getting a little frothy, which represents the pre-condition for a major top.

As a result, we are publishing one report in an occasional series of "things you don't see at market bottoms":

- Irrational exuberance in credit markets: Argentina's 100-year bond offering
- The equity Irrational Exuberance Indicator at fresh highs
- A start-up to help people without funds to spend
- More signs of excesses from the Chinese debt time bomb

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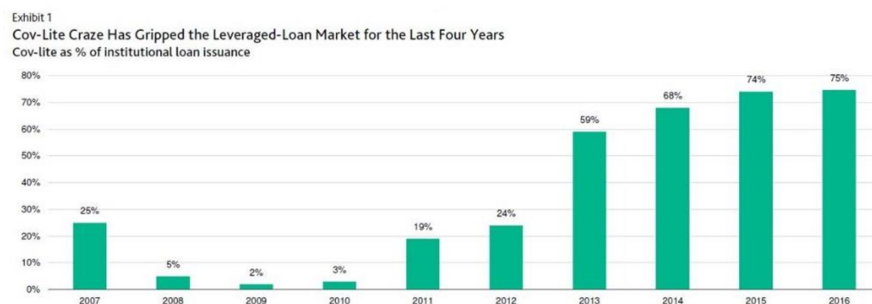
Irrational Exuberance in Credit Markets

Last week, Argentina announced that it had received US$9.75 billion in its financing for a 100-year USD-denominated bond offering (Reuters report here). Demand was strong, and the deal was priced at a yield of 7.9%.

Excuse me? Didn't Argentina just emerge from default? Who in their right mind would lend Argentina money at 7.9% for 100 years? This financing is evidence of how starved the market is for yield.

Indeed, the stretch for yield has prompted issuers to take advantage of the easier credit environment. As the chart below shows, the percentage of covenant light loans has been rising steadily since 2010 and cov-lite loans are now the norm.

Exhibit 1: Cov-Lite Loans Are Now the Norm



Source: Thomson-Reuters

Irrational Exuberance in Equities

Jeroen Blokland, portfolio manager at Robeco, recently pointed out that the Irrational Exuberance Indicator, which is calculated from Yale's Survey of Confidence that the "market will be higher one year from now" compared to confidence in "valuation of the market", recently reached all-time highs. This is a sign that investor greed is overtaking fear.

Exhibit 2: Irrational Exuberance Indicator Near All-Time Highs

Source: Jeroen Blokland, Yale Investor Confidence Monthly Surveys

Speaking of things that you don't see at market bottoms, we came across this ad of Mike Tyson promoting an online broker, which is reminiscent of the TV ads from the dot-com bubble.

Exhibit 3: Echoes of the 1990s Dot-Com Bubble?

Source: Trade12

A Start-up for Customers without Funds

If "irrational exuberance" is defined as equity investors throwing caution to the winds, what do you call the excessive consumer risk-taking behaviour? The following news item recently came across our desk (via Tech Crunch):

> *If you're looking to buy something, but don't want to pay for it yet, Blispay thinks it has the solution for you. The start-up works with small and mid-sized businesses to help retail customers defer payments for six months…*
>
> *If someone walks into a participating store and wants to make a purchase of at least $199 without paying anything upfront, they can sign up on the Blispay app in 2–3 minutes and once they submit the form they will find out if their credit is approved within 15–20 seconds. They can then take the item home without any payments or any interest for six months, while also getting 2% cash back. Blispay makes money off customers who don't end up paying for the item when the six months comes around and then they are subject to 19.99% interest.*
>
> *But as far as the businesses are concerned, it costs them nothing more than the roughly 3% credit card processing fee that they would be paying Visa anyway. Blispay allows businesses "to leverage technology in a way that makes it efficient and affordable to service a far broader swath of a merchant base," said Lisiewski.*

File another item under "things you don't see at market bottoms".

The Chinese Debt Time Bomb Ticks On

Economic recessions serve to unwind the excesses that occurred in the previous expansion. In the U.S., there are no significant excesses that, if unwound, are likely to totally tank the economy. While some valuation excesses can be found in unicorns, the implosion of excessively valued stocks like Snapchat and other Silicon Valley darlings are unlikely to cause significant economic damage.

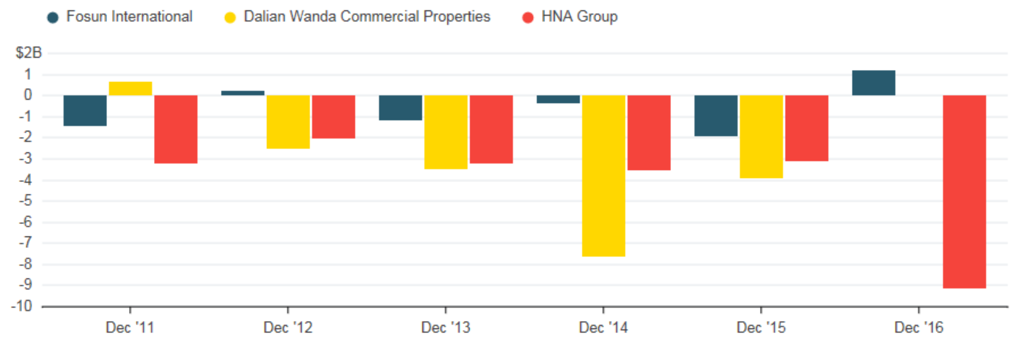
From a global perspective, however, much of the excesses can be found in China. The *New York Times* recently reported that the market was getting spooked because Beijing was cracking down on the foreign takeover financing of a number of large Chinese conglomerates:

> *Some of China's largest companies may pose a systemic risk to the country's banks, a senior banking official said on Thursday, in the latest signal that Beijing is ratcheting up scrutiny of a financial system plagued with hidden debt that poses a hazard to the health of the economy.*
>
> *The official, Liu Zhiqing of the China Banking Regulatory Commission, did not name any companies. But shares of some of China's biggest global deal makers plunged on Thursday.*
>
> *They included the publicly traded arms of Fosun International, which in recent years bought the Club Med chain of resorts and other properties; Dalian Wanda, which owns the AMC Theaters chain in the United States and has long sought deals in Hollywood; and the HNA Group, an acquisitive conglomerate with murky ownership.*

At a briefing on Thursday in Beijing, Mr. Liu, deputy head of the commission's prudential regulation bureau, said that his agency was looking into "systemic risk of some large enterprises," according to numerous media accounts, and that the risk could spread to other institutions.

Bloomberg columnist David Fickling revealed that much of the concerns stemmed from the fact that many of the large Chinese acquirors have been free cash flow negative. In other words, these companies are relying on the kindness of the financial system to maintain both solvency and their acquisition sprees.

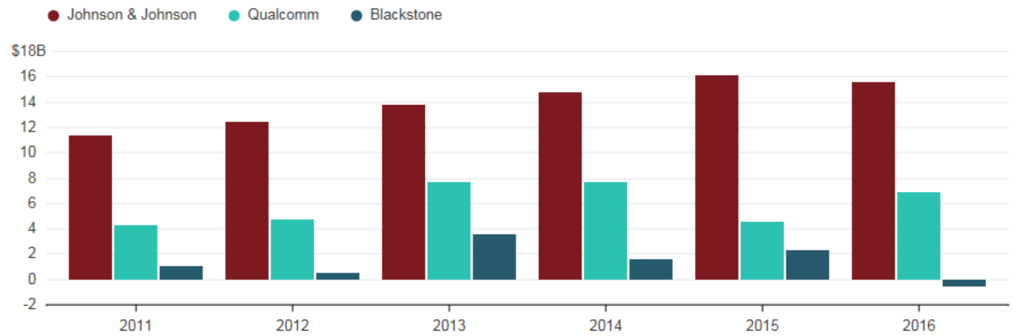
Exhibit 4: Chinese Acquirors Are Free Cash Flow Negative



Source: Bloomberg

By contrast, the free cash flow of recent major American acquirors has been consistently positive.

Exhibit 5: American Acquirors Tend to Be Free Cash Flow Positive



Source: Bloomberg

These two charts dramatically illustrate the point of the differences in the levels of financial excesses between China and the U.S. While we are not predicting an imminent collapse of the Chinese economy, this is another thing that you don't see at market bottoms.

What the Fed Could Do

Alan Greenspan biographer Sebastian Mallaby recently penned an Op-Ed in the WSJ to address the problem of excessive risk taking by staying unpredictable and ambushing the markets once in a while:

> *With every passing month, the U.S. economy feels, ominously, more like it did in 1999 and in the mid-2000s. Both were times when a promising mix of full employment, low inflation and buoyant spirits gave way to a financial convulsion that triggered a recession. Unfortunately, the Federal Reserve under Janet Yellen is ignoring a relatively painless policy that would reduce the danger of a sequel…*
>
> *A different debate could help the Fed out of this bind. Even if Ms. Yellen's current, rather gradual pace is appropriate, the Fed can reduce the odds of a financial bust by tweaking the manner of its tightening.*
>
> *To do so, the Fed should examine a tenet of the central-banking faith: that transparency is always virtuous. By being less transparent—and reserving the option of deliberately ambushing investors with a shock move—the Fed could discourage them from taking too much risk.*
>
> *Such an ambush would unsettle markets, to be sure; but that would be the point. The painfully learned lesson from the late 1990s and mid-2000s is that excess financial serenity leads to excess risk-taking, which in turn increases the chances of a blow-up. In the first case, that meant the tech bust of 2000; in the second case, it meant the planet-shaking subprime-mortgage meltdown. Since market convulsions caused the last two recessions, reducing the probability of the next one must be a Fed priority.*

In the absence of negative shocks, excessive risk-taking is likely to continue until the occurrence of a market dislocating event. Despite these negatives, we reiterate the belief that this is not the top of the equity market (see our recent report, *Four Steps, Where's the Stumble?*). Nevertheless, investors should be aware of the risks of an environment in which sentiment has become increasingly greedy without regard of the risks involved.

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