Where's Our Irving Fisher Moment?

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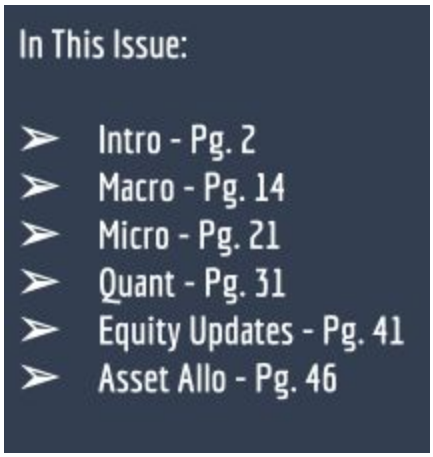


We've got a lot of great stuff for you in our August issue of the MIR.

First up we discuss what constitutes a bubble. Then we get into the *real* reasons why valuations are high, along with why they're going higher. And finally we'll talk about how the whole shebang is gonna end.

Then we review the three primary macro drivers of markets and look at the vertical trends in planned and actual US CAPEX... as well as some trades to play it.

After that we'll dive into one of our favorite trades — a company we're intimately familiar with.

We'll finish up with our Quant section where we look at the relationship between volatility and liquidity.

I'm excited to hear your thoughts on on everything we have to say.

Be sure to send me an email at alex@macro-ops.com with what you think.

Your Macro Operator,

Alex

Intro: Where's Our Irving FIsher Moment?

ñStock prices have reached what looks like a permanently high plateaué ò

These were the infamous words spoken by one of the most respected economic authorities of the time — Irving Fisher.

Fisher spoke them only a few weeks before the great bull market peaked in 1929 and then crashed.

You could say Fisher's timing was a little off…

FISHER SEES STOCKS PERMANENTLY HIGH

Yale Economist Tells Purchasing Agents Increased Earnings Justify Rise.

SAYS TRUSTS AID SALES

Finds Special Knowledge, Applied to Diversify Holdings, Shifts Risks for Clients.

In this month's MIR, we're asking the question, "where's our Irving Fisher moment?"

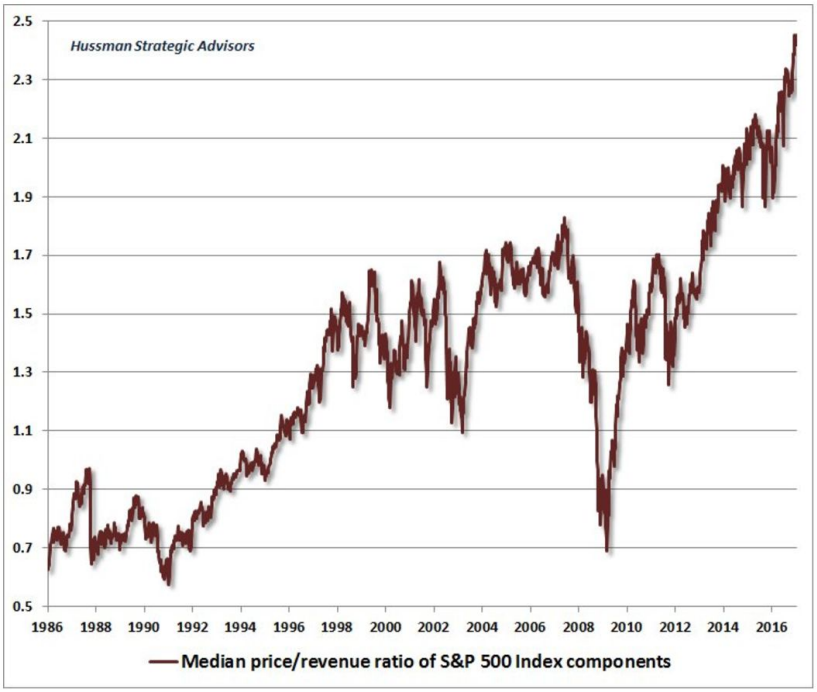
We'll explore why valuations are so damn high (hint: it's structural changes). And why, counterintuitively, these high valuations have actually *helped* keep this bull running.

Then we'll dive into the macro and quant of the current market as well as some trades we're scoping out.

Let's begin.

You've probably seen charts like the one to the right showing the high valuations US equities are trading at.

Valuations are indeed high by any objective measure and have been for a while… which is why the popular narrative of referring to this market as "The Everything Bubble" spawned in late 2013.



'The Everything Bubble': Why The Coming Collapse Will Be Even Worse Than The Last

by Tyler Durden
May 17, 2017 10:20 PM

735 SHARES

Behold The Everything Bubble

Jared Dillian, Mauldin Economics June 22, 2017

Now I only have two market cycles (2000 and 2007) of experience under my belt, but I don't remember such a large group of bubble spotters in either.

It was just the opposite.

You were ridiculed in 2000 if you said tech stocks were in a bubble as well as in 06' if you said home prices could "go down". The majority would look at you with pity for not "getting it", thinking you must be too dense to understand the new world we lived in.

One of my favorite market thinkers is Jeremy Grantham of GMO. We're going to talk about him more in a sec, but he has a solid definition of what a bubble is. He explains it as:

> *Best characterized by a market with excellent fundamentals that are irrationally extrapolated… which leads to euphoric sentiment and the popular belief that 'this time is different'.*

In *The Five Stages of A Bull Market* we wrote how this bull has been one of the *most* hated in history and how its negative sentiment was great for its continuation.

Remember *playing the player*… if a rising market is marked by negative sentiment, it means there's a lot more fuel in the tank to push it higher.

So when you have a large subset of the market claiming it's an "Everything Bubble", there's a good chance it's not…

For a bubble to exist, the majority of the market has to *fervently* believe in it… to the point where the only thing that matters is how much a stock is up over the prior month and how much margin can be borrowed to buy it.

Valuations are always high this late in the cycle. But it takes euphoria to drive margin buying and create a bubble. The leverage *is* the instability.

And this euphoric, blind, FOMO-driven margin buying is something we haven't seen this cycle… though there's signs it may be starting.

This brings us to an important question: what's the "everything bubble" crowd getting wrong? If high valuations are not due to euphoria, then what's causing them?

The answer is simple. It's the thing that always drives price: Supply and Demand.

Grantham recently wrote in his quarterly letter titled *"This Time Seems Very, Very Different"* that the shift to higher valuations over the last 20 years is due to 3 structural changes… changes that are unlikely to be resolved anytime soon.

These are:

1. **Globalization**
2. **Corporatization (monopoly state)**
3. **Low interest rates**

On globalization, he writes:

> *Increased globalization has no doubt increased the value of brands, and the US has much more than its fair share of both the old established brands of the Coca-Cola and J&J variety and the new ones like Apple, Amazon, and Facebook. Even much more modest domestic brands – wakeboard distributors would be a suitable example – have allowed for returns on required capital to handsomely improve by moving the capital intensive production to China and retaining only the brand management in the US. Impending global trade today would decrease the advantages that have accrued to US corporations, but we can readily agree that any setback would be slow and reluctant,*

> *capitalism being what it is, compared to the steady gains of the last 20 years (particularly noticeable after China joined the WTO)*

On the corporatization of America:

> *Steadily increasing corporate power over the last 40 years has been, I think it's fair to say, the defining feature of the US government and politics in general. This has probably been a slight but growing negative for GDP growth and job creation, but has been good for corporate profit margins. And not evenly so, but skewed toward the larger and more politically savvy corporations. So that as new regulations proliferated, they tended to protect the large, established companies and hinder new entrants… New entrants into the US business world have plummeted since 1970! Increased regulations cost all corporations money, but the very large can better afford to deal with them. Thus regulations, however necessary to the well-being of ordinary people, are in aggregate anti-competitive. They form a protective moat for large, established firms. This produces the irony that the current ripping out of regulations willy-nilly will of course reduce short-term corporate costs and increase profits in the near future (other things being equal), but for the longer run, the corporate establishment's enthusiasm for less regulation is misguided: Stripping out regulations is working to fill in its protective moat.*

And finally, on low interest rates:

> *Stock prices are held up by abnormal profit margins, which in turn are produced mainly by lower real rates, the benefits of which are not competed away because of increased monopoly power, etc. What, we might ask, will it take to break this chain? Any answer, I think, must start with an increase in real rates. Last fall, a hundred other commentators and I offered many reasons for the lower rates. The problem for explaining or predicting future higher rates is that all the influences on rates seem long term or even very long term. One of the most plausible reasons, for example, is the aging of the populations of the developed world and China, which produces more desperate 50-year olds saving for retirement and fewer 30-year-olds spending everything they earn or can borrow. This results, on the margin, in a lowered demand for capital and hence lower real rates. We can probably agree that this reason will take a few decades to fade away, not the usual seven-year average regression period for financial ratios.*

These are all solid points. Each has plainly driven profit margins higher and made moats easier to defend, thus leading to higher valuations for stocks.

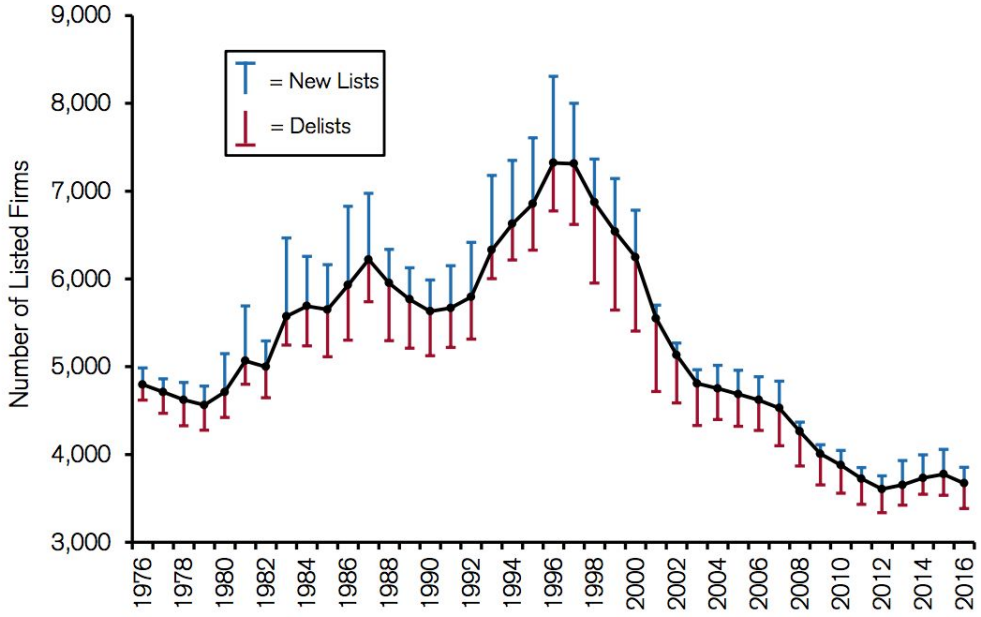
But there's even more to the valuation story.

The following three structural changes, along with those noted by Grantham, have led to a semi-permanent supply/demand imbalance in US stocks which have led to high valuations. These are:

1. **The cannibalization of public markets has led to a decline in single issues and a drop in total equity shares**
2. **Systemic stress in the international banking system outside the US, combined with high USD liquidity sloshing around the globe, has created large structural demand for US assets (ie, stocks and bonds)**
3. **The ETF-ization of the US market has lowered the risk of equity ownership through passive market cap weighted diversification. This brings down the risk-premia (expected relative return over bonds and cash) while also creating a relentless bid thus creating a reflexive low volatility "melt up" in stocks**

Let's start with the first structural change — the disintegration of US public markets. Take a look at the chart below of the trend in listed public companies in the US.

Exhibit 2: Additions and Subtractions to Listed Companies, 1976-2016



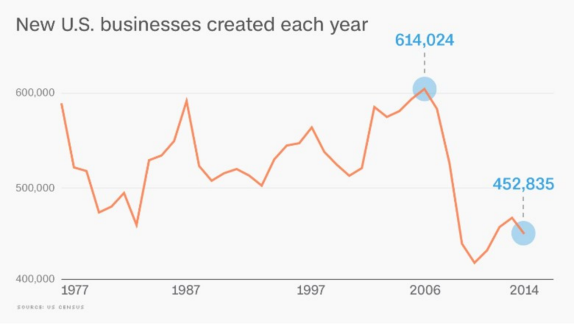
Source: Craig Doidge, G. Andrew Karolyi, René M. Stulz, "The U.S. Listing Gap," Journal of Financial Economics, *Vol. 123, No. 3, March 2017, 464-487 and Credit Suisse estimates.*

They've more than halved since the late 90s.

> In 97', there were more than 2,500 small caps and nearly 4,000 "microcap" stocks. Now, fewer than 1,200 small caps and less than 1,900 microcaps are left

The number of new companies started each year has fallen from an average of 600,000 in the 1970's to only 450,000 today — a decline of 25%!
The number of people working at companies that are less than 2 years old (both public and private) has more than halved since 1970

Doesn't exactly paint a picture of a thriving entrepreneurial America, does it?



The fall in the number of publicly listed firms is due to fewer initial public offerings (IPOs) and a rise in mergers and acquisitions (M&A).

The rise in M&A comes from two points Grantham noted:

1. Low interest rates means cheap funding for leveraged buyouts.
2. The government-allowed corporatization of America has changed the incentive structure for US executives. It's more profitable, in the short term, to buy growth and boost your stock price than to invest and organically create it.

M&A became popular over the last two decades due to ill-conceived government policies under President Clinton that tied executive compensation to stock prices and secularly low interest rates. It was cheap to borrow and easy for a company to carry debt.

Charlie Munger always says, "incentives are everything".

With cheap credit and executives *incentivized* to focus on short-term stock prices over long-term value creation, it became more profitable to borrow and buy — merge and acquire — versus invest and grow.

The second structural change is the stress in the international funding markets.

This is a complicated topic and it would take pages and pages to describe the mechanisms at work. You would be bored to tears in the process. So instead, here's the gist of it and why it matters.

Many international banks, primarily large European financial institutions, never recovered like their American counterparts following the financial crisis. This has created a structural asset-liability mismatch in the international dollar funding markets. A lot of strange things have happened as a result, such as the breakdown in covered interest parity theory but I digress…

Essentially, this financial stress has caused persistent structural demand for US dollar assets such as US stocks and bonds. When you combine this with the large amount of USD liquidity currently sloshing around the world, you end up with a lot of dollars chasing fewer equity shares.

Again, it's all supply and demand.

The this structural change is the ETF-zation of markets and collapsing risk-premia.

The ETF-ization of US markets is one of the largest and most underappreciated drivers of valuation increases.

Pseudonymous blogger "Jesse Livermore" lays out the reasoning clearly on his blog *Philosophical Economics.*

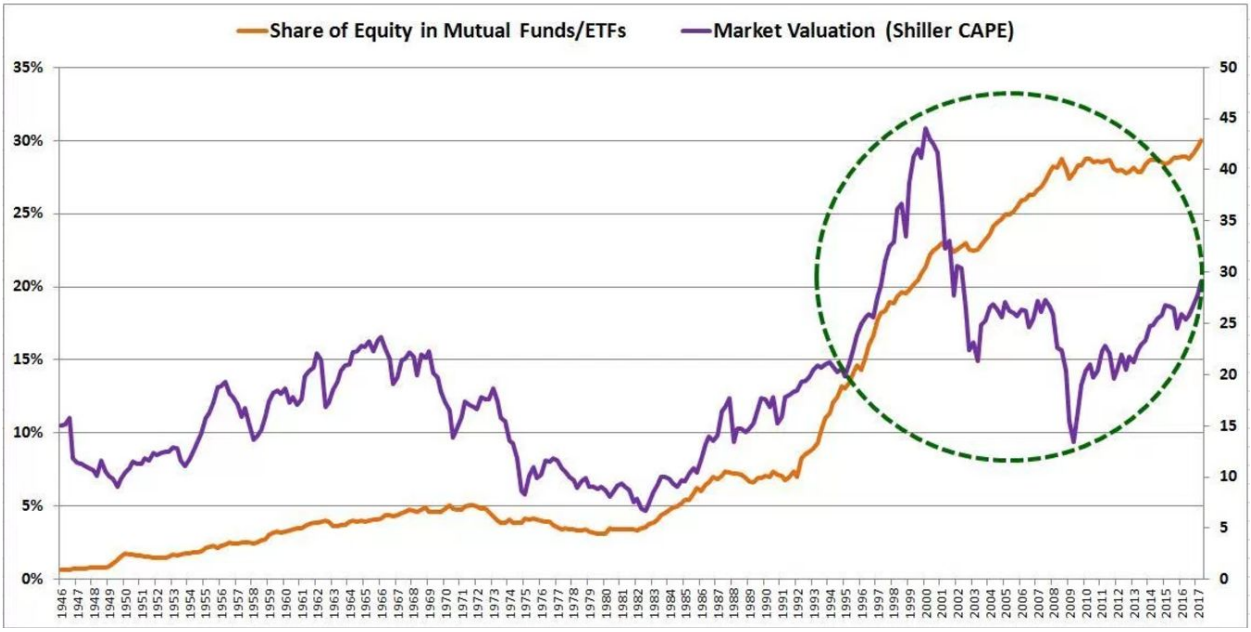
> *The market builds and popularizes increasingly cost-effective mechanisms and methodologies for diversifying away the idiosyncratic risks in risky investments, the price discounts and excess returns that those investments need to offer, in order to compensate for the costs and risks, comes down. Very few would dispute this point in other economic contexts. Most would agree, for example, that the development of efficient methods of securitizing mortgage lending reduces the cost to lenders of diversifying and therefore provides a basis for reduced borrowing costs for homeowners–that's its purpose. But when one tries to make the same argument in the context of stocks–that the development of efficient methods to "securitize" them provides a basis for their valuations to increase–people object.*

The logic is simple. Stock returns are a function of perceived risk. The higher the perceived risk, the higher the expected return needed to compensate for that risk. Risk and expected return balance out so price clears. That's what price discovery is all about.

When you take away single issue risk (ie, accounting fraud, mismanagement, product risk) by automatically buying a basket of stocks, you diversify that risk lower. The passive inflows into ETFs drive the risk-premia spreads (the difference in return of stocks over bonds and cash) on asset classes lower because their risk is lower. Livermore again writes:

> *To summarize: over time, markets have developed an improved understanding of the nature of long-term equity returns. They've evolved increasingly efficient mechanisms and methodologies through which to manage the inherent risks in equities. These improvements provide a basis for average equity valuations to increase, which is something that has clearly been happening.*

This chart makes the point evident.



The rise in the share of equity and mutual funds has pulled market valuations higher. As it should.

So you could kind of sorta say… "This time *is* different".

- **There's a lower supply of US equity shares due to M&A and fewer businesses being started and going public.**
- **There's larger persistent demand due to the structural need for US dollar assets in the international funding market. This means more dollars chasing fewer stocks.**
- **And the securitization of the stock market through the rise in ETFs has pulled the risk-premia lower on stocks. A lower relative risk-premia equals higher valuations.**

And the interesting thing is, these structural changes — especially those due to ETFs — have formed an important reflexive relationship between demand for stocks, volatility, and valuations.

The passive inflows into ETFs tend to tie together the relative values between stocks as money automatically flows into the market. The stocks with the largest public float and market cap all grow relatively in tandem.

This has the effect of dampening volatility, something we've seen a lot of. The lower volatility leads to lower perceived risks, as value at risk (VAR) models adjust to the lower vol environment. This leads to larger position taking in the market (ie, more money flows).

A reflexive relationship is born where ETFs' lower volatility increase capital inflows, which leads to even lower volatility.

So combine these points with those offered by Grantham and it's easy to see how valuations have gotten so high while sentiment has been mostly poor, at least until recently.

It's simply a case of a structural supply and demand mismatch and not one of euphoric buying inflating a bubble.

We're in a new value paradigm, but not a permanently high plateau.

How long we stay here, I don't know.

I agree with Grantham that it depends on interest rates. And as a result, the direction of inflation.

He's a little more sanguine on the subject and thinks we don't see full mean reversion for another 20 years. But I believe there's a good chance inflation comes back with a vengeance in the next cycle. Driven by populist policies, trade wars, and a push by the forgotten worker to get his share of the pie back.

So back to the question… are we in a bubble?

Grantham recently said in an interview:

> *I've dedicated my life to financial bubbles, and I don't think it is a bubble… This is the broadest market of all time.... That is not the nature of a bubble. We value investors have bored momentum investors for decades by trotting out the axiom that the four most dangerous words are, 'This time is different.' I would like, however, to add to this warning: Conversely, it can be very dangerous indeed to assume that things are never different.*

Like we talked about in our February Brief *Margin of Spread;* valuations can't be looked at in a vacuum.

All asset prices are relative to one another. It's dangerous to be ideological in this game — as many smart value investors and central bank haters have been the last few years.

Ideology blinds critical objective judgement. The only thing certain in this game is that it's always changing. Rigid thinkers get competed away.

Valuations are high. But now you know this is due to more structural changes to markets than it is euphoric sentiment.