COMING FULL CIRCLE

Starting in the funds management industry in August 1987 I have had the “fortune” to experience first-hand, perhaps too many crises. Some epic, others significant, plenty just side shows.

Listing these provides some context:

October 1987 - The Crash (Epic) largest one day fall in living memory in the US equity market, -20.5%. It just so happened that the night before London was hit by a hurricane. This knocked out all means of transport, so I walked into work. I was the only one in the office in the era long before mobile communications. Nature forewarned the impending doom. Portfolio insurance was all the rage at the time – it did not work. It required the counterparty to a) pick up the phone; and b) still be in business the day after. Most counterparties failed on both counts. My favourite piece of research in my career to date, a single line from Shearson Lehmann “Please ignore all research prior to 19th October 1987.” In terms of this COVID-19 correction compared to 1987 we are close to the bottom.

14th December 1989 - (Epic) The beginning of the end of the great Japanese domination of world financial markets. Japanese banks ruled the financial waves. Property prices in Tokyo were so sky high that the Emperor’s Palace was worth more than the state of California and the Australian Embassy land value had the ability to reduce Australian government debt by a large quantum. The Japanese equity market PE was over 60X, more was spent on corporate entertainment than corporate dividends in 1989 and the US dollar warrant bond market was where everyone got sucked in.

In November 1988 my then boss went to zero in Japanese equities, at the time accounting for 48% of global equity markets by value. He lost his job in November 1989 post a rally in the Japanese market of some 30%. The poor relative performance could not be tolerated. Japan today is 65% below the level it reached on 14th December 1989. So much for long term investing.

1989-1991 - Australia’s last recession and near-death experience of Westpac and ANZ banks (**Epic**). (CBA yet to be listed!). Commercial property prices nosedived. 101 Collins Street, Melbourne went bust allowing my company to move into level 25 on a 7-year rent free period and all fit out paid for. The then head of Pacific Dunlop had a whole floor of the same building to himself. The administrator simply needed the space filled. From Level 25 you could look across Melbourne at sunset and see straight through most office towers – all empty! Recent anecdotal evidence suggests that major retailers could well go into administration – more CBD real estate looking for tenants.

15th September 1992 - (Significant) George Soros forces British Pound out of the Exchange Rate Mechanism (ERM) as the currency breaches the lower currency exchange limit mandated by the ERM. Soros effectively took on the Bank of England and won!

1994 - “The Great Bond Massacre” (Side Show) Investors learnt for the first time since the 1970s that government bond prices can actually fall and that you can lose money investing in bonds. Capital guaranteed products in Australia found not to be so “guaranteed”. Another example of structured products failing when put to the sword of reality.

July 1997 - Asian Currency Crisis. (Significant) The collapse of the Thai Baht due to lack of foreign currency reserves sparked fears of financial contagion in the region. ASEAN foreign debt to GDP ratios exceeded 150%. South East Asian markets go into meltdown. The Asian Tiger economies lost their claws.

August 1998 - Russian Debt Crisis (Side Show) and the “termination” of Long Term Capital Management (LTCM), massively geared enterprise buying up illiquid Russian debt assets. In the scheme of things, a side show. Rumour was that US Federal Reserve twisted the arm of several US banks to sort out the mess! (I am currently reading “Bankers and Bolsheviks” which tells the story of how the American and European banks were lured into issuing huge amounts of debt to the failing Russian Empire directly in front of the 1917 Revolution. I quote “Tsarist bribery of the French financial press was found …whereby less scrupulous newspapers sought to use the threat of bad publicity to extract rents from potential bond issuers”. Fake news is nothing new!)

April 2000 - The Dot Com Crisis. (Epic) The Nasdaq plunges by 85%, wiping some US $5 TRILLION permanently from the wealth of those exposed to the Dot Com space. In November 1999, the Janus Henderson IT Fund (a dotcom fund) raked in 95% of every retail dollar. In December 1999 Wall Street Journal headline read “The King Is Dead” referring to the demise of Warren Buffet’s

performance as he bypassed the dotcom mania! In 1989 most foreigners were scathing about the valuations in Japan – shame they forgot their own wisdom but 10 years later.

1st December 2007 - Global equity markets peak ahead of the Global Financial Crisis (GFC) (Epic). The GFC was sparked by falling house prices in the USA (which started to fall in 2006) due to the huge oversupply of new housing. Excessive borrowing in the period up to 2006, to fund ever rising house prices, led to significant number of loan defaults which in turn triggered the demise of a multitude of structured products with strange acronyms, CDOs, MBSs, Ninja (No Income, No Job, No Assets) Loans, to name but a few. The US equity market fell by 45% with many global financial institutions going to the wall and/or needing government bail outs. European debt crisis followed.

December 2019 – COVID-19 (Epic) causes a massive supply/demand shock to the global economy. End point yet to be reached, markets off some 30 – 50% thus far.

Outside of the historical and intellectual buzz of witnessing history (some of it 200 hundred years in the making) what are my key lessons/findings?

- There are only 5 asset classes – Equities, Bonds, Property, Cash/Currency and Commodities. Every product is linked to these 5 in some way – don't assume that there is some new "class/product" that will diversify away your risk. It does not exist.
- When these 5 asset classes correlate to 1, risk models "melt" and prove to be highly ineffective and dangerous.
- Liquidity, liquidity, liquidity is critical. LTCM went to the wall because they held assets that they could not sell. If there is no buyer, then said assets are momentarily worthless.
- When buying a company on 200X Price Earnings Multiple (PE) you are paying for earnings 200 years ahead! Even if the share price falls by 90% it still trades on a PE of 20X, hardly cheap. Amazon lost 90% of its value during the dotcom crisis.
- Structured product invariably blow up when stressed against the sword of reality. Mathematical simulations can create whatever outcome you tell the computer you want!
- When markets are gorging at the table of greed, SELL. When the table is empty of all diners and the fear of the end is apparently nigh, BUY.
- Debt is a fabulous slave but a furious master – there are only 3 ways you can reduce debt. Sell assets, earn profits or raise fresh capital. By the time the crisis hits the only real option is to raise fresh capital, usually at a massive discount to the then share price which is highly dilutive to existing shareholders.
- A confluence of events is typically needed to cause a major crisis – in the current crisis we had extended valuations; the belief that Central Bank "put" options would ensure everlasting euphoria in global financial markets; the peak in the globalisation of trade and all ends of the risk spectrum rallying together.
- The change in the rate of change (either accelerating or decelerating) is what markets reward/penalise, not static numbers.
- When you feel that you have hit your philosophical use by date then markets have probably peaked
- Being too early in your "call" can be career limiting
- Never waste a good crisis

How to navigate your way out of a crisis

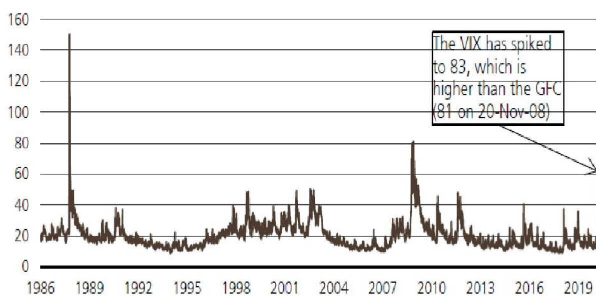
There are 4 basic steps that I have developed thus far in my career to help navigate through a crisis.

1. Understand the causes/drivers of the crisis as best you can.
2. Establish triggers/markers to guide you through the fog of fear once drivers of the crisis have been identified.
3. Communicate these to you, our clients, so that you have an understanding and certainty as to what we will be doing on your behalf as the triggers/markers are checked off.
4. Execute on your view and intuition gained from experience. When there is uncertainty there is no data set to draw upon.

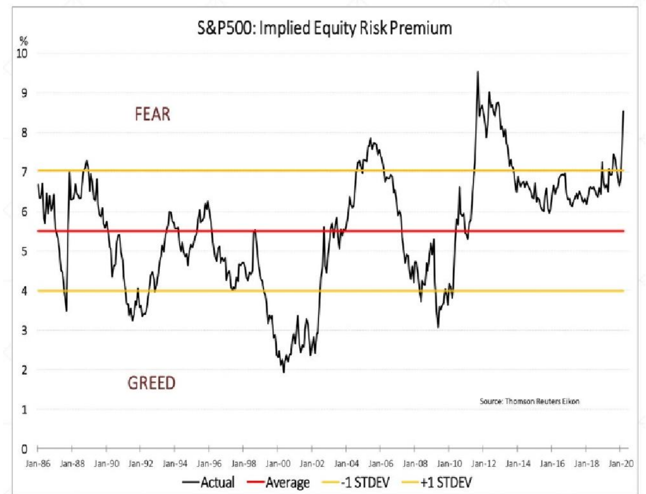
Current Triggers/Markers that we are Monitoring to Navigate Out of COVID-19

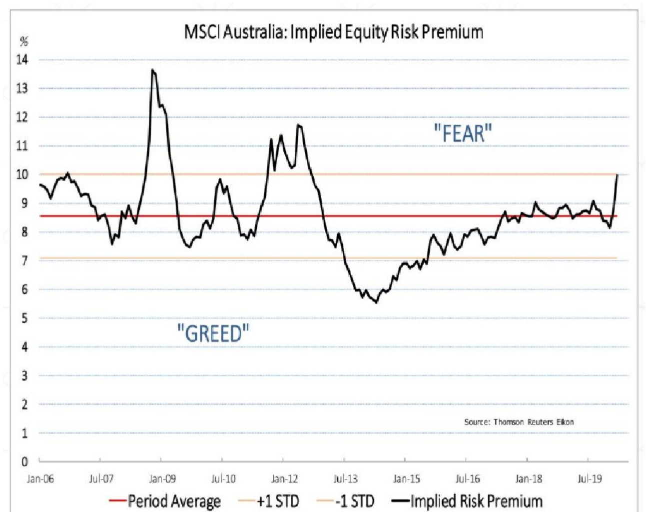
- The AUD/USD cross rate. The Australian Dollar is regarded as the global barometer of growth. In July 2011, at the height of China's demand for Australian commodities the AUD/USD cross rate hit US$1.10. On 19th March 2020 it plunged to US$0.55. The Little Aussie Battler is predicting a major global economic fallout in the next 6 months. The all-time low for this cross rate was US$0.4775 in April 2001 just before Australia experienced the biggest bull run in commodities in over a century! The proximity of the AUD/USD cross rate to this all-time low would suggest that significant economic slowdown has been priced in.

- The Chicago Board of Exchange Volatility Index (VIX) – its current level has exceeded that reached at the nadir of the GFC. There is a lot of fear priced into markets. We need to see this stabilise to determine whether we have hit bottom. A period of the VIX travelling above 50 but below current highs of 80+ typically indicates a bottoming out process in markets.

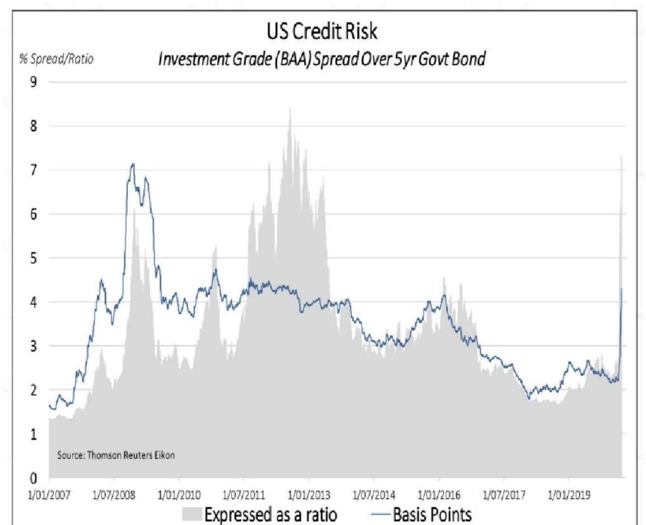


- Watch the interaction between government bond yields and equity prices. We need to see these 2 asset classes performing in an inverse manner (bond yields up, bond prices down/equity prices up) to ensure normal transmission has been resumed. One variation of this measure is known as the Equity Risk Premium. The two following graphs indicate that much fear has been priced into equity markets already.





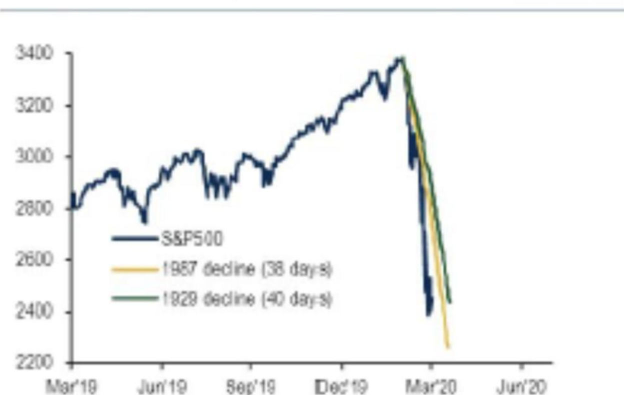
- Monitor corporate bond yield spreads over equivalent duration government bond yields. When the spread is high then much fear has been priced in. Whilst not at the extreme level reached in 2009 at the peak of the panic in the GFC, the current spread indicates a significant change in investors attitude to risk.



- Price shares at the same level they hit at the bottom of the market in the prior crisis – this is a good indicator for an actual level of "cheap". Barclays Bank in the UK in 1974 hit a forward PE of 4X and dividend yield of 14%. No guesses as to what valuation level it reached in March 2009 when it was priced at 65p down from 8 pounds?
- When you first put fresh money to work during a crisis expect to lose 10 – 15% - you can never pick the bottom. Within 12 – 18 months you are likely to be rewarded.

Investment Conclusions

We need to distinguish between event as opposed to corrections driven by structural change. COVID-19 is an event driven correction – fast and furious. The timing and speed of recovery when the event passes, history shows to be sooner and more exuberant than when structural change is afoot. Post the Spanish Influenza Pandemic we moved into the Roaring 1920s. How ironic is it that we may move into the roaring 2020s!



On the policy front, all Governments and Central Banks of the largest economies are alert and aware as to what they must do to avert a deep, prolonged recession. On this occasion, even the IMF has joined the liquidity injection party. There will be failures and fall out, but the stimulus and zero rates provide significant impetus for recovery when COVID-19 subsides leading to a sharp recovery in markets.

Where there is certainty is in China. The "powers that be" can execute unilateral control. When China "re-opens" expect Australian equities to outperform the rest of the world and witness the AUD/USD cross rate to jump dramatically. When this occurs, if you hold significant levels of US cash, you should carefully consider whether it would be better to switch it back into Australian Dollars and be prepared to buy local shares.

Based on the above experiences and monitoring the markers noted above, my hunch is that we are 75% to 85% through this current crisis. Fear is now rampant where once Greed was dominant.

As we said before 'Never waste a good crisis'. We will stay connected with you, but never hesitate to call us for anything you may need.

In the words of Sir Ernest Shackleton, we "need to put footprint of courage into stirrup of patience".

Above all we wish all our clients to remain healthy and safe.

Harry Cator
Director – SG Hiscock & Company
Executive Chairman - DMP Asset Management

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