Hype Cycle

Is it too soon to buy?

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Equity markets as well as other risk assets have corrected in the fourth quarter of 2018 and the question on everyone's mind is: "Is it too soon to buy or should we even sell into this decline?" We analyse the sentiment and fund flow data in global equities and show that equity markets are subject to a fascinating divergence of behaviour. While retail investors seem to have become overly pessimistic, institutional investors seem to have stayed calm and may even have put additional money at work. Past evidence points towards these situations as indicative of a recovery in the next three months.

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Introduction

Every investor knows the sinking feeling when one makes an investment just to see it tank in the weeks right after the purchase was made. Similarly, every research analyst has a couple of reports on the shelf that he wishes he had never written. The last instalment of our Hype Cycle report is one of these.

In that report, published on 10 October 2018, we wrote about the calmness in the movements across the Hype Cycle and the opportunities in biotechnology stocks since they had seen improving price momentum that was followed by increased investor interest and increased flows into biotech ETFs and closed-ended funds. Since then, the Nasdaq Biotech Index has declined 19.7% (as of 3 January 2019).

One might point out that we also emphasized wind energy stocks as an area to be cautious about, but the 7.7% decline in the ISE Global Wind Energy Index pales at a time when risk assets suffered severe declines across the board. Also, the fact that equities, UK property and hedge funds remained in the "despondency" quadrant, indicating that returns should remain subdued or even negative in the fourth quarter 2018, might provide some consolation. But overall, the signals sent by the Hype Cycle last quarter were rather poor.

Due to the strong correction across all risk assets in the fourth quarter, price momentum has turned negative in almost all asset classes we track. Since the hype index we calculate was negative beforehand already, this means that most asset classes are now in the despondency quadrant defined by a combination of negative price momentum and pessimistic investor sentiment. Even some asset classes that investors were optimistic about, like diversified private equity or European property, are now in the despondency quadrant of the hype cycle.

This widespread despondency indicates that it might be too soon to buy into risk assets. However, there are two asset classes that are not in the despondency quadrant that allow a deeper investigation if this conclusion is warranted. Global equities, as well as high dividend stocks, are currently characterised by negative price momentum but positive investor hype.

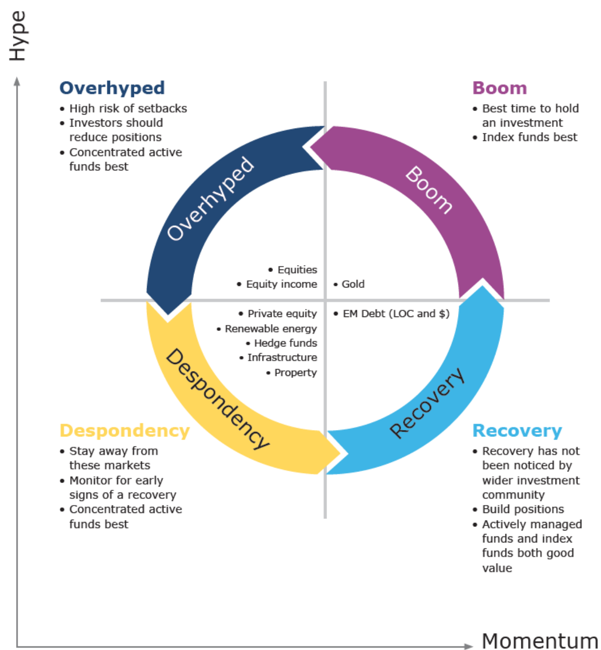
Could it be that this combination, which normally characterises an overhyped market, might in fact indicate the green shoots of a recovery? If one looks at the increased investor demand for gold and the positive price momentum in the yellow metal, one might say no, but we need to investigate both gold and global equities further to fully understand what is going on in markets.

Fig 1: Asset class moves around the hype cycle

Asset class	Hype cycle		Performance last 3M (%)
	Q4 2018	**Today**	
Equities	Despondency	Overhyped	-13.9
High yield	Recovery	Despondency	-4.7
Hedge funds	Despondency	Despondency	-6.1
Diversified PE	Boom	Despondency	-18.5
Property UK	Despondency	Despondency	-9.9
Property EU	Boom	Despondency	-5.5
Property US	Recovery	Despondency	-7.4
Infrastructure	Despondency	Despondency	-6.2
Renewable Energy	Despondency	Despondency	-2.8
Cat bonds	Recovery	Despondency	-1.7
Gold	Despondency	Boom	7.6

Source: Fidante Partners. Data as at 3 January 2019. Past performance is not a reliable indicator of future outcomes.

Fig 2: Hype cycle overview

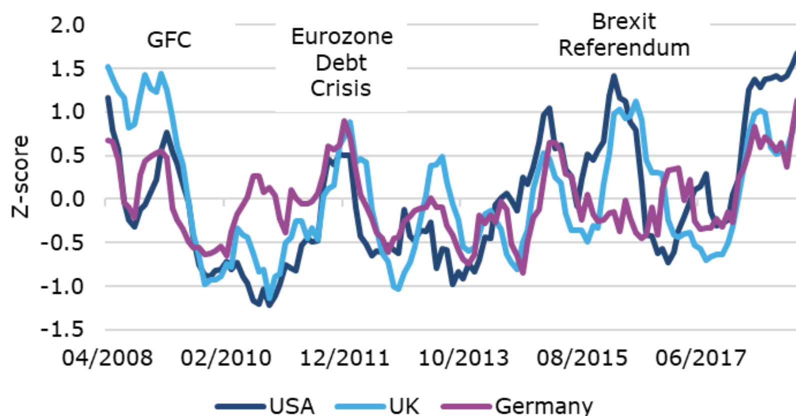


Source: Fidante Partners.

Who is afraid of a US recession?

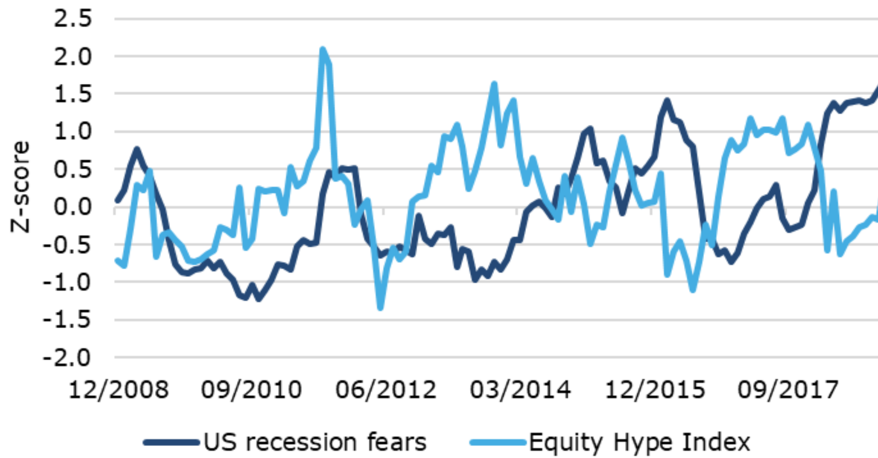
Everyone apparently. In recent weeks, charts have made the rounds that show that the number of Google searches for the word "recession" has reached the highest level since the Global Financial Crisis (GFC). If we follow our standard procedure of normalising 12-month growth rates in word searches (Fig. 3), we can see that in the US, the searches for the term "recession" are very high. Relative to the calmness of 2017, the increase in recession fears is in fact higher than the increase in recession fears in 2008 and 2009. Fig. 3 shows the Google searches for the term "recession" in the US, but also for the UK and Germany (using the German term "Rezession"). Given the potential for a hard Brexit and the weakening economy in Germany, investors in the UK and Germany certainly have more reasons to be worried than investors in the US. Yet, recession fears in the US at the moment seem even higher than in the UK and Germany.

Fig 3: Google searches for the term "recession"



Source: Google Trends, Fidante Partners. Data as at 3 January 2019.

Fig 4: Recession fears vs. Equity Hype Index



Source: Fidante Partners. Data as at 3 January 2019.

Given this increase in recession fears, one would expect our Hype Index for global equities to decline. The Hype Index is a combination of Google searches for terms like "equities", ETF fund flows, and the development of closed-end fund premia to NAV, all of which should decline when recession fears rise.

As Fig. 4 shows, most of the time our Equity Hype Index does indeed provide a mirror image of the development of recession fears. An increase in recession fears typically coincides with a decline in the Equity Hype Index and vice versa. Over the last quarter, however, the Equity Hype Index has risen drastically while recession fears have increased as well. Similar developments could be observed at the end of the GFC in late 2008 and early 2009, as well as during the summer of 2011 when the Eurozone Debt Crisis came to an end and the US narrowly avoided a default.

During these past episodes the co-movement of recession fears and the Equity Hype Index indicated that investors were buying the dip in the midst of a period of negative sentiment. In the months that followed, equity markets did indeed recover from their lows.

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Saying one thing and doing another is typically a skill practiced by politicians and less often by investors, but it could be the reflection of a struggle between different investor groups. If one investor group (e.g. retail investors) is afraid of a potential recession while a different investor group (e.g. institutional investors) is using market setbacks to buy into the market, then this difference in opinion would lead to pessimistic sentiment as well as increased fund inflows for funds dominated by institutional investors and an increase in the Equity Hype Index. In this case, one would assume that the more sophisticated investor group (in our case the institutional investors) would be the one to be on the right side of the trade.

Pessimistic retail investors vs. opportunistic institutional investors

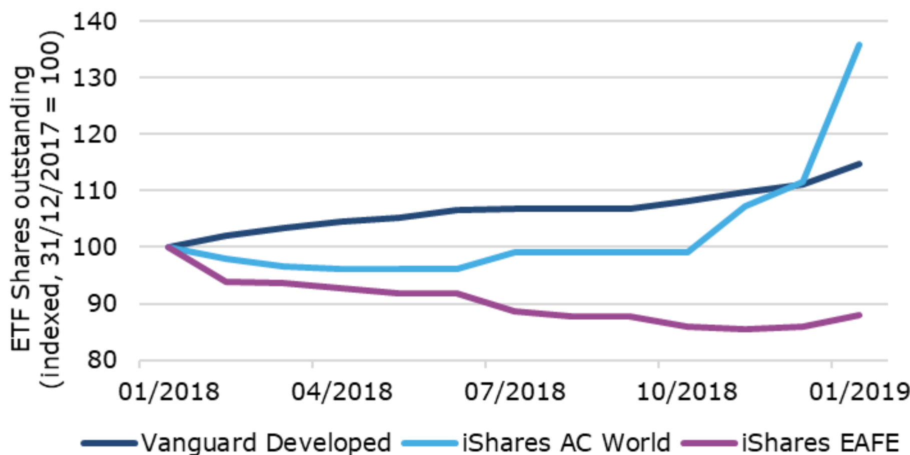
In Fig. 5 we show the development of the number of shares outstanding for the three largest equity ETFs in the US. The Vanguard FTSE Developed Market ETF has a market cap of c. $65bn and is largely owned by different institutional investors (c. 73% of the assets are held by institutional money managers). The ownership structure of this ETF has been very stable over time and throughout 2018 this predominantly institutionally-held ETF has seen stable inflows (dark blue line in Fig. 5).

In comparison, the iShares MSCI All Countries World Index ETF, with a market cap of $11bn, sees large fluctuations in ownership over time. At the beginning of 2018, 40% of the fund's shares were held by institutional money managers. After the February market setbacks, this had climbed to 46% before declining towards 35% as stock markets recovered in the summer months. This fund seems to act as the vehicle in which to invest if one wants to buy the dips. In late 2015 and early 2016, when stock markets had their most recent significant correction due to the decline in oil prices and the worries about a Chinese growth slowdown, institutional investors increased their stake in this ETF from 25% to 55% within six months.

Since the latest 13-F filings of institutional investors are not publicly available, yet, we can only speculate whether institutional investors have added to their positions in the fourth quarter of 2018, but what is remarkable is how much assets under management for this ETF have risen in November and December (light blue line in Fig. 5).

Finally, the third ETF we track in Fig. 5 is the iShares MSCI EAFE Index ETF which tracks stocks outside the US and has a stable institutional ownership of about 75% of the fund's assets. This $62bn behemoth again acts more like a long-term core holding for institutional money managers than a tactical instrument with which to take advantage of short-term market dislocations. As European and Asian markets have consistently underperformed the US throughout 2018, this ETF has seen a steady outflow of assets that only stopped in December, when US stocks started to underperform European markets.

Fig 5: Cumulative fund flows of three large US-based ETFs

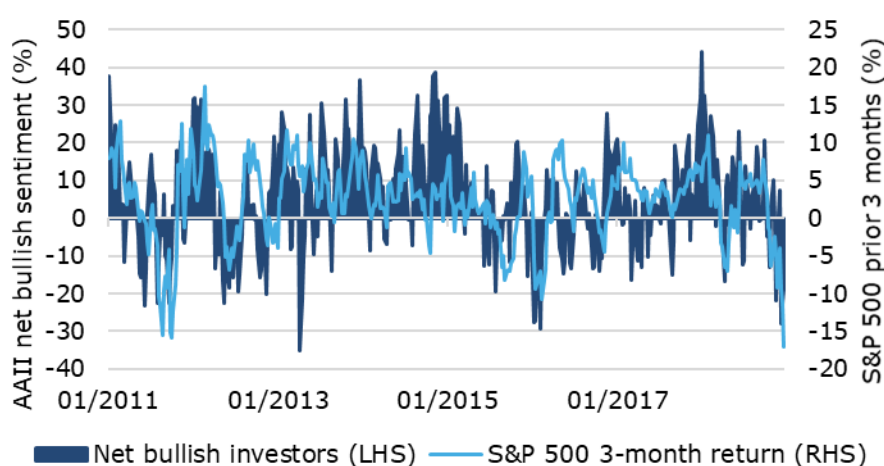


Source: Bloomberg, Fidante Partners. Data as at 3 January 2019.

It seems as if institutional investors have largely held their core holdings stable while increasing positions in ETFs that have historically been used as tactical instruments. While we cannot know for sure until the latest set of 13-F filings have been made, it seems as if institutional investors have bought stocks as markets corrected in the fourth quarter of 2018.

But for our hypothesis of a divergence between retail and institutional investors to be correct we need retail investors to show signs of increasing pessimism while institutional investors remain level-headed. The American Association of Individual Investors runs a weekly survey amongst its members on their outlook for US stock markets in the next six months. Fig. 6 shows the difference between the percentage of respondents who are bullish and the percentage of investors who are bearish. This net bullish sentiment of retail investors typically closely follows the past performance of the S&P 500 and has become increasingly pessimistic throughout the fourth quarter 2018.

Fig 6: Retail investor sentiment



Source: Bloomberg, Fidante Partners. Data as at 3 January 2019. Past performance is not a reliable indicator of future outcomes.

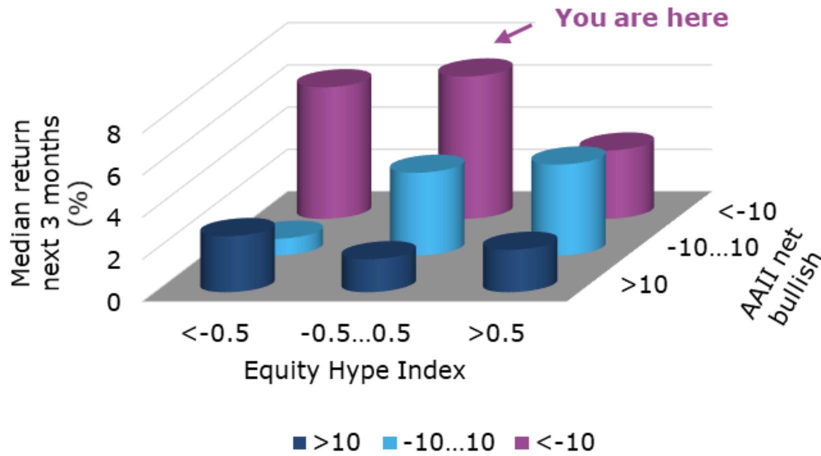
Fig. 6 shows that the second part of our hypothesis also seems to be correct. Not only have institutional investors remained largely level-headed and maybe even invested more in stocks as they corrected, retail investors have increasingly become pessimistic, which might have driven the increased Google searches for terms like "recession" we saw earlier.

If this tug of war between retail investors and institutional investors exists, then one would naively expect that one should follow the view of the supposedly more sophisticated institutional investors. In order to test this assumption, we have looked at the performance of the S&P 500 index over three months depending on the constellation between retail investors and institutional investors since 2008. Because our Equity Hype Index is mostly driven by institutional behaviour rather than retail investor sentiment, we use this index as a proxy for institutional investors and the AAII net bullish sentiment as a proxy for retail investors.

We split the index readings of both variables into thirds. The third most negative retail sentiment readings are indicated by AAII net bullish sentiment below -10 while the most optimistic ones are readings above +10. For AAII net bullish sentiment between -10 and +10 we consider retail sentiment to be undecided.

Similarly, we characterise the most pessimistic periods in our Equity Hype Index as periods with a reading below -0.5 and the most optimistic periods by a reading above +0.5. An equity Hype Index between -0.5 and +0.5 indicates a "meh" attitude towards markets.

Fig 7: Future stock market performance as a function of retail sentiment and Equity Hype Index



Source: Bloomberg, Fidante Partners. Data as at 3 January 2019. Past performance is not a reliable indicator of future outcomes.

Several observations stand out in Fig. 7. First, the row of light blue coloured bars shows that if retail sentiment is undecided (between -10 and +10) stock markets do better the higher the Equity Hype Index is. This is the foundation of our Hype Cycle since a higher Equity Hype Index indicates increasing inflows into funds and expanding premiums to NAV for closed-end funds. Thus, these times create their own virtuous cycle of improving price momentum creating additional inflows, which in turn create more inflows etc.

If retail sentiment becomes too pessimistic, as is currently the case, then higher readings of the Equity Hype Index are no longer predictive of higher future stock market returns. The highest equity market returns have historically been achieved when retail sentiment was excessively pessimistic, and the Equity Hype Index was either negative or neutral. This is exactly the situation we are in today. If the Equity Hype Index is very low at the same time as retail sentiment is very pessimistic, we have the classical capitulation phase of a stock market when every investor is throwing in the towel.

However, when the Equity Hype Index is close to zero while retail sentiment is very pessimistic, this indicates a situation where retail investors are scared for no reason. In this environment it is typically better to remain invested and wait for a recovery in stock markets. In the seven instances over the last ten years when we have observed such an environment, stock markets had a positive return over the subsequent three months in six cases (83%). Quite good odds for a recovery.

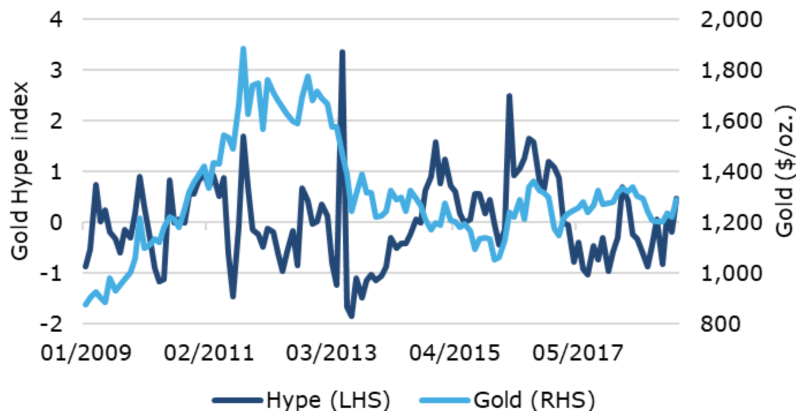
> “During the last decade, in six out of seven instances when we could observe a similar environment as today, stock markets had a positive return over the subsequent three months.”

Is the gold boom going to last?

Stock market bears have pointed out that it is not only the decline in risky assets that is cause for concern but also the rise in gold prices and other safe haven assets. During the fourth quarter 2018 gold prices rose almost $100/oz. and at the time of writing they are closing in on $1,300/oz. As Fig. 8 shows our proprietary Hype Index for gold followed the price momentum into positive territory, positioning gold as the only asset class firmly in the "boom" quadrant of the Hype Cycle.

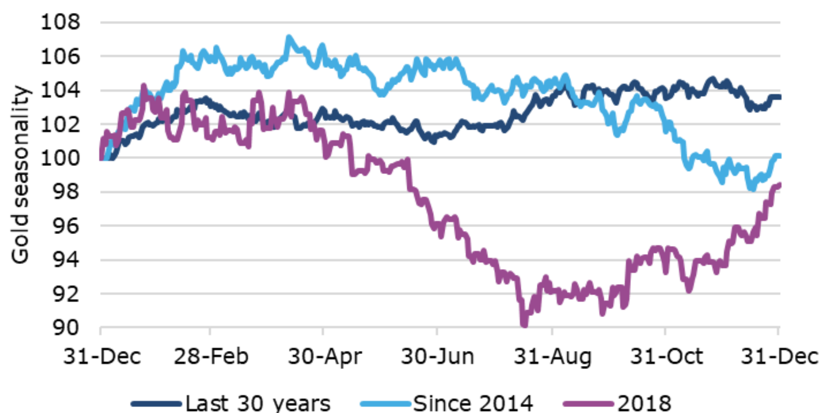
Our spontaneous reaction to this rally in gold is one of scepticism since gold traditionally has a seasonal pattern with rising prices from September to the end of February and declining prices from March till August (Fig. 9). This long-term seasonal pattern disappeared over the last five years since the gold crash of April 2013. In 2018, gold started to follow this seasonal pattern somewhat more closely again with a rally up to February followed by declining prices from March until September and a recovery from October onwards. While the recovery of gold in the fourth quarter 2018 came somewhat later than the typical seasonal pattern would suggest, it was also more pronounced, especially in December when the rally accelerated.

Fig 8: Gold price and Gold Hype Index



Source: Bloomberg, Fidante Partners. Data as at 3 January 2019. Past performance is not a reliable indicator of future outcomes.

Fig 9: Seasonal pattern of gold prices

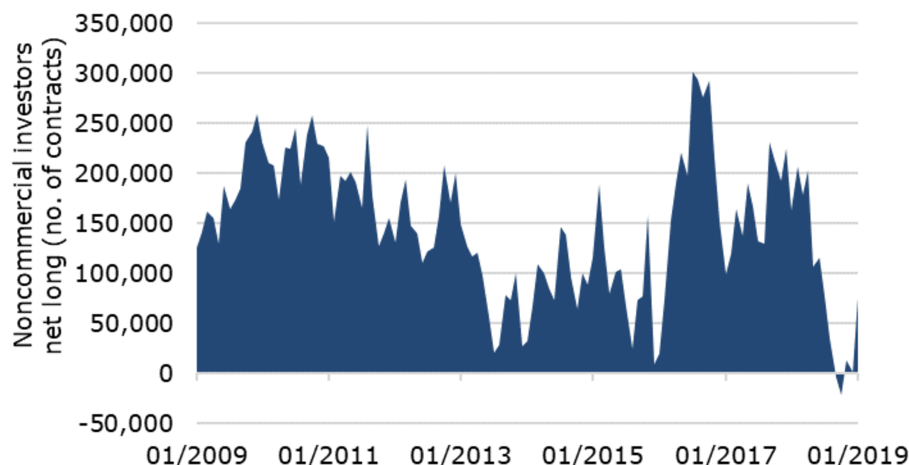


Source: Bloomberg, Fidante Partners. Past performance is not a reliable indicator of future outcomes.

This seasonal pattern of the gold price is rooted in the demand for physical gold from India. Gold has played an important role as a wedding gift and in a country with a severely underdeveloped banking system it often serves as a store of value for the rural population. Demand from the rural population in India accounts for roughly two thirds of Indian gold demand. These demand factors have made India the second largest buyer of gold globally and exposes gold prices to demand fluctuations that are linked to the Monsoon season. As the rainy season starts in spring, demand for gold declines and then picks up again at the end of the rainy season in late summer. However, in recent years, rising import duties for gold have dampened Indian gold imports somewhat and may have helped reduce the traditional seasonal pattern.

But with the re-emergence of the seasonal pattern for gold in 2018, one might speculate that gold prices may continue to rally for another month or so. What supports this notion is the observation that speculative investors are starting to increase their long positions in gold futures again (Fig. 10). After a significant decline in speculative net long positions throughout 2018, to the point when hedge funds and other speculative investors were net short gold in early October 2018, they are now following prices higher. At least in theory, this increased demand for gold futures might lead to rising prices for the physical underlying but the historic relationship between futures positioning and gold prices is weak at best.

Fig 10: Speculative investor positioning in gold futures



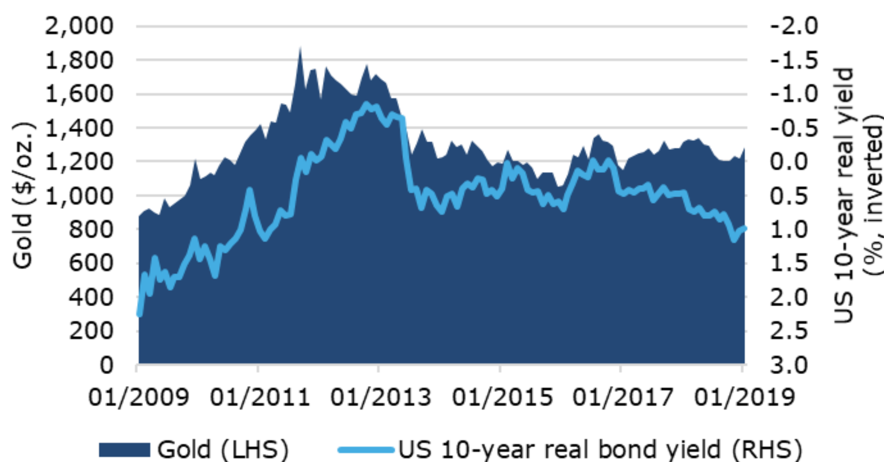
Source: Bloomberg, Fidante Partners. Data as at 3 January 2019.

While indicators such as seasonality or investor positioning in futures markets remain supportive of gold for now, one needs to be aware that these indicators are much less reliable for gold than similar indicators in stock markets. Gold prices are famously volatile and hard to predict. In the medium to long term, the best predictors of gold prices are inflation and real interest rates. And the real yield of US TIPS has increased steadily throughout 2018 while inflation expectations have remained well-anchored. As Fig. 11 shows, this has led to a divergence between the price of gold and the real yield on US TIPS. The last time a similar divergence was observed was in the second half of 2013, when 10-year real yields increased from 0.4% to 0.7% while gold prices remained largely stable. The divergence was eventually resolved throughout 2014 when gold prices declined $100/oz. while real yields dropped to 0.5%. Today the 10-year real yield in the US is hovering around 1%, which we would consider too high in an environment of slowing US growth. However, with the Fed hiking interest rates, we would be surprised to see a significant decline in real yields as long as the Fed sticks to its planned two rate hikes in 2019. Of course, it is possible that

the Fed will be forced to change course and stop hiking interest rates sooner than expected. In this case we should expect real rates to drop significantly, providing further support to gold prices. But this remains outside our main scenario for the time being.

Thus, we would abstain from following gold prices higher at this point. While the current rally may well continue into February, the time window is increasingly short and difficult to exploit for institutional investors.

Fig 11: Gold and real interest rates



Source: Bloomberg, Fidante Partners. Data as at 3 January 2019.

Conclusions

While it is impossible to call a bottom in equity markets and other risk assets at this point in time, we have shown in this report that the evidence points towards a divergent behavioural pattern between retail and institutional investors. While retail investors have become excessively pessimistic about equity markets, institutional investors seem to have remained more level-headed and may even have put additional capital to work in order to benefit from lower prices. Our analysis of similar developments in the last ten years shows that these situations typically were followed by positive returns in stock markets in the next three months. Of course, things might be different this time and the poor track record of our analysis for the fourth quarter 2018 should dampen our optimism. But in our view the odds are in favour of a recovery in equities and other risky assets in the first quarter of 2019.

The only asset that is booming at this time is gold. Gold has had a remarkable recovery in the fourth quarter of 2018 and investors are increasingly optimistic about the near-term prospects for the metal. However, this recovery in gold prices may have been driven by fickle and less reliable drivers like seasonality and speculative positioning in futures markets. While these indicators do have some predictive value in equity and bond markets, the empirical evidence is less convincing in the case of gold.

On the other hand, the current rally in gold prices is at odds with the 2018 increase in real interest rates. It could be that real interest rates have risen too far given the current growth slowdown in the US, but as long as the Fed sticks to its projected two interest rate hikes in 2019, we find it difficult to envision a scenario of declining real rates that could support the current rally in gold. Overall, we think that the current gold rally may well continue but the time window for the continuation of the rally is increasingly short and it seems difficult for non-traders to benefit from the rally.

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