A STOCK MARKET DETACHED FROM REALITY.
Are Passive Funds to blame?

The capitalists always like to boast about their prowess. The fact is that only 10% of their winning decisions are based on ability. The biggest factor is economic conditions (75%). Most investors make profits when the going is good. If further proof of this was needed, look no further than indexed based funds which have now outstripped active funds (stock picking funds where ability predominates). However, these ETF's and passive funds which appear riskless when the going is good, become ticking time bombs when stock market indexes start falling.

On the 12 February John Gittelsohn published a report on Bloomberg's website analysing the changing relationship between passive funds and active funds in an article titled: *Passive Funds Overtake Stock-Pickers in the U.S. Large-Cap Market.* Using MORNINGSTAR data, he revealed that passive funds (including ETFs) had grown from 40% in 2008 to 104% by 2018 relative to the size of active funds. In total, both sets of funds amounted to $5.7 trillion in 2018 or about one quarter of the total market (although by being more active they punch above their weight). The reason passive funds have grown so quickly is that in terms of returns, they have beaten active funds by three to one. (https://www.bloomberg.com/news/articles/2019-02-12/passive-funds-overtake-stock-pickers-in-u-s-large-cap-market)

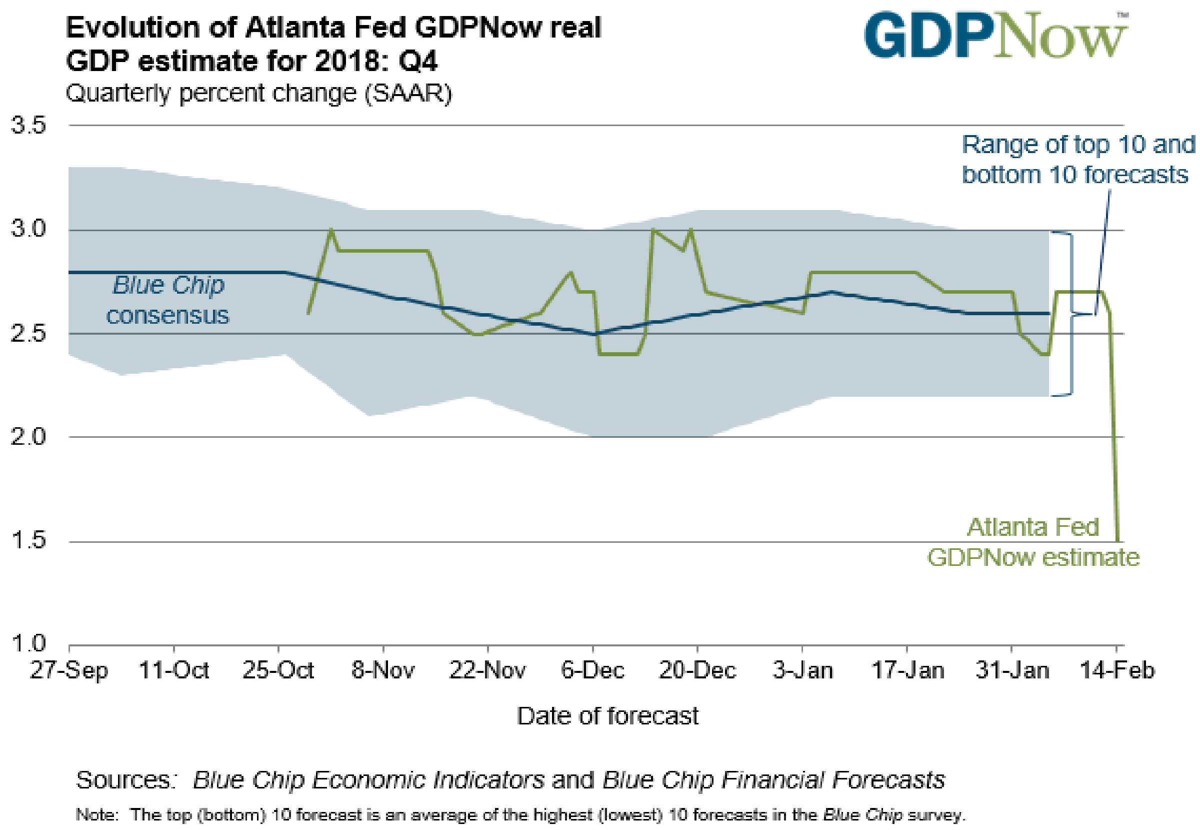
Stock markets have risen for 8 straight weeks in succession this year, in inverse proportion to the weight of negative news. The negative news has been unrelenting around the world. A synopsis follows. Global trade volumes actually fell in December. This is verified by the Baltic Dry Index which provides the going rate for hiring large dry cargo vessels.

Graph 1. Baltic Dry Index Chart.

Although it has not fallen to levels last seen in 2016 it has fallen by two thirds since the middle of 2018. Hiring rates for vessels are now well below break-even.

Germany narrowly avoided a technical recession as growth was revised upwards to 0% for quarter 2 having fallen by 0.2% in the previous quarter. Similarly, over the second half of 2018 the Japanese economy contracted. In the United States GDP data is delayed because of the government shutdown. However, projections for the final quarter of 2018 have been revised sharply downwards from between 2.5 to 3.0% to only 1.5% as shown by the green line in the Graph 2 below. So much for the Trump bump which lasted exactly nine months.

GRAPH 2. Forecast for US GDP growth 4th Quarter 2018



The reason was the sharp reversal in retail sales in December. Instead of the consensus rise of 0.1% it fell 1.2%. Of course, a number of reasons or should we say excuses have been put forward, but they can be dismissed, because preliminary data for January show a fall double that of December. (More in the section on Amazon and Google) There is a distinct likelihood that US GDP for the first quarter of 2019 could fall to as low as 0.5%. The *Econoday* weekly report (a useful buy at under £2 a month for the electronic version) shows how the data, with few exceptions, fell below the consensus range set by economists. While some prints for January are not as bad as December, the international reporting is still one of a decelerating global economy.

The prospect for US corporate profits grow dimmer by the week. In the previous week, FACTSET EARNINGS INSIGHT projected a fall of 1.8% in earnings per share for the S&P 500 this quarter, now they project a fall of 2.2%. This extends to at least the mid-year. If profits per share for the S&P are falling, then real corporate profits are falling even faster. For this reason, it is likely that unadjusted real corporate earnings fell in the fourth quarter with this fall accelerating into the current quarter. The reason the S&P 500 is so important is that it represents 80% of the total value of US stock markets which at $30 trillion represent over 40% of the global total for stock markets.

The Price to Earnings Ratio remains elevated as Graph 3 shows. The Shiller Index needs to be treated with caution as it looks back ten years. If that ten years includes a recession it can be distorted. However, as the up to date Index reaches to February 2009, it avoids the worst of the financial crash. Thus, it is comparatively robust. In contrast to the current Shiller Index reading which stands above 25, the forward p/e is around 16 with a median of around 15. This is above the ten-year average, though it is not as overpriced as it was in mid-18 when it approached 20.

Graph 3. Shiller P/E Index.

In evaluating the world economy, it is important to differentiate the industrial from the financial. When the United States was both the dominant industrial and financial economy, this was not necessary. But today the US only dominates financially despite China's astounding 60% share of global credit-creation these last ten years. However, it is China that dominates the world industrially and while the attribute, "when China sneezes…." Is not yet earned, it is clear that the industrial slowdown that has occurred in China has impacted a whole number of major economies such as Germany, Japan and South Korea.

The key question is why have stock markets outperformed the world economy. Clearly momentum is in play rather than valuations because there is nothing in the hard data globally to suggest anything is improving over the next six months. The worst December for the global stock markets since 2008 was followed by the best January performance since 1987, and yet as January's economic data emerged, it grew increasingly negative.

Four factors may explain this disconnect. Firstly, the U-turn by the FED on further rate rises. Secondly, positive comments on the trade dispute between China and the US started outweighing negative comments albeit superficially. Thirdly, China increased its financial stimulus even as the US tax stimulus wore off. Fourthly, that these market rises have been engineered in both China and the USA as part of the posturing by both countries during the negotiations.

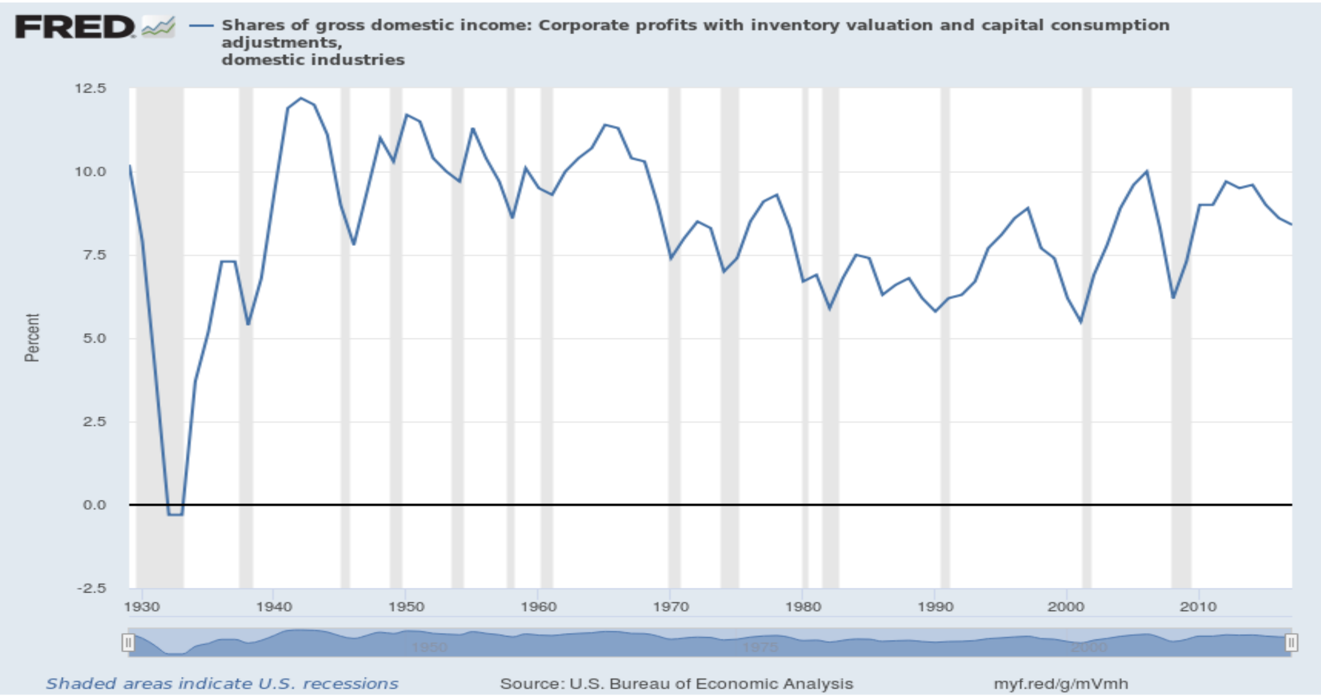
The fourth point is worth elaborating on. The financial blogosphere is full of commentary on why the markets have been rising. Primarily the debate is about who is supporting it. Professional investors and funds are currently shunning the market because of concern over deteriorating fundamentals and outlook. For example, the recent sharp miss on December's retail sales, the worst since the last recession, barely fazed the markets, which is highly unusual. It could of course be the march of the algorithms where the highest weight is not aligned to fundamentals but to the behaviour of the FED. And of course, it could be down to the volume of share buybacks and bank buying aimed at propping up the market.

Clearly, if there was a bloodbath on both Wall Street and Shanghai, that would rob the negotiators of any advantage on both sides. To date the concessions offered by China, while beneficial to farmers, oil companies and tech companies, is marginal to the economy as a whole. In fact, the opposite is the case. It is not a question of what to gain but what to lose. About a quarter of US corporate profit margins arise from cheaper inputs originating from China in particular. Raising the cost of these inputs because of 25% tariffs will result in a severe hit to already weakening profit margins.

US profit margins are not robust enough to weather such a challenge. As Graph 4 shows, pre-tax profit margins which peaked in 2014 have been falling long before Trump came to power. And they have been falling partly because China's ascent up the value chain has begun to erode the US's monopoly position. This is most evident in the smartphone industry where Apple is now being forced to discount its over-priced iPhones ending its 60% share of global smartphone profits. (There has also been a slowdown in the annual rate of turnover which has impacted profit margins.)

A further rise in tariffs will merely accelerate the fall in profit margins. Thus, there is really no hard evidence that negotiations will help restore profit margins and therefore support the current rise in share prices. Nor will attempts by the US to maintain its intellectual property. Those halcyon days are long past. All the US can do is slow down a process that is underway, set up obstacles as in the case of Huawei, none of which will restore profitability, only decelerate its decline.

Graph 4. US Domestic Industry pre-tax Profit Margins.



Instead the opposite is the case. Global capitalism requires an end to national peculiarities. This always weighs on profit margins by increasing the expenditure of unproductive labour on pushing paper to resolve these peculiarities, or, productively by disrupting production to meet specific regulations rather than universal regulations. At a time when global profits are under pressure, the move to intensify national peculiarities is undermining profitability.

But it is not only in the realm of commodity flows that tariffs are raising its head. A recent study by *Freshfields Bruckhaus Deringer,* the international law firm specialising in cross country mergers and acquisitions, has shown that 60% of G20 countries have now tightened rules on foreign acquisitions of local firms. Thus, in the name of national security, the process of centralising capital in order to improve profit, is being obstructed.

The stock markets are thus in dangerous territory. An unjustified rise means a greater consequential fall. The recent rise in share prices could quickly unravel. The violent gyrations in share prices in December showed the presence of unruly algorithms. If indexes start falling, and continue to fall, then passive fund selling will become intense, because these funds have only two rules: chase upward index momentum or retreat from falling indexes. The former pushes up share prices while the latter collapses them.

Alphabet and Facebook.

One of the other factors propping up share prices are Tech companies like Facebook and Alphabet (Google). As expected they played the game during the current reporting season by beating expectations in terms of revenue and profits. How long they can continue to do so is numbered. Their business model is based on a growth in e-commerce. However, contained in the December figures was a disturbing slowdown in e-commerce sales. These sales which were growing at an annual rate of 14.5% in the third quarter fell a third to only 9.6% in December. Worse, adjusted sales in December were lower than in November and October.

This is an iPhone moment. When Apple decided to introduce more expensive phones to compensate for falling volume, I predicted that the world's largest company was a busted flush. And so it has turned out. Now it is the turn of the rest of the FANG corporations. The only thing that has sustained their business model was rapidly rising ecommerce sales. The outlook for January e-commerce is even bleaker because this is when returns have to be accounted for. Returns as a share of sales has been increasing particularly for e-commerce. The failure to issue net sales, or sales which are duplicated through the secondary sale of these returns has artificially inflated both the growth and size of e-commerce. In addition, processing these returns are costlier for e-commerce because they have to be collected. If net e-commerce sales are now subsiding, while new entrants crowd in, then the premium paid for FANG shares are over.

This is particularly true for Amazon. The draconian conditions within Amazon's distribution network is not a sign of its underlying profitability but its lack of profitability. Amazon has to compete with consumers driving or walking to shops, then walking up the aisles filling their own trollies, then going to the checkout counter, then walking or driving their products or groceries home. All of this is unpaid. On the other hand, Amazon has to pay for these processes.

Amazon survives by overworking its labour force and minimising taxes. If a level playing field on taxes, both national and local was in place, after tax profits would evaporate. Furthermore, as of January 1st this year, accounting rules covering long term leases has changed. Instead of accounting for them piecemeal on a month by month or quarterly basis, the long-term liability of these leases have to be accounted for. For example, if Amazon leases a truck for three years, it has to account for the full three-year liability, instead of the amount it paid in the reporting quarter. Only now will the leverage of corporations like Amazon become apparent and it will be ugly.

Similarly, the subsiding of ecommerce threatens Google and Facebook, but in a different way. Shoshana Zuboff's new book on surveillance capitalism has taken the intellectual world by storm. It is a scholarly book which I intend to review shortly. However, like most of the books in its field it presents capitalism to be a much more sophisticated system and thus misses out on its crudities or more accurately, the contradictions that trap it. But it is precisely these crudities which determines its profitability and it is these crudities which places definite limits on the use and exploitation of information data.

This needs to be spelled out. When the likes of Google first emerged selling big data it helped focus and redirect sales. It gave a comparative advantage to those who first deployed this knowledge resulting in higher sales than rivals. This allowed the sellers of this knowledge to charge a premium and make super-profits. But soon the sale of this knowledge to broader and broader sections of industry and commerce ensured that rivals were also in possession of this data. The competitive field was levelled, and the comparative advantage was lost.

This marked the commodification of this data. Once this occurred the advantage moved from the seller to the buyer. This was particularly true for the biggest spender of all on data, the advertising industry. Whichever way Google, Facebook and their ilk may like to present themselves, they are just advertising platforms, no less no more.

Big advertisers like Procter and Gamble have begun to question the cost effectiveness of this data. As a result, the advertising industry is undergoing convulsive change as middle men are shoved out of the way and advertisers take a direct interest in directing and investigating their advertising spend on digital platforms. Two problems confront advertisers. The limiting factor is not knowledge it is income. If the majority of one's customer base suffer income that is stagnant to falling in real terms, because wages are not keeping up with prices, or because health and housing costs are emptying pockets, then knowing who your customer is not as important as how much they are able to spend. And the lower their income the lower their discretionary spending. Knowing consumers better than they know themselves, anticipating their every move, does not put money into their pockets.

Secondly, smartphone, tablet and PC advertising breaks all the rules. Modern marketing emerged in the 1930s to provide "mood music" rather than factual information. Adverts today which pop-up all over screens are aggressive and intrusive, eliciting exactly the opposite reaction to that intended, it pisses off the viewer. This is particularly true of high-end consumers. By degrees advertisers are beginning to question the efficacy of digital advertising.

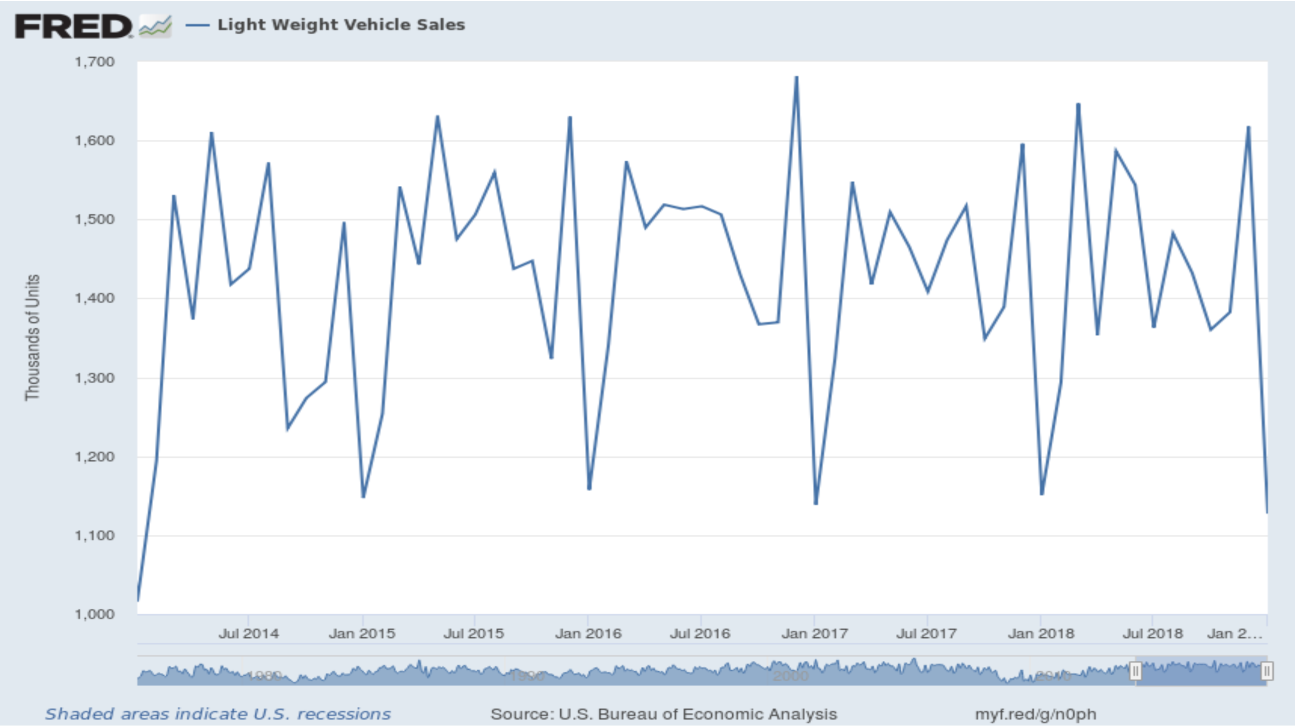
Combine this with decelerating e-commerce sales and the halcyon days for these corporations are over. With their sales falling, the big advertisers like Procter and Gamble (the world's biggest) will cut back on their advertising sharply. Why pay for data when you know that the impoverishment of society is leading to the inevitable growth in cheaper own-brand sales. Knowing, is different to being able to change behaviour when needs must. Thus, the biggest prop holding up the stock market, the mislabelled high-tech companies, is rotting away below the surface.

Finally, there is another side to machine learning. The primary purpose of machine learning (ML) is to find connections, structure, patterns not easily discernible, because the more information which is collected, the noisier it becomes. But ML contains a fatal flaw which is only now becoming apparent. Algorithms are designed to find connections, any connection, for that is their prime directive. But connections can be misleading. They can be counter-productive and waste a lot of time and money when researchers and others are diverted chasing these spurious connections. That is the difference between real intelligence (based on experience) and learning.

In conclusion.

There has been one real recent connection, one which does not require any artificial intelligence: the connection between spending and asset bubbles. In our 1929 world of inequality, where the top ten percent spend as much as the bottom eighty percent, any deflating asset bubble immediately impacts spending. The spending of the top 10% is predicated on whether they are enjoying "capital gains" or not. If stock prices in particular are depreciating, this makes them feel less rich and it causes them to curtail their spending. It was this effect that caused the unexpected sharp fall in retail sales in December. It is also the cause of the plunge in high end vehicle sales this January to the lowest since 2013, as Graph 5 below shows.

Graph 5.



The same applies to housing sales, both new and existing residential sales.

Graph 6.

The final observation is the most pertinent. It is this. Recent tax or credit impulses have had effects shorter in duration. The Trump tax cut endured for all of nine months before GDP growth fell back to abnormal. In China, the credit impulse around its most recent Congress lasted all of 18 months. It is taking more debt to obtain less growth over a shorter period. Combine this to the depleted options facing central banks and the prospects of emerging from the Crash of 2019 is bleak.

More and more financial authorities have become resigned to collapsing global growth for the indefinite future. The Japanesing of the world economy is seen as a distinct possibility, because pumping additional liquidity into the world economy yields only diminishing returns. This represents a distinct change to the view held in mid-2018.

A few economists venture further and suggest a recession is imminent. A number of major countries have skirted with recessions over the last six months and the general trend is downwards. The Chinese Communist Party unleashed a huge credit impulse in January which is unlikely to reverse the downward trajectory of the economy, but it could delay a global financial crash for a few months. Nor is the resolution of the trade dispute of major significance. It is but one skirmish in an escalating war. This quarter will determine the fate of the world economy.

And here lies the final indictment of the information age. The Chinese Authorities are using social media to track and influence the behaviour of their citizens on an unprecedented scale. But they know that these efforts will come to nought if the economy fails and jobs are not provided. Xi has not turned himself into a Napoleon in order to make social media more effective, he has done as dictators have done for centuries, to better deal with social unrest through good old-fashioned political repression.

Brian Green, January 2019