MOI GLOBAL

Default to Optimism: Our Investment Outlook in a Complex World

This article is excerpted from a letter by Peter Mantas and Matthew Castel, general partners of Logos LP, based in Toronto, Canada.

Most asset managers, analysts and pundits are currently being asked the same question: “What is your target for the S&P 500 next year?” or “what will next year hold for equity markets?”

As we’ve said in the past, predicting where the S&P 500 is going to be one month from now is hard enough, so trying to predict where prices will be a full year from now is almost pointless.

Who could have predicted at the end of Q4 2018, a time in which stocks had experienced their worst December since the Great Depression, that in 2019 if you add in dividends, the S&P (in $USD) would rally 30%+?

Looking back at our year-end Q4 2018 letter last year we stated the following:

“We also believe that there is a chance (that many are not pricing in) that markets will break out massively to the upside if several uncertainties which have clouded the minds of investors are resolved. To name a few, think Brexit, China-USA tensions, gridlock in Washington and fears of China slowing down. The buying would be exacerbated by the fact that investors have already reduced portfolio risk in 2018 and seem poised to continue to do so in 2019. The FOMO buying by excessively bearish managers caught flat footed could be intense.”

Seems like we may have been on to something as after large selloffs markets tend to recover as the pendulum swings back from extreme fear…

Nevertheless, after a 30% year for the S&P, such a call is certainly more difficult to make and so as a new decade dawns, we feel confident in predicting that the search for outsized yet sustainable investment returns is not going to get any easier. Instead, it will likely get harder as too much capital chases too few good deals.

Interestingly, through the middle of December 2019 sentiment was above average on less than 10% of all trading days. Since 1990, there have only been six other years where sentiment was above average on less than 15% of all trading days, and in the year after each of these occurrences, the S&P 500 was higher for an average gain of 22% compared to an average of just 7.2% for all other years since 1990.[1]

Furthermore, measures of sentiment among institutional investors are still suggesting a major lack of confidence in the bull market evidenced by significant portfolio exposure to cash and cash equivalents.[2]

In addition, data from the 1950s to the 2010s suggests that when the market goes up 5% or less over a 20-month period, returns in the two years ahead tend to be stellar. Taking a composite of these periods implies a 53% return for the S&P 500 over the periods that follow flat markets.

This points towards returns that could top 25% for the S&P 500 in 2020, with 2020 potentially serving as the mere beginning of this new breakout rally.[3]

Regardless, the pendulum can often violently swing from extreme fear to extreme greed and thus we will continue to look for signs which confirm that markets have entered into the “belief” stage or even final “euphoric” stage of this secular bull market. Nevertheless, we feel like we are simply exiting a mid-cycle correction period rather than entering into an “end of cycle” period, yet time will tell. On a more specific level, we believe that this year will be the year of fiscal expansion as monetary policy is running out of road. As such, the biggest (obvious) risk facing investors will likely be if monetary policy loses all effectiveness and governments shy away from fiscal stimulus.

As for the U.S. specifically, we believe that if unemployment remains low, and wage growth picks up, Trump is likely to be re-elected and his re-election could bring more relief to markets, as Wall Street will know who they are dealing with. Furthermore, the U.S. tends to be politically aligned with trends in the U.K. and we just saw Boris Johnson win by a landslide…

To wrap up the decade, contrary to the 24/7 news cycle and the default outlook of pessimism which seemed to pervade the 2010s, we believe the past decade just might be the best in history.

The world is far from perfect but we’ve seen unbelievable improvements in areas like extreme poverty, technological innovation, and living standards over time.

At Logos LP we choose optimism as the default setting and as we move into the next decade we do so with the following reflection:

> “Praise and blame, gain and loss, pleasure and sorrow come and go like the wind. To be happy, rest like a giant tree in the midst of them all.” –The Buddha

[1] Bespoke Investment Group.
[2] State Street Investor Confidence Index.
[3] Fundstrat’s Tom Lee.