How to Invest When Both Stocks and Bonds Are Overpriced

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[Introduction by Dan Steinhart, Managing Editor, The Casey Report:

Today we get to hear from a seasoned hedge fund manager with over a decade of experience in financial planning and investment consulting. The hedge fund he runs is anything but typical—it doesn't invest in stocks, bonds, or even commodities.

***Mark Whitmore** is CEO and founder of Whitmore Capital Management, a currency hedge fund. His strategy is simple yet effective: identify currencies that are out of whack with their fair values, then bet on them to return to fair value, which they usually do.*

Why currencies? In the first place, the currency markets are the largest and most liquid on earth. Second, over the long term, currencies have little correlation to the performance of stocks or bonds.

That second point is critical, and here's why: You used to be able to hide from weakness in US stocks by investing abroad. If you expected the S&P 500 to struggle, you could put some money in the Nikkei to diversify.

That doesn't work so well anymore. Since the world's central banks revved up the printing presses in unison after the 2008 financial crisis, correlation between developed markets has soared. When a crisis hits, pretty much all stocks fall, regardless of what market they trade on. You can "diversify" into as many stocks in as many different locales in as many different industries as your brokerage account can handle. But you still won't be truly diversified, because you'll still own just one asset class: stocks. …

Back to our friend Mark Whitmore. As you'll read below, currency investing is one of the solutions to the dilemma of how to properly diversify. Read on for Mark's fascinating analysis of stocks' and bonds' dismal prospects, followed by his specific advice on which currencies to invest in now to both truly diversify your portfolio and generate uncorrelated returns.]

We take certain realities for granted—like the reality that nearer events are easier to predict than ones that are further ahead.

For instance, I have been a Seattle Seahawks football fan for 37 years now, as evidenced by my ever-burgeoning amounts of gray hair. Needless to say, their Super Bowl victory was a lifetime sports highlight for me. They are a young team, and their best players are generally signed to cheap contracts for another couple of years. If you were to ask me what the odds are that they will make the play-offs next year, I would say roughly 75-80%.

However, change the time frame, and my response is quite different. If you were to ask me about those same odds for 10 seasons from now, I couldn't say much above 40%—or just slightly above the 38% odds that any random team makes the NFL play-offs in a given year. There are simply too many unforeseeable variables—like the quality of the team's future drafts, coaching changes, and management upheaval—that make it impossible to accurately predict the fate of the 2024 Seahawks.

This is consistent with our everyday experiences. Ask someone how likely it is that they'll be living in the same house six months from now, and he or she will likely respond with a great deal of certainty. Extend that prediction out seven years, and the respondent will be markedly less sure. New jobs, new relationships, family issues, or a variety of other unforeseeable future events could induce someone to move.

Somewhat paradoxically, asset forecasting does not follow this reality. In fact, it's the exact opposite. Investors who appreciate that fact can better avoid assets that generate subpar returns at best and inflict losses at worst. They're also more likely to consider investing in currencies as an alternative asset class.

2014—Murky Waters for Stocks and Bonds?

I love watching interviews with Jim Rogers. Almost inevitably, the interviewer will pose a question like, "So Jim, where do you see the price of gold at the end of the year?" His response is almost always the same, some variant of: "how the heck should I know? All I know is that in light of current global financial circumstances, gold is cheap. I continue to hold it, and if it drops in price, I buy more."

Rogers, with his vast investing acumen and experience, knows that animal spirits are the dominant intervening variable in the financial markets in the short term. Fundamentally cheap assets can get even cheaper as fearful investors run for the hills, while fundamentally expensive assets can become yet dearer in price as greedy investors pile into them. However, time is the great leveler, humbling the mighty (witness tech stocks in 2000, US real estate and stocks in 2008, and the yen in 2012), while elevating the exiguous (think precious metals fin de siècle, the Canadian dollar in 2002, and commodities in early 2009).

In light of this insight, what are the prospects for the biggest traditional asset pools in North America: US stocks and bonds?

Turning first to stocks, there are those who continue to pound the table for US equities, arguing that they represent good value, even as the S&P 500 reached brand-new record highs last week. Bulls point to the fact that valuations as measured by P/E ratios are much lower than at previous market peaks in 2000 and 2007. Abby Joseph Cohen and her ilk also cite the fact that long-term returns in the markets are higher than average when P/E ratios are low, which purportedly bodes well for US stocks in the future.

Their point that valuations are not as lofty today as they were during the 2000 peak is a good and valid one. I also agree that low starting P/E ratios have led to higher-than-average long-term returns. But I am almost completely agnostic as to the near-term direction of the market. We have all been witness to frothy bull markets ascending to highs that few of us believed possible. It is entirely possible that the S&P 500 could end the year higher than it stands today, particularly given a Fed with less self-restraint than my three-year-old at a chocolate factory.

Yet, an abundance of contrary indicators are flashing danger signs for the months ahead. Margin debt recently reached levels only seen in 2000 and 2007. Insiders have been selling stocks at a torrid pace. Investor optimism has been off the charts, by some measures reaching levels not seen in more than twenty-five years.

It is worth noting that neither Wall Street nor economists as a whole have an awe-inspiring track record of predictions, particularly of market peaks and troughs—which highlights the fact that focusing on the short term, particularly anything less than a year, may be a fool’s errand.

The bond market offers short-term prognosticators similar challenges.

On the one hand, you have interest rates hovering at exceedingly low historical levels. At 1.5%, five-year Treasury notes are yielding **less** than the CPI in 2013. Yet the CPI itself has been adjusted so much over the years, one can almost fairly say that it avoids measuring anything that actually goes up in price.

According to ShadowStats, were the CPI measured the way it was in 1990, inflation would be running at roughly 5% year-over-year, while if it were measured the way it was in 1980, the rate would be almost 9%. With ten-year Treasury bonds yielding a puny 2.75%, it is not hard to envision a situation in which interest rates rise (and bond prices thus drop) in the near future. The unprecedented money printing from central banks around the world makes that an even more likely result.

On the other hand, it is evident we are still dealing with the consequences of an unwinding credit bubble, an extremely deflationary phenomenon. The US is seeing its weakest post-recession recovery (excluding the financial sector, thanks to Bernanke allowing Wall Street virtually unfettered access to what is essentially free capital) in its history. Europe is barely growing, with systemic debt problems in Portugal, Ireland, Italy, Greece, and Spain (the PIIGS) threatening the economic solvency of the entire Eurozone. China is on the edge of a financial precipice, with its private sector borrowing as a percentage of GDP exceeding that of the US prior to our financial meltdown.

Should any one, much less two, of these legs of the global economic stool give way in the coming months, one would expect interest rates to plunge (and therefore bond prices to rise) on deflationary concerns and a flight to safety.

So where do stocks and bonds end the year? Your guess is as good as mine, and probably a lot better than the folks residing on the Upper East Side of Manhattan who are getting paid seven- and eight-figure bonuses!

A Decade Can Make for a Clearer Crystal Ball

Back when I first started investing around the turn of the millennium, I followed several excellent investing minds (including Doug Casey) who were extremely optimistic about the price of gold and other precious metals. Their case was compelling. Having endured a grinding twenty-year bear market, gold, priced at less $300/oz, was becoming uneconomical to mine. Something had to give. Either all gold miners were going to shut down and the amount of gold in the world would remain fixed, or prices had to rise. We all know the story from there.

But some may have a hazy memory about the timing of gold's resurgence. From just below $300/oz at the start of 2000, gold actually declined more than 10% over the next 15 months before bottoming out just above $255/oz.

Further, many of those same great investment minds that were recommending gold had been warning about the hazards of the tech bubble as early as 1997. Yet in 1998, the NASDAQ rose an astonishing 38%. Surely this madness had to end there. No major equity market in the previous fifty years had seen such extremes in valuation. Yet to the shock and dismay of many (including yours truly), 1999 brought what had theretofore been the biggest blow-off stage of a bubble in modern financial history as the NASDAQ soared almost 85%.

The few prescient forecasters, struggling to be heard among the horde of lemmings chanting "This time it's different," looked absolutely foolish for a few years. As John Hussman recently noted, "The problem with bubbles is that they force one to decide whether to look like an idiot before the peak, or an idiot after the peak."

So what is the point? You could have made the "investment recommendation of the decade" in the late '90s by going long gold and being short (or at least avoiding) US tech stocks, yet still have looked like a bloody fool for not just months, but for years. Nevertheless, had a disciplined, patient, and wise investor simply used the dips in the price of gold to dollar-cost average into his positions, he would have stood to profit handsomely over the next ten years. Similarly, if he'd had the intestinal fortitude to ignore his colleagues, neighbors, and family members boast about their gains in XYZ.com without succumbing to the siren song, his portfolio would have avoided the shellacking that most endured.

Truly, investing is perhaps the only area in which we can see the distant future much more clearly than tomorrow.

With that perspective, what can be said about the longer-term prospects for US stocks and bonds, and what might that mean for alternative assets like foreign currencies?

US Stocks and Bonds: The Bell Tolls for Thee?

First, looking at US stocks, let me address the issue of their supposed reasonable valuations. Returning to perma-bull Abby Joseph Cohen (apologies for picking such an easy target), she loves to prattle on that at around 16 times projected 2014 earnings, US stocks are attractively priced. In this year's Barron's Roundtable, she noted that with inflation under control, P/E expansion to near 18 is possible, which would take the S&P 500's fair value up another 12% to nearly 2,100.

What Ms. Cohen fails to recognize is that the denominator in the P/E ratio is at a record—and unsustainable—level. If you substitute a more realistic number for earnings going forward, the P/E ratio rises considerably. Presently, corporate profits after tax (CPATAX) as a percentage of GDP are just over 10%. The previous post-WWII high in CPATAX? Just 8.5%, which interestingly occurred in 2007, right before the last bubble burst. The historic norm for CPATAX is only 6%.

This is a huge issue, as Jeremy Grantham of GMO notes:

"Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly."

If you look at a chart of subsequent four-year annual profit growth following peaks in CPATAX, you'll find that in every instance, it declined between 10% and 20%. If you adjust expected corporate earnings downward to reflect this likely reversion to the mean, the "forward" P/E will be 25 to 30. Which would be a very expensive market indeed, and would suggest subpar returns for the S&P 500 for the next many years, through at least 2020.

This more realistic P/E range is consistent with the Shiller P/E ratio, which is widely regarded as one of best, if not the very best, predictor of ten-year equity market returns. It smoothes valuations by calculating the P/E ratio using average earnings over the last ten years.

It is thus both noteworthy and alarming that while the historical median Shiller P/E ratio is less than 16, the current ratio is **over 25**. The only time prior to the late '90s that it was ever higher than 25 was on the eve of Black Tuesday in October 1929. That doesn't bode well for US equity investors. Indeed, should the Shiller P/E ratio revert to its historic average in the next ten years, annualized stock returns will be less than 1%!

As for bonds: It's a wonder that any pension fund manager in the US can get a good night's sleep. In today's era of explosive worldwide monetary expansion, holding a ten-year T-bond to maturity looks like a guaranteed way to lose purchasing power. Literally, the only situation in which such an instrument would be attractive for a long-term investor is if we have a ten-year global depression. Such a possibility cannot be ruled out, but it's far more likely that central bankers will meet any severe global economic weakness by printing more money than ever before; QE *ad infinitum*, if you will.

Perhaps ominously, the last time US ten-year bonds yielded so little was during the Eisenhower administration, with rates rising steadily through the '60s (guns and butter) and '70s (stagflation), inflicting massive losses on longer-duration bonds. Paul Volcker managed to stem the hemorrhaging by raising rates decisively and rapidly.

Unfortunately, if an award were given for a central banker **least** likely to emulate Volcker, Janet Yellen, a.k.a. The Dove's Dove, would win. And while the bond vigilantes have apparently been taking an indefinite siesta since the Greenspan era, I would not be surprised if they awake from their slumber on Yellen's watch, leading to a bloodbath for bond prices and a backup in interest rates.

The behavior of "smart money" is another sign of bad tidings for US equity and bond investors. Over the last eighteen years, the composition of Harvard's endowment portfolio has changed dramatically. Back in 1995, before the tech bubble, Harvard had fully 53% of its assets in US stocks and bonds. Today, only **15%** of its assets are in domestic equities and bonds, a reduction of more than 71%.

Not surprisingly, Harvard is not trying to time the markets. According to Jane Mendillo, CEO of Harvard Management, "We're looking at investments over a five- to ten-year time frame." Apparently, Harvard is also not impressed with the longer-term prospects of US stocks and bonds. In the last ten years, Harvard Management has outperformed the S&P 500 by 30%, obtaining annualized returns of nearly 10%.

Currency Opportunities

Why would a currency manager spend the bulk of an essay discussing non-currency assets? Because if domestic equity and bond markets are fairly valued at best and significantly overvalued at worst, investors may need to look elsewhere for hope of obtaining decent returns.

Indeed, many non-traditional assets have superior risk-reward profiles to equities and fixed-income instruments. Harvard Management has increased its exposure to real and alternative assets by more than 200% in the last twenty years, and they now comprise 40% of Harvard's total portfolio.

As with any asset, I encourage those interested in currency investing to keep a longer-term horizon. Mendillo's five- to ten-year time frame is a good one. The good news is that in a world where most central bankers are acting like frat boys spiking the punch at a toga party (note to self—expunge image of Mario Draghi wearing nothing but a bed sheet), it's not too hard to separate sound currencies from the dross.

One of the more interesting currency pairs is the Norwegian krone (NOK) versus the Israeli shekel (ILS). Both are generally "risk-on" currencies, in that they tend to appreciate when global risk appetite is moderate to high. They have historically been moderately correlated. This is helpful in mitigating macroeconomic risk in one's currency portfolio, since no matter which direction the global economy may break, they tend to appreciate or depreciate against the dollar in the same direction.

Norway is a paragon of fiscal and monetary responsibility in a world in which such old-fashioned macroeconomic virtues have been all but forgotten. The country is running a fiscal surplus of 13% of its entire GDP. At that rate, Norway will be able to pay off its already minuscule national debt in a few years. Norway's central bank has also been circumspect regarding money printing. M3 money supply is up a scant 3.6%, year-over-year. Contrast that with the typically judicious Swiss, whose M3 money supply escalated at more than twice that rate last year.

Norway's current account surplus is nearly as impressive as its fiscal surplus, also approaching 13% of GDP. The only traded currency backed by a larger current account balance is the Singapore dollar. The recent run-up in oil prices should only increase Norway's fiscal and current account surpluses, strengthening the already solid Norwegian economy. Further oil price increases will make the krone even more attractive. Of course, that means lower oil is a risk factor for Norway, and if crude prices collapse, it would be a large negative for the NOK.

My pick of the shekel as the short currency in the pairing is based upon valuation and the heightened level of both geopolitical and terrorist risk confronting Israel. The ILS has appreciated against not just the NOK, but against the USD and most other currencies in the last eighteen months. Talking to people who live in or frequently visit Israel, most find prices there quite high, implying that the shekel is overvalued on a purchase power parity basis.

The NOK/ILS has declined by more than 15% since September 2012, and it's trading 13% below its average over the last ten years. And while Norway faces a fairly significant risk of oil prices collapsing, I think that Israel faces much greater overall risks given the prospects for conflagration in the Middle East or a major terrorist event.

Speaking of risk, some may recall my recommendation from November concerning the Russian ruble (RUB) and the Turkish lira (TRY). I certainly could not have picked two currencies subject to more event risk and volatility over the last few months. Even as emerging-market currencies, their price action has been wild. In the two months after my first essay, the RUB/TRY appreciated almost 11% as investors worried that Turkey's acute current account imbalance would cause a currency collapse.

Then Turkey's central bank raised its overnight lending rate by more than 400 basis points. The TRY soared as investors took heart in the Turkish central bank's assertion that it would not need to intervene in the markets to support the lira. Simultaneously, the ruble has plummeted, as Putin's shenanigans in the Ukraine have made investors very nervous. Remarkably, after all these gyrations, the RUB/TRY sits within 1% of the level it was at when I wrote the first essay back in November.

So the question is, what now? Clearly, the risks for *both* currencies have increased. I believe that the Turkish central bank decided not to support the lira because its foreign reserves were already so paltry that it knew it couldn't do much anyway, and it didn't want to fire what little ammunition it had for naught. Turkey's overall economic fragility remains extremely high, not to mention the fact that its raising interest rates 400+ basis points will cause a serious headwind to future economic growth.

So long as Putin does not directly intervene militarily in the Ukraine (which, granted, is anything but a certainty), I suspect the long-term impact upon the RUB should be negligible. Much of the concern over Putin's authoritarian proclivities appears to be priced into the ruble, which is down approximately 25% against the dollar in the last several years. Overall, while far from a widows and orphans investment, I would still rather be long the RUB and short the TRY.

One last thing: For those of you interested in my thoughts on what gains to expect in the NOK/ILS and RUB/TRY this year, let me defer to the wisdom of Jim Rogers and say, "How the heck should I know?!?" Suffice it to say that I like each pair's prospects for the next five to ten years.

After six years of practicing law in the Seattle area, Mark left in 2002 to pursue investing full-time for the next nine years, focusing primarily upon currency markets. In June 2012, Mark launched Whitmore Capital, a hedge fund that solely invests in currencies. In its first twenty-one months, Whitmore Capital is up over 50%, net of fees, while the Barkley's Currency Traders Index (BCTI) is up a total of 2.7% since January 2012. Investors should be reminded that past performance is not necessarily indicative of future results. Whitmore Capital is open to accredited investors both domestically and abroad. Interested accredited investors can email Mark at mark@whitmorecapitalmanagement.com, call (206) 227-0644, or visit whitmorecapitalmanagement.com.