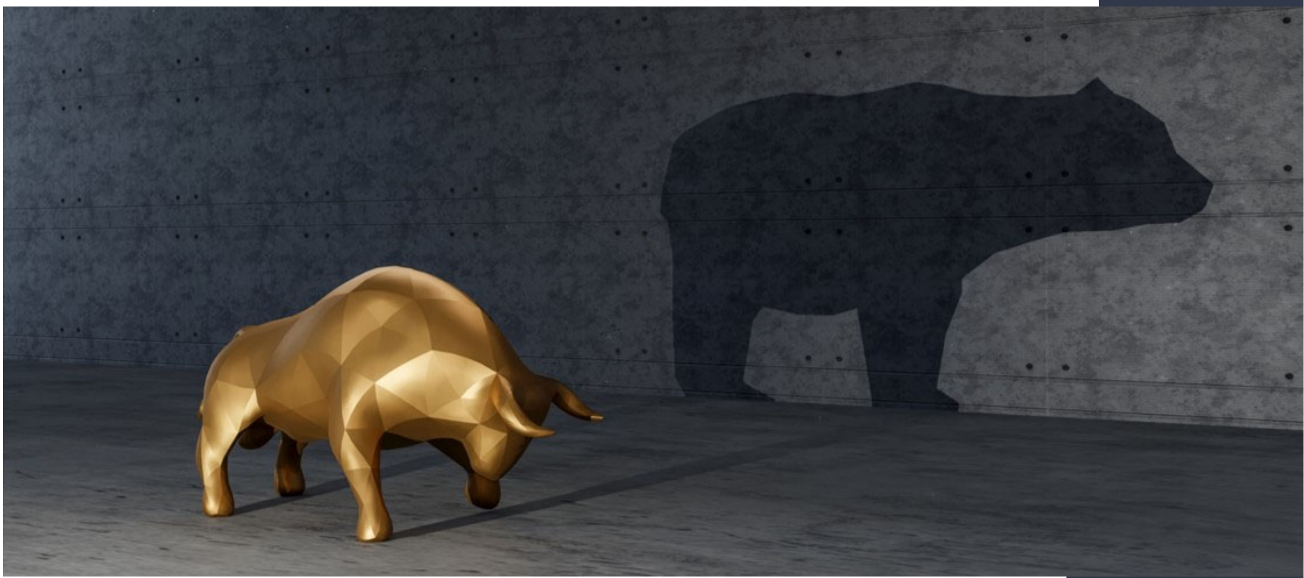
OUT OF THE ORDINARY

WEEKLY DIGEST | 27 June 2022

Are We There Yet?



John Wyn-Evans
Head of investment strategy

Investors can be impatient. Many are asking whether we have seen the bottom of what is now deemed to be an “official” bear market, at least for the equity indices that have fallen by 20% or more from their most recent cycle peaks. It is remarkable how swiftly sentiment can shift from being worried about having too much equity risk in portfolios to having too little.

Have we seen the bottom of the bear markets?

The first word of caution is that bear markets tend to be punctuated by very sharp rallies sometimes dubbed a "short squeeze" or "suckers rally". Such movements can be exacerbated by lower liquidity as volatile market conditions decrease the amount of capital that can be put at risk. We also observe instances of "the tail wagging the dog", where, for example, the covering of positions in options markets can have a meaningful effect on the cash equity market.

At certain times of the year, portfolio rebalancing can also come into play. According to various informed sources, that is happening right now as we approach the end of what has been another brutal quarter for equities.

As equity markets have fallen, their weight in portfolios will also have fallen relative to better performing asset classes (notably cash and some Alternatives). Fund managers are not necessarily obliged to switch out of the outperformers into the underperformers, although many will perform this function automatically at either month or quarter ends. It is deemed to be good investment practice to keep portfolios close to recommended asset allocation benchmarks as it maintains the potential to deliver returns on a par with clients' objectives and with the correct volatility profile. There is therefore current demand for equities from large institutional investors such as pension funds and sovereign wealth funds.

What rallies have we seen?

It is worth having a look at what has happened to the S&P 500 Index in the US this year (I choose this market because it accounts for more than half of the capitalisation of world equity indices and because it sets the tone for other markets). Last week's rally took it 6.7% above the most recent trough. But it's the fourth such rally already this year. The first, at the end of January, saw it rise 6.1%; the second, in the second half of March, was a barnstorming 11%; and the third, in late May, added 7.1%. How many hearts have been broken already?

I have also looked back to the bear markets of 2000/03 (the Tech Bust) and 2007/09 (the Great Financial Crisis or GFC). The former contained seven meaningful rallies ranging from 7.7% to 21.4% (average 14.9%) during a peak-to-trough drop of 49.2%. The latter contained five ranging from 7.1% to 24.2% (average 13.9%) during a peak-to-trough dive of 56%.

Are there three types of bear market?

Peter Oppenheimer, the Chief Global Equity Strategist at Goldman Sachs, classifies bear markets into three types: Structural, Event Driven and Cyclical. He deems both the Tech Bust and the GFC to have been structural, and they tend to be the worst type, typically seeing equities fall 60% over three years and then taking another ten to regain their previous peak. Event-driven bear markets would include the Crash of 1987 (a result of computerised portfolio insurance products running amok) and the Covid Crash of 2020 (of which we need little reminding). These fall around 30% on average but within a much shorter six-month window, before recovering lost ground within a year.

So how does he classify the current episode? Some might say it's event-driven (caused by lingering Covid effects and Russia's invasion of Ukraine), others might deem it to be structural (the beginning of the end of the global debt boom), but he is in the mainly cyclical camp, and we would tend to agree. This is foremost about central banks doing their utmost to rein in inflation and rising expectations of future levels of inflation via the tool of monetary policy tightening. Yes, there might well be some structural issues in the background ranging from geopolitical power shifts to the challenges of the energy transition, but the fight against inflation is the one that is currently top of mind for investors.

What might we expect from cyclical bear markets?

Cyclical bear markets fall, on average, around 30% over two years and then take another five to climb back to the peak. There is a growing feeling that this one will probably play out faster for a couple of reasons: first, the effect of resurgent inflation is already evident in changing consumer behaviour; second, central banks, in current word and deed, appear to be deadly serious in their intention to reduce inflation sooner rather than later. A phrase doing the rounds in markets is that they will "tighten until something breaks", with the problem for both them and us being that nobody really knows where the breaking point for the economy lies.

I have been thinking recently that, at least in my experience, this bear market feels a bit like a combination of the Tech Bust and the correction of 1990 (when the S&P 500 narrowly avoided a bear market by falling 19.92%). The Tech Bust element has been evident in the meltdown of speculative investments, not just equities. But if I look back to the late 1980s, the stage was being set for an eventual market retreat by the Federal Reserve raising rates from 6.5% to a peak of 9.75%. It just took a while to sink in. Equities traded sideways for more than a year before suffering that near-20% fall in just four months and then recovering strongly. And the trigger for the turn? The Fed began cutting rates more aggressively, from 8% in October 1990 to 4% by the end of 1991 – cue an equity market rally of 41% over that period.

Indeed, it's hard to find evidence of a market rallying sustainably from bear market territory into the teeth of a monetary tightening cycle, although sometimes equities can continue to prosper during the initial phase of one. Remember that earlier this year there were plenty of strategists citing that, on average, the market continues to make gains after the first interest rate rise, and we were very cautious that, in the current circumstances, one could be easily led astray by relying on such averages.

Although markets have recently reduced the expected peak level of interest rates and breakeven inflation rates (inferred from market prices) have also dropped, it still feels too early to "fight the Fed". And this is a wider phenomenon. The latest central bank to join the rate-rising party was Norges Bank of Norway, which took economists by surprise last week by raising its deposit rate by 0.5% (rather than the expected 0.25%) to 1.25%. Talk is now of "reverse currency wars", where central banks are desperate not to be left behind in the tightening cycle in case traders start to attack their currencies. As I mentioned last week, just look at what is happening to the Japanese yen, where the Bank of Japan is the exception.

This line of thinking pervaded the latest meeting of our Global Investment Strategy Group. Although the average view across the committee was that inflation indices will eventually surprise people by how fast they fall and that a global recession is by no means inevitable, although possibly more likely in Europe and the UK than in the US.

There was also concern that corporate earnings are heading for a period of negative revisions, caught in a margin squeeze between slower demand and rising costs. That could well be the last shoe to drop in this bear phase. It remains to be seen whether such a development would be sufficient to prompt a pause in the monetary tightening cycle, or even a reversal. Much will no doubt depend upon the state of unemployment. We continue to believe that a more opportune moment to increase risk budgets will present itself in the months ahead.

Economic Commentary

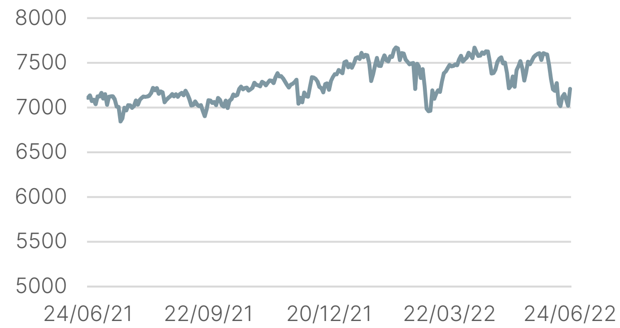
FTSE 100 weekly winners

JD Sports Fashion Plc	11.9%
Hikma Pharmaceuticals Plc	9.4%
AstraZeneca PLC	8.6%
Rentokil Initial plc	8.4%
Avast Plc	7.2%
Flutter Entertainment Plc	7.1%
Just Eat Takeaway.com N.V.	7.1%

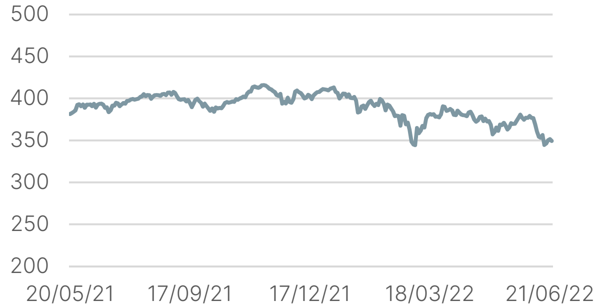
FTSE 100 weekly losers

Anglo American plc	-8.3%
Rolls-Royce Holdings plc	-7.7%
Weir Group PLC	-7.4%
Antofagasta plc	-7.0%
Polymetal International Plc	-5.7%
Berkeley Group Holdings plc	-4.0%
Smiths Group Plc	-3.9%

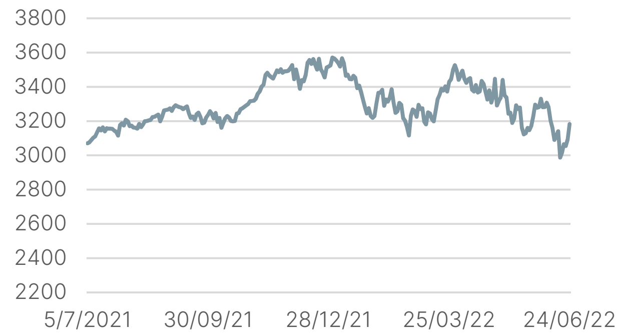
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



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