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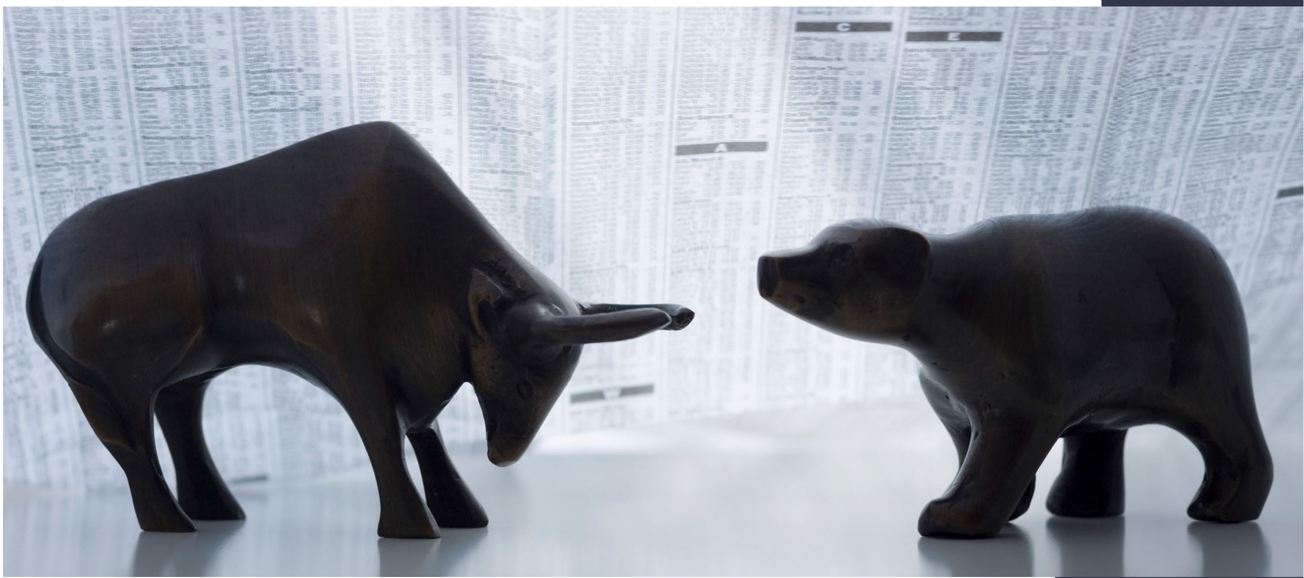
A Guided Tour Of Bear Markets



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The prospect of back-to-back four day working weeks is always a pleasing one. The Easter holiday marks the end of a first quarter which seems to have gone by in the blink of an eye, and it has been a good one for balanced portfolio investors, backing up the positive end to 2023. Many headline equity indices have made new all-time highs after a long hiatus, including the S&P 500 and NASDAQ indices in the US, the DAX in Germany, France's CAC-40 and, perhaps most notably of all after a thirty-four year wait, Japan's Nikkei 225. The UK's FTSE 100 is absent from the list, but only around one percent away from joining it.

And yet very few people seem to be enjoying this extended rally. I am asked much more frequently "when is this market going to crash?" than "how high will it go?" There is little doubt that both the Global Financial Crisis and the early part of the Covid pandemic have conditioned many to believe that a crash of some sort is how markets resolve to the downside and you could add the Tech Bust of 2000/03 to that list, although, as we shall see, it was much more specific in the sectors that were afflicted.

A big, fast drawdown usually needs some sort of catalyst. I have looked back at all of the sharp drops in global equities going back to the 1990s. Even though there has almost always been some sort of imbalance or underlying structural weakness evident in the lead up to the fall, something usually has to break to open the trapdoor. It was Thailand's currency devaluation in 1997, and then Russia's in 1998 (which itself triggered the demise of hedge fund Long Term Capital Management). Although the build up to the financial crisis was a long one, it was the bankruptcy of Lehman Brothers in 2008 that really caused the damage; a downgrade of the United States' credit rating (exacerbated by worries about the future of the euro) was the trigger for a drop in 2011; and it was the initiation of lockdowns in 2020 which sent investors rushing for cover.

These are all what one might describe as "air pocket" events of some magnitude. The peak-to-trough drop in the MSCI All-Countries World Index (ACWI) was 21% in 1998, 59% in 2007/09 (-41% post-Lehman), 21% in 2011 and 34% in 2020. What might be the reason for something similar to happen today? The "easiest" answer might be a major geopolitical incident, such as a nuclear escalation in Ukraine or a Chinese invasion of Taiwan, neither of which can be dismissed as having a zero probability. However, they remain, in our opinion, "tail risk" events, such that one can carry some insurance, but not position a whole portfolio for that specific outcome.

Some of the other big bear markets have been more drawn out. The bust at the end of the Technology, Media and Telecoms boom played out over three years during which the ACWI dropped 51%, with the much more exposed NASDAQ Composite Index falling 78%. There was no big "moment" (even allowing for the shock of 9/11), more a gradual dawning of the fact that valuations had become extremely stretched, punctuated by a persistent stream of disappointing growth relative to expectations, hyped companies going bust as they ran out of cash, and, to add icing to the cake, a few cases of outright criminal behaviour, for which Enron was the poster child. We shall return to this period because it is the one to which more bearish commentators are comparing the current market. Sector wise in the US, while Technology (-80%) and Communications Services (-72%) crashed, Consumer Staples was up 30% and Healthcare just about held its ground with dividends included.

The 17% drop in global equities during 2018 did not qualify as a bear market, but it came close and was not a pleasant ride. This was the result of a gradual increase in interest rates by the Federal Reserve which had started as far back as December 2016. 2.5% was as high as they managed to go before Fed Chair Powell had to execute his infamous "pivot" in early 2019, which set the bulls running again. This period of weakness was also characterised by the ramping up of tariffs on trade by then-President Donald Trump. That's probably something we need to consider as a potential risk factor in 2025 if the result of this year's election goes his way.

Then, of course, there is the most recent bear market in 2022, which saw the ACWI fall 27% (and NASDAQ 36%). This was a function of a huge resetting of interest rates and bond yields, which saw US policy rates rise from zero to 5.5% and the 10-year US Treasury yield from below 1% to more than 4%. And those rates rose because headline inflation jumped from less than 2% to more than 9%. There were also echoes of 2000 in this fall, especially for the

NASDAQ, owing to rampant speculation in technology shares (especially non-profitable ones) in late 2020 and 2021.

There is an incident in 2015 that is distinct from all of these, not caused specifically by high market valuations, higher rates or rising bond yields. Between mid-May 2015 and mid-February 2016, the ACWI fell 20%. The "air pocket" moment came in August when China "devalued" its currency, and the whole episode was symptomatic of the early stages of China's still lingering malaise. Commodity prices came under intense pressure, with the oil price dropping from $67 to $28 as OPEC (+ Russia) tried to put the American shale oil industry out of business (it had been as high as $115 in mid-2014).

It's instructive to look at sector performance during that period because it shows how specific the downdraft was. In the US, Energy fell 31% and Materials fell 24%, but the S&P 500 "only" fell 14% owing to less exposure to these sectors, while the FTSE 100, replete with drillers and miners was off 21%. BP was down 32% and Rio Tinto was down 40%. Glencore, deemed to be the most leveraged resources company fell 70%, with its solvency being questioned at one stage. China's main CSI 300 Index was down 38%.

It's also instructive to look at where that has led us to now. So much for the Saudis and the Russians trying to destroy the US energy industry. Nearly a decade later, the US is the world's largest producer and recently extracted a record 13.4 million barrels of oil in one day. Furthermore, the existential shock suffered by extractive industry companies following years of profligate spending and lax balance sheet management forced them to "grow up" and focus on cash generation, fortress balance sheets, strong returns on capital and a more generous distribution policy. Good for the shareholders, but not so good for the supply of important metals owing to much reduced capital expenditure. It's always fascinating to see cycles play out like this over several years.

One lesson I have learnt from nearly four decades of being involved in financial markets is that it is rarely the perpetrators of the worst excesses in one cycle who are guilty of the same crime in the next cycle. They are generally brought to heel by investors and/or regulators and there is usually a management reshuffle in favour of more conservative leaders.

What lessons, if any, can we apply to markets today? The first thing I would say is that a high valuation by itself is insufficient reason for markets to engage reverse gear. There needs to be a catalyst. Rising interest rates are a pretty reliable one, but, if we take central banks at face value, the next rate moves will be lower, not higher. No doubt that is dependent upon inflation behaving itself, and so we are going to have keep a very close eye on how that develops. The last few prints in the US have been a bit too sticky for comfort, but so far just enough to deter faster rate cuts than to see them rise again.

Are there massive imbalances in the global economy? We don't think so. The biggest is probably in China's Real Estate market, but the government is managing that down and definitely does not want to cause any kind of "Lehman moment". Yes, there is also a bit of a problem in the US office-related real estate sector. Some of its pigeons will come home to roost in the regional banks' balance sheets, but the Fed has already shown its hand when it comes to backstopping that sector. A lot of losses will be absorbed by investors including pension funds and endowments, who should at least have been making some decent returns elsewhere. The biggest banks have been forced by regulators to carry more capital and they also appear to have plenty of excess reserves at the moment to mop up any problems. And this also looks like a slow burning fuse as loans mature over several years.

Neither have we seen the sort of Merger and Acquisition (M&A) or Initial Public Offering (IPO) frenzy that might be associated with a spiky top. I was reminded of the ill-fated AOL-Time Warner deal the other day when reading the obituary of Jerry Levin, the architect of that deal. It was a $165bn merger, the biggest in history at the time. Even though it only took place on January 10th 2000, it was already being lined up as the “worst deal of the century”. Nothing like setting out one’s stall early.

Vodafone also had a pretty good effort with its purchase of Mannesmann for $181bn in February 2000, overtaking the AOL-Time Warner deal in terms of size. Vodafone’s shares peaked at 568p in March 2000 and now trade at just 68p. Although last week’s IPO of Reddit went quite well, there were plenty of failures last year, and the IPO window has only just properly reopened.

I’m not saying for one moment that equity markets are totally insulated from a setback – they never are. Indeed, based on averages, it is reasonable to expect around a 10% fall every year. But that is part of the normal tidal flow of financial markets. Forecasting something much worse than that is a big call, and not one that is necessarily on the cards given the available evidence. I’ve written a few potential “famous last words” in the past and survived. Let’s see how these words age!

There is more to be said about the relative positions of today’s Technology leaders and those of 2000, but that will have to wait till the Easter Eggs have been consumed. Make sure to savour them this year – apparently the soaring cost of cocoa means that they are 50% more expensive than last year.

Economic Commentary

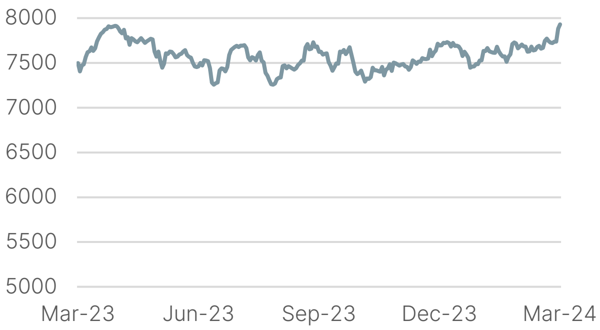
FTSE 100 weekly winners

Melrose Industries PLC	8.8%
NatWest Group Plc	8.7%
Croda International Plc	8.3%
Johnson Matthey Plc	8.2%
Next plc	8.1%
Ferguson Plc	8.1%
3i Group plc	8.1%

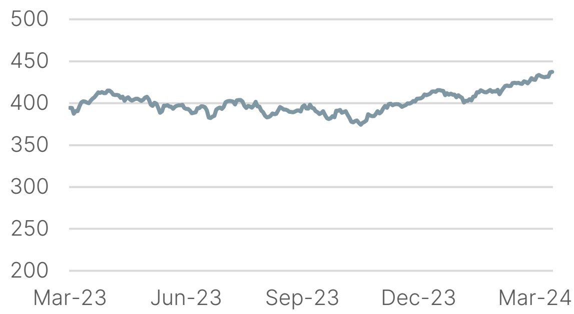
FTSE 100 weekly losers

Burberry Group plc	-6.8%
Schroders PLC	-3.3%
Fresnillo PLC	-2.7%
B&M European Value Retail SA	-2.4%
Smith & Nephew plc	-2.3%
Prudential plc	-2.2%
Vodafone Group Plc	-2.0%

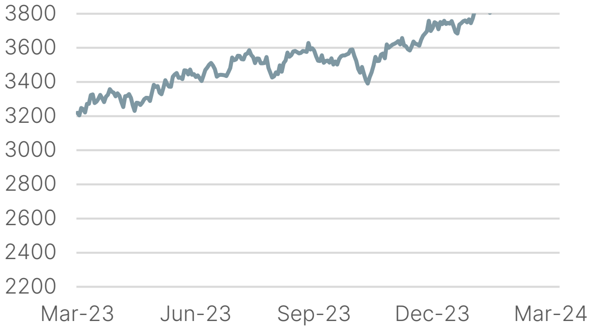
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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