The Anatomy of Bear Markets

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Bear markets are great! Let me explain. Lower prices mean greater future returns. Bear markets always occur during global slowdowns as investor confidence is shaken from lower growth expectations. It is only when investor expectations are low that the foundation is set for fantastic returns.

The usual definition of a bear market is based on an arbitrary level of negative returns, such as -20%. While there can be flash crashes during bull markets (for example, 1987 or 2010), in our opinion, proper bear markets occur when global growth slows. Over the last thirty years, there have been eight global slowdowns, which have coincided with significant share market corrections. The anatomy of these bear markets and recovery (peak to trough return, peak to trough duration, trough to peak duration, peak to peak duration) are displayed in the table below:

Bear Market Anatomy - All Ords Price Index

Global Slowdown Periods	Peak to trough return	Peak to trough duration (mnths)	Trough to peak duration (mnths)	Peak to peak duration (mnths)
1990	-27%	16	31	47
1994	-21%	12	21	33
1997	-11%	11	5	16
2002	-19%	20	15	35
2008	-51%	16	124*	140*
2011	-17%	6	17	23
2015	-16%	12	13	25
Average (excel 2008 GFC)	-19%	13	17	30
2018/2019	-11%?	4?	5?	9?

**not yet complete*

Source: Iress

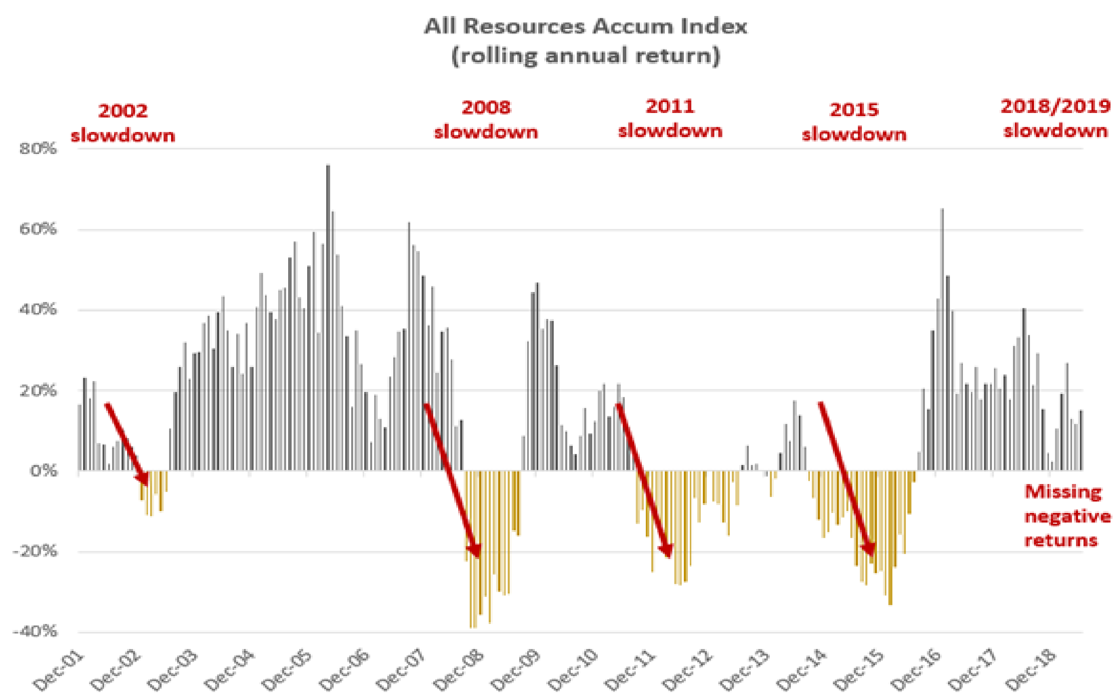
During an economic slowdown, the average peak to trough return was about -19% and the average bear market and recovery duration (peak to peak) was about 30 months (excluding the 2008 GFC period which is yet to complete).

Bear markets do not end abruptly. They tend to be drawn out processes with lots of volatility. Hence, something is very peculiar about the recent share market correction. The All Ords index collapsed in the fourth quarter of 2018 which reflected global growth concerns. Despite no sign of a global recovery, the market formed a V-shaped recovery and recorded its strongest half year return (20%) since 1991. If December 2018 was the market low, then this correction would be one of the most benign in terms of magnitude (-11%) and peak to peak duration (9 months). The correction to date happened so fast that there are not many wounds to lick, unlike previous global slowdowns.

This strange bear market behaviour is driven by a divergence from historical precedents in both the All Resources and the All Industrials indices.

What is driving the resource divergence?

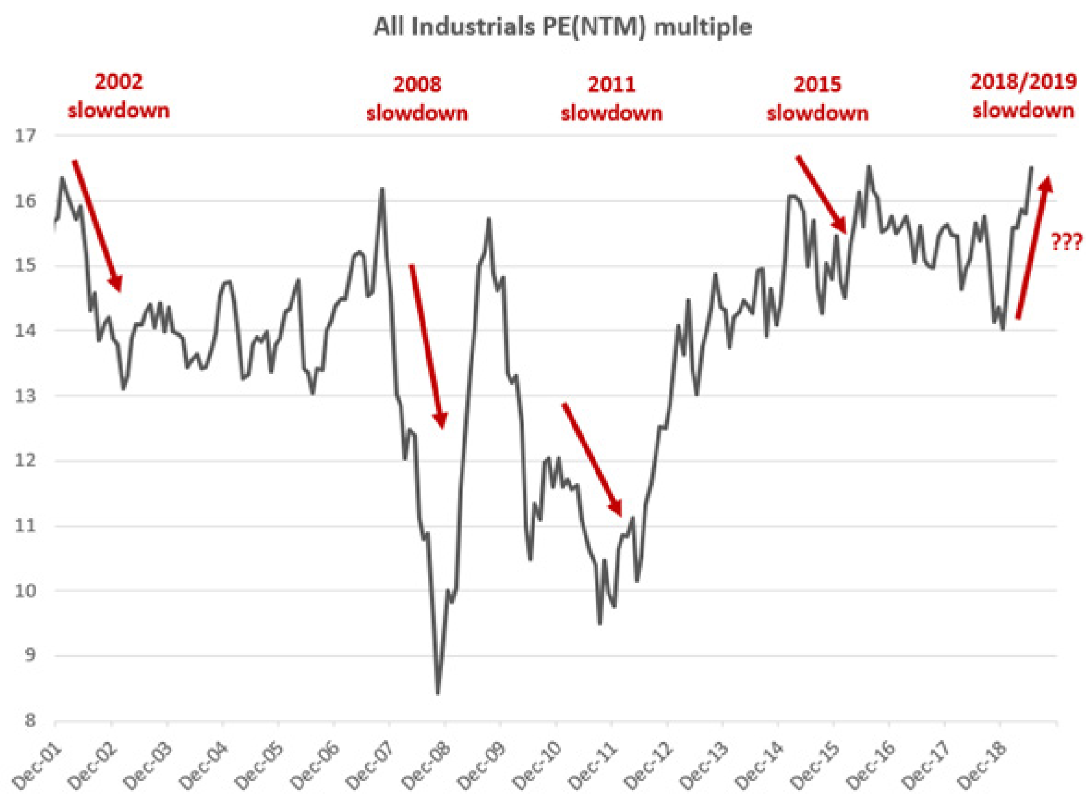
Resource stock earnings are highly sensitive to the global environment because of their operating leverage to commodity prices. Typically, during global slowdowns the earnings of resource stocks collapse and the All Resources index records negative annual returns. However, for the first time in twenty years the performance of the resource sector has diverged during a global slowdown. The rolling annual return for the All Resources Accumulation Index has amazingly remained positive (even prior to the Vale dam disaster in January 2019). This once in a lifetime divergence is due to the Chinese supply side reform implemented in 2016. By cutting supply for certain commodities, the Chinese have engineered high prices to help some of their heavily indebted industries pay off debt.



Source: Iress

What is driving the industrial divergence?

However, resource stocks account for about 20% of the market. The majority of the All Ords is driven by industrial stocks, which have rallied so hard that current market valuations are on par with the technology boom peak. This is the fourth time in the last twenty years that the All Industrials has hit its 16.5x PE multiple ceiling. The high valuation multiple is more akin to market tops, which is in direct contrast to previous global slowdowns where PE multiples contract.



Source: UBS

While the WAAAX (Wisetech, Appen, Altium, Afterpay, Xero) stocks get a lot of attention about their exhilarating growth, it is the large companies with slower growth prospects that have pushed the market to its highs. For example, Commonwealth Bank (CBA) and Woolworths' (WOW) PE multiples have expanded despite their earnings being revised down over the last few months. Like the market, their PE multiples have also hit their historical extreme PE ceilings. In contrast, during previous global slowdowns both CBA and WOW had contracting PE multiples. Contrary to popular opinion, WOW was not so defensive in the past.

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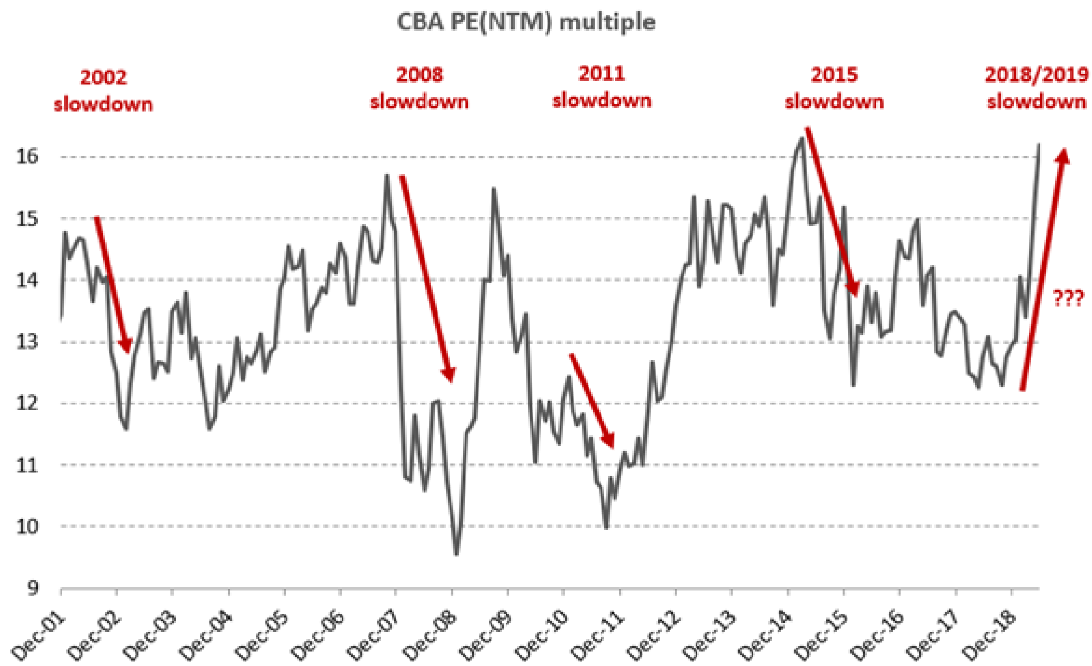

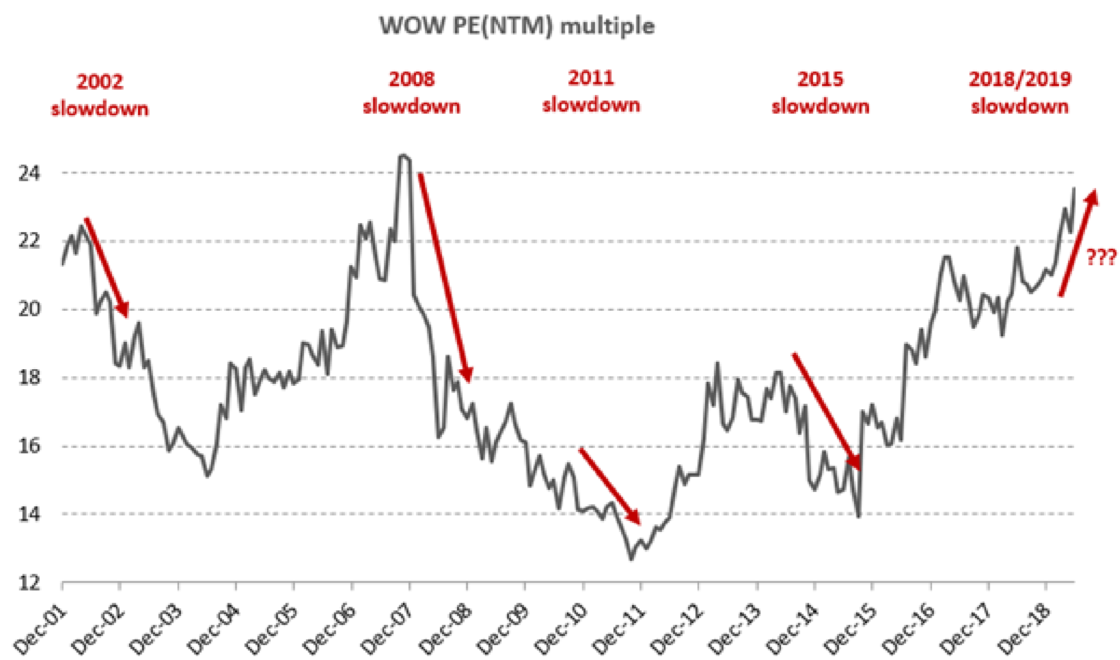

Source: Factset

During economic slowdowns, interest rates fall and valuations compress

Many pundits attempt to justify rising stock valuations by pointing to falling interest rates. This is only partially correct because valuations are not a one factor model based on interest rates – growth is a more important factor. In periods of economic slowdowns, valuation multiples typically compress because the impact of lower growth expectations outweigh the impact of lower interest rates. This is the same reason why PE multiples generally expand when economic growth is robust.

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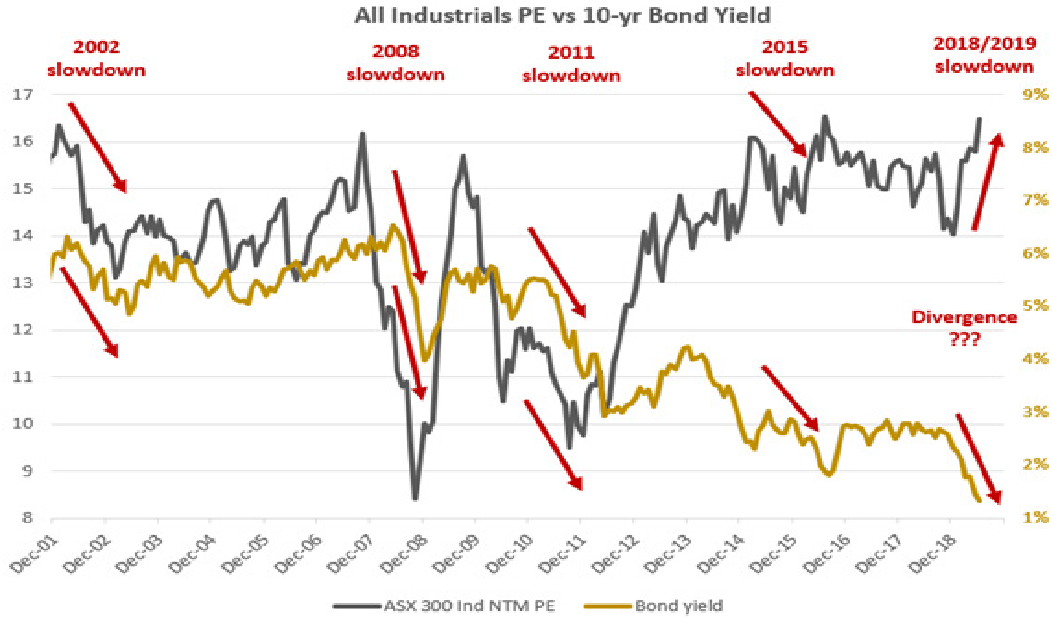
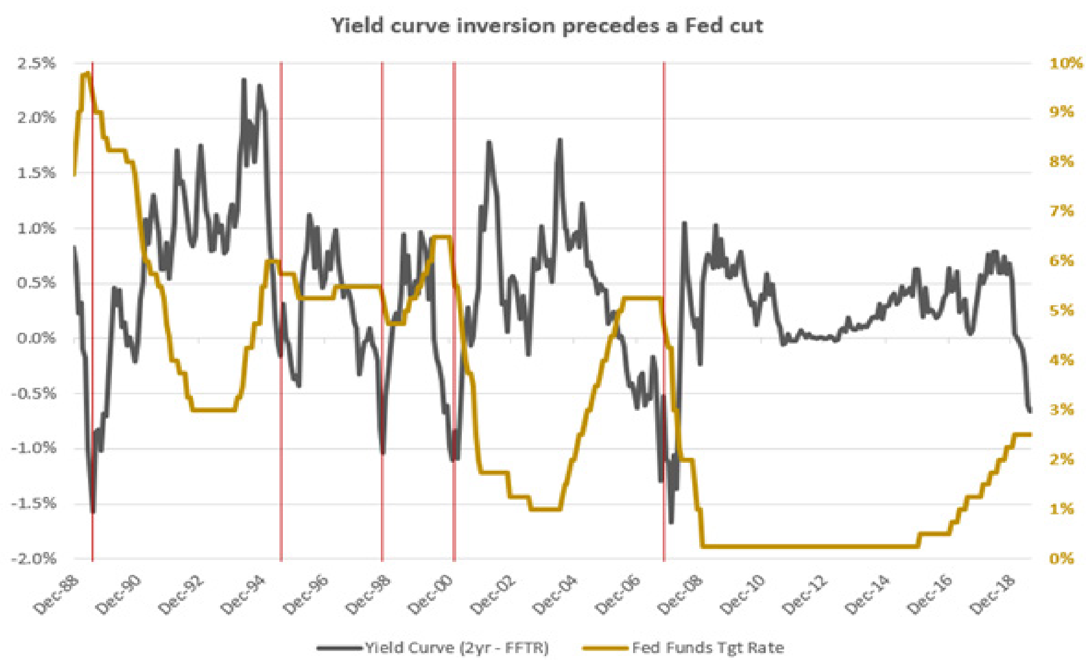


Source: UBS, Iress

Can Central Banks engineer a shallow slowdown?

The divergence between rising PE multiples and negative earnings revisions (which coincide with falling bond yields) stems from excessive risk seeking sentiment – more so than in previous global downturns. Alternatively, maybe the worst is over, and an economic recovery is shortly underway as Central banks will save the day.

Indeed, the Reserve Bank of Australia has consecutively cut rates twice in June and July 2019. And the US treasury market is expecting the Federal Reserve to cut rates at the end of July 2019. Over the last forty years, when the short-term yield curve (2-year treasury yield minus Federal Funds target rate) inverted, it preceded the Federal Reserve cutting interest rates.

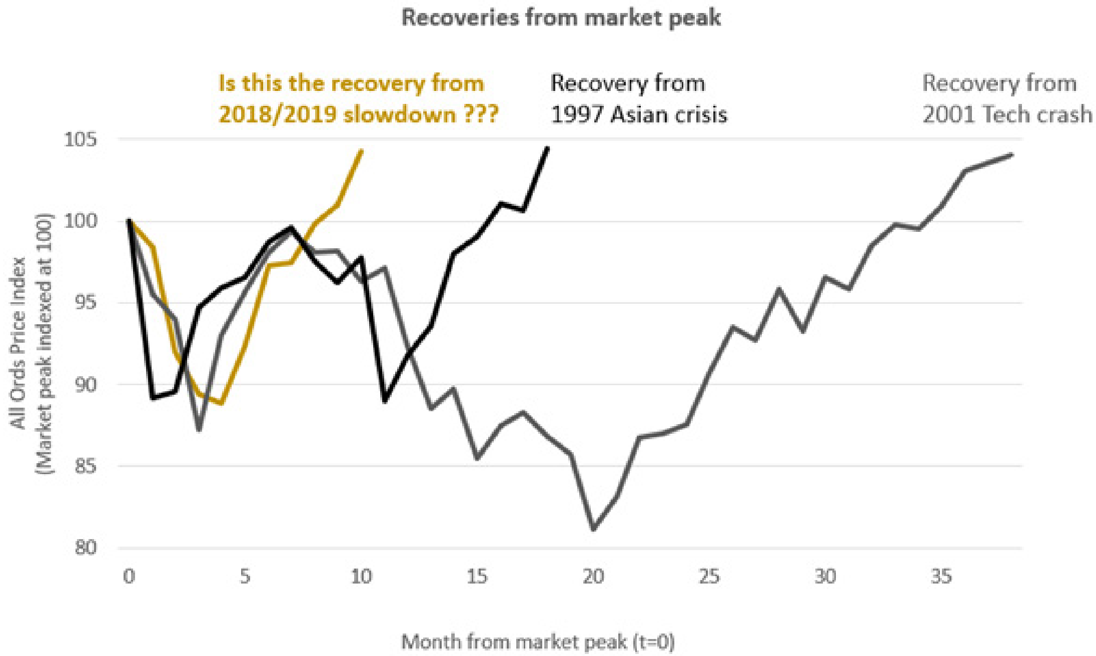


Source: Refinitv

Before the current inversion, there were five instances since the late 1980s when the short-term yield curve inverted. Two of them coincided with shallow market corrections (1994 and 1997) and the other three (1990, 2002, and 2008) were deeper corrections that coincided with US recessions. From a pure statistical basis, two versus three is not favourable odds for the Federal Reserve to engineer a shallow slowdown. Putting one's faith in a recovery based on the first rate cut by the Federal Reserve is not a great strategy to aggressively buy stocks.

V-shaped recoveries occur infrequently

Historically, V-shaped recoveries are infrequent, occurring twice (1997 Asian crisis and 2001 Technology crash) out of seven prior slowdowns. They also tend to be fleeting as the initial market optimism eventually deflates and morphs into a W-shaped recovery. Volatility prevails when investor expectations are too out of sync with economic reality.



Source: Iress

Conclusion

If corrections are the market's winter season, then the fourth quarter of 2018 saw a quick hail storm before becoming balmy with sunny skies. It saw half the average bear market return, one third the duration and the sharpest V-shaped recovery in history – all extraordinary.

Excessive optimism has pushed PE multiples to their historic highs. This is despite negative earnings revisions within the current global slowdown. Investors who adopted the same risk seeking behaviour in prior slowdowns would have been caught in a blizzard with no clothes.

While the current market recovery appears to have seen many firsts, perhaps there is another explanation. Maybe the correction process is still underway. With expectations extremely high, this sets the foundation for risk rather than the fantastic returns that is on offer at the bottom of bear markets.

About the author

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Jason founded Vertium Asset Management in 2017 and has around 20 years' Australian equity investment management experience. He leads Vertium's investment team and is responsible for the firm's investment philosophy, process and portfolio management.

Before establishing Vertium, Jason was a Senior Portfolio Manager at Investors Mutual. He was the architect of the Investors Mutual Equity Income Fund, which he successfully managed for almost six years. As the second-longest serving employee at Investors Mutual spanning over 16 years, he had a variety of roles including managing a share of the Investors Mutual Australian Share Fund and as an Equity Analyst and Senior Quantitative Analyst.

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