Equity Markets: Where To in 2009

During the Asian Crisis of 1997, the Malaysian equity market fell initially by over 60% in from early to late 1997. It then rebounded by nearly 50% in early 2008 before falling another 60% for a total drawdown of some 76%. In Jakarta, the initial loss was 57%, the bounce 73% the subsequent fall 53% for a cumulative loss of 65%. In Hong Kong stocks fell 46% then rallied 34% before falling 40% for a total drawdown of 58%. In Singapore the initial loss was 39%, the bounce 36%, the subsequent loss 42% for a cumulative return of -52%.

Since then those markets have recovered and the economies rehabilitated themselves.

Since their highs in 2007, the FTSE lost 46% in the initial fall, rebounded 28% from Sep 2008 lows to Dec 2008 before falling to a new low in March, the Eurostoxx fell 45% to Sep 2008, rose 30% to Dec 2008 then fell 27% to March 2009, the S&P500 fell 36%, rose 30%, fell 27% before rising 23%.

The psychology of crashes and recoveries is that initially, investors take leave of their senses and the market rises to some highly overvalued level unsupported by fundamentals. Something happens to burst the bubble and once again investors take leave of their senses in an avalanche of panic selling. Markets fall precipitously to levels unreflective of fundamentals. That is not to say that fundamentals themselves are not rapidly evolving. Governments and regulators get involved in an effort to avoid systemic failure. Investors are at first skeptical and there is no market recovery. After a while, the new measures take hold but only slightly. Investors take leave of their senses in a wave of buying fueling a relief rally. The market surges beyond the paltry improvements in fundamentals. Repeat with less volatility until investors come to their senses and market prices come to reflect fundamentals a bit more closely.

The question is which one was the big relief rally? Was it the November, December 2008 rally or the March 2009 rally? If it was November 2008, then the market low of March 2009 may have been bottom or close to bottom and the current rally is the start of a proper recovery. If the current March 2009 rally is the big relief rally, then it is likely to run out of steam soon, and the market will likely test the lows of March later this year. If it survives the test then we have the beginnings of recovery. If it barrels through to a new low, then the bear market is alive and well and new levels of support will need to be formed and tested.

The reality of the fundamentals is that things will not improve for some time yet. The first quarter 2009 results are not going to be positive, how can they be? The market has either discounted them or not. That is a matter of psychology. As for the medium term fundamentals, unemployment is on a trend with considerable momentum, trade is also on a downtrend, the various rescue plans of the US government are not very detailed and at best fail to address a number of important issues, are a supply side solution without addressing demand side problems and the outlook for economic growth is at best highly uncertain. Things could improve quickly with the volume of stimulus that has been applied, or they could simply muddle along. The point is that with volatile fundamentals, it is impossible for the market to price them.

The market is therefore likely to be a trading market driven by sentiment more than fundamentals. Direction is therefore dependent on the weather.

Later in the year, I expect we will have more clarity either way. It could be worse or it could be better. I hold with the optimists. Nothing lasts forever, not bull markets and not bear markets.