

Is The Equity Bear Market Rally Really Over?

Equity Market Review

Once again equity markets are looking vulnerable. The high octane markets in Asia such as Shanghai, HK and Bombay have certainly corrected sharply, and this amid quite benign news. How do we make sense of these markets? The retail investor and, quite embarrassingly, the professional investor panicked in the second half of 2008. Both retail investor, and again, embarrassingly, professional investor, missed the turn in 1Q 2009 but was happy to get into the market late in the rally. Most professional investors argued that the recovery was nothing but a bear market rally. Some, like the strategists at Goldman Sachs for example, believed that it was the beginnings of a V shaped recovery. We won't know who is right until it is too late, too much time has passed, and its no longer important.

Emerging market crises of the past teach us that markets can exhibit very high volatility post a crisis. The strength of the first relief rally can be very strong and resemble a V shaped recovery. The subsequent reality can bring a market to new lows. The number of oscillations before a new cycle begins varies.

The rally was a bear rally and its all over now:

- Economic fundamentals remain weak. The current recovery is based on a short term adjustment from inventory restocking.
- Employment numbers remain weak. Unemployment and weak personal income will cap consumption and thus a broad based recovery.
- Personal balance sheet repair will cap consumption.

- Credit may have eased up but this has been a transfer of risk from private to public balance sheets
- Fiscal and monetary policy will lead to unsustainable public debt levels
- Emerging markets seem to be recovering but the growth is driven by infrastructure and fiscal policy, the numbers are false, the recoveries are unsustainable, the recoveries are unbalanced.
- Earnings have beat forecasts but this is because forecasts were acutely over pessimistic to begin with – possibly because the crisis was concentrated and originated in the financial sector – where forecasters originate.
- Valuations are not compelling. The recent rally left equity valuations stretched since there has been no progress in fundamentals.
- There may be green shoots of recovery but these are very moderate recoveries from very depressed levels. Quarter on quarter or month on month numbers may be recovering but year on year numbers are still dismal.

The market is currently in a correction as part of a wider recovery, there is nothing to worry about:

- Fiscal and monetary policies are being operated on an unprecedented scale and will repair the economy – if not in real terms then in nominal terms.
- Policy makers will err on the side of caution and will continue reflationary policies well into recovery.
- Industrial production and capacity utilization are turning around.
- Consumer sentiment is lagging as unemployment is still rising.
- The recovery due to the inventory restocking is part of a more sustained recovery. It always starts with inventories.

- Jobless claims are still high but not rising.
- Economies are being reshaped. US and Europe export sectors are likely to grow at the expense of the domestic sector.
- China, Brazil, India and the Emerging Markets will generate sufficient economic growth to make up for the retrenching Western consumer.
- Every recovery has its beginnings in month over month improvements.

For every argument that the economy is on the way to recovery, there is another argument that it is doomed. The truth is somewhere in the middle. History repeats itself, but its timing is never precise. There is a segment of the market that expects equity markets to collapse into September 2009 in a repeat of 2008. Signals of these expectations are telegraphed into option open interest and trading activity. September 2009 will likely not see the same collapse. If there is to be a further bear market of the proportions of 2008, it is likely to manifest only once the investors who expected it to happen in September have waited sufficiently long past September to say that all is well and that the signs of danger were unwarranted.

An optimist is someone who believes that we live in the best of all possible worlds and that whatever the damage in the past, we will emerge stronger, eventually. The pessimist is someone who fears that this is true.

Unfortunately, especially for me, I cannot say where the market will go. My linear reasoning module tells me that the market will weaken into September, unwinding the excesses of the liquidity driven rally, not with the ferocity of the year before, but in continuous tradable fashion. I think that the market will need to consolidate before it makes a more sustainable fundamentally driven recovery. My non-linear reasoning tells me that the market consensus will be confounded and that the market correction will be short-lived,

that policy will be more than supportive of risky assets, that negative expectations will lead to weak shorts and short covering, and that the rally will extend to the year end. Then we might get that almighty crash. Or not. I just think that the coming correction will be postponed until the experts and the stale bears throw in the towel and proclaim a new dawn.