The End of This Equity Market Rally

I am not an equity market bear; if anything I am firmly of the view that **the world economy is on the path of recovery and repair**. Equity markets have, however, run well ahead of themselves and of fundamentals. Technically, **equities are heavily overbought**. Fundamentally, they are not cheap either. In an earlier article dated 15 June 2009, I suggested that **This Equity Market Rally** had run out of steam and that a significant correction was probable.

Equity markets have indeed lost some momentum and some markets have corrected sharply. However, it is too early to tell if this is simply a consolidation before further gains. I do not think so. I believe that we are now firmly in a **resumption of the bear market** and that 20 – 25% declines are probable in Western markets and 30 – 40% declines are probable in emerging markets.

I am also a firm believer in **decoupling of the underlying economies, between emerging and developing markets**. So how do I reconcile this with my expectation that emerging markets equities will underperform?

First of all, **why do I think that the bear market will resume?** The bull market of the last 2 months has been driven by banks, financials, and consumer cyclicals. The dispersion of returns in these sectors has been high. These are sectors with poor earnings visibility and poor predictability of cash flows. In sectors with more predictable cash flows, equity prices have been less, not more, dispersed. In other words, the market has been very news driven, not fundamentals driven; it has been driven by relief rather than conviction; it has been driven by a very thin base and has not been broad based. These are the **classic elements of a relief rally**, not the underpinnings of a new secular bull market. History has also taught us that markets don't move in straight lines and that there are basic elements to post traumatic environments. Equity busts have at their roots overvaluation as euphoria overcomes rationality. Weaknesses that were hidden by euphoria eventually manifest resulting in catastrophic loss. Panic ensues. That was last year. Panic turns to despondency and overshooting on the downside. Inventory cycles turn, industrial production surprises to the upside and a relief rally results. These types of rallies can be powerful as short covering reinforces value investing and investors fearing they might lose out. Throughout all this, fundamentals do not feature one bit. By the time they do, the relief rally has outrun fundamentals by a significant margin and its time for a painful correction yet again. I simplify in this example of 2 rallies and 2 crashes but the general principles are there. There can be any number of rallies and corrections but the psychology is pretty much the same.

Technical factors began to show signs of weakness 15 June 2009 across global markets to greater or lesser extent. Only Shanghai markets continued to power ahead. Every one else from DJIA and SPX in the US, the Stoxx and FTSE in Europe, the All Ords, Hang Seng, Sensex, all began to lose steam last week.

On 21 June, the markets began to experience some real weakness. On 23 June 2009, **World Bank reduced its 2009 GDP forecast from -1.7% to -2.9%** and its 2010 forecast from 2.3% to 2.0%. Developed economies growth was revised from -3.0% to

-4.5%. Markets did not like that at all.

Backing up this gloomy view is the fact that there is immense spare capacity in the global economy from developing to developed economies. US capacity utilization for example is below 70%, levels not seen even in the mid 70’s and early 80’s. Unemployment in the US has reached 9.1%, again levels not seen since the mid 70’s and early 80’s. Business confidence has rebounded from its lows but is still very much depressed. GDP is likely to recover in line but again such rebound is likely to be limited. US consumption has rebounded as well but production is still falling. Much of the retail numbers are supported by extraordinary fiscal transfers which are highly unlikely to be repeated, so it is more likely that retail weakens back in line to production than vice versa. US industrial production has fallen by more than has been the case in previous recessions save the Great Depression. For these reasons, it is premature to call a recovery in the US economy and hence US equities for some time yet.

Not all is doom and gloom. There are reasons why the global economy will heal itself. As long as markets are free and protectionism is kept at bay. Emergency measures which might create adverse selection should be quickly reversed. Accommodative monetary and fiscal policy should be maintained until sure signs of recovery are evident. Inflation is unlikely to be a problem for the reasons of spare capacity we discussed. Deflation is unlikely as long as commodity prices can stay near current levels and there is every expectation that they are likely to be well supported. The inflation outlook is likely to be quite healthy, in the old ‘neither too hot nor too cold’ range. The pieces are in place for recovery to take place. However, recovery does not happen in a day. The scale of the damage from the credit crisis was significant.

However forward looking equity and debt markets may be, **the current rally is simply too much too soon and a correction is well overdue**.

Where do we go from here? A simple optical (and linear in log space) analysis of the Dow and the S&P from pre Great Depression times until today would indicate potential downside at about 5600 for the Dow and 650 for the S&P. Are we likely to get there? I think not, but I think that we might get halfway there quite easily. In the assessment of emerging markets like the BRICs it is important to distinguish between beta and volatility. The volatility in emerging markets is such that in a correction, the losses are likely to be higher than in developed markets. The outperformance of emerging markets will likely manifest over a medium to longer term. Intuitively, and quite simplistically, one would be positioned net short at current levels in anticipation of a correction and net long when markets have fallen to more reasonable levels. Intuitively also, a more risk controlled expression would be to maintain fairly balanced books with different growth – value biases in developed and developing markets. A long growth short value position would make sense in emerging markets poised for growth while in developed markets, a long value short growth position would make more sense. Of course micro analyses will reveal richer themes but this is a rational approach to driving the idea generation behind the ultimate portfolio construction.