How real is the rally?

Global markets are witnessing some euphoria, as stocks rally across geographies. **Rehan Syed**, however, urges caution, as in the past bear markets have experienced multiple false rallies.

An enervating 18 months have expended since the not-so-great "Great Recession" started. How much longer will this bear growl? And what is the gestation period for a bear to sire a bull? Is the recent market rally, which has boosted developed equity markets about 30 per cent and emerging markets 45 per cent above recent March lows, a reliable precursor to recession's end? Hold the fizzy, not so soon.

When will the real rally reveal?

Typical bear markets experience multiple false rallies or "head fakes", ranging from 10 per cent to 20 per cent magnitude and two to three months duration, often only to retrace gains or worse. The recent rollicking rally might well exhaust soon because there is too much optimism based on too few "green shoots" and fluffed-up Q1 bank earnings. Could the market go up another 10-15 per cent toward theoretical fair value targets of S&P just above 1,000 before fizzling? Yes, if the recent shoots sprout taller - if for example the ISM index, a leading indicator of economic health, moves quickly up toward the magic mark of 50. But worse scenarios have significant probabilities.

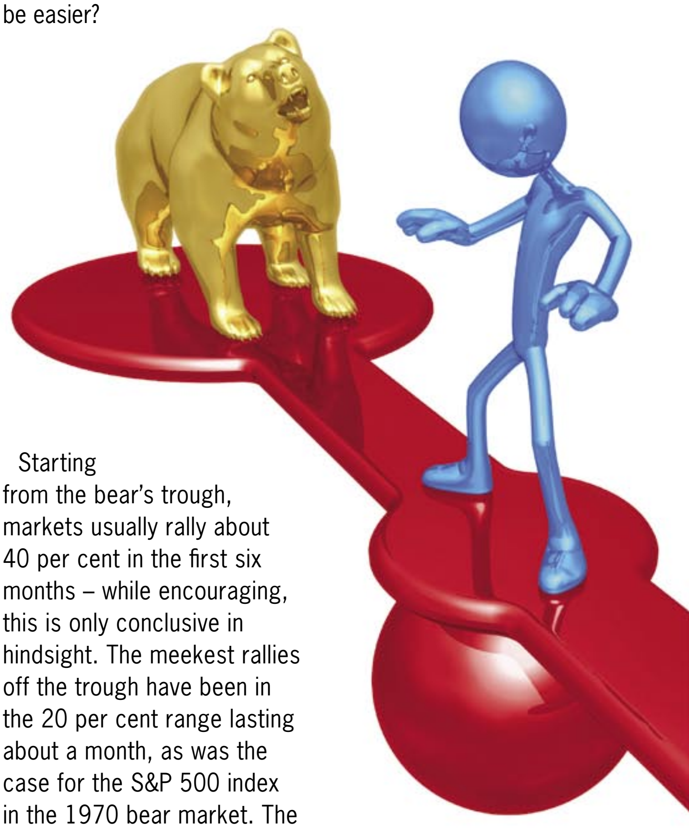
In context, a typical equity bear market lasts for about 18 months and experiences a 35 per cent loss in value from start to finish. This bear has lasted almost exactly that long thus far and is down 45 per cent. The average bear market retraces about 70 per cent of the gains of the prior bull. A typical bull lasts about three years and sees through an approximate doubling of equity value, as was also the case in 2002-07.

The global stock markets hit their first recent low in November 2008 with the MSCI World index a tad below 800; in early March 2009 it struck a lower low of just below 700. Could a retest of lows recur? While it is unlikely we break the March lows, since back then the market jury was deeply skeptical about the stimulus plan's viability, a partial retracement of recent gains is highly likely. Hence we are underweight equities and would take advantage of the recent run to book some profit and rebalance toward the still-attractive high-grade corporate bond market or switch into an absolute-return based protected equity strategy.

Recessions are rife with rallies

A typical bear market sees at least three tests of the lows over an average period of six months before a durable bull phase occurs. Call it a minimal gestation period if you will.

In the 2000-03 recession, there were nine failed attempts to defeat the bear. Of these, there were five major rallies averaging over 15 per cent of average duration just under two months. In the final eight months there were three tests of the MSCI World index with lows in the 700 to 750 range, before the eventual rally that pushed it to its all time high of 1,675 in late 2007. Similarly, there were six rallies in the 1990-92 recession averaging about 10 per cent, and lasting on average about a month and a half. Why should this time be easier?



Starting from the bear's trough, markets usually rally about 40 per cent in the first six months – while encouraging, this is only conclusive in hindsight. The meekest rallies off the trough have been in the 20 per cent range lasting about a month, as was the case for the S&P 500 index in the 1970 bear market. The strongest rally without at least a 10 per cent correction was in 1990 when the S&P index breathlessly tripled in six years; but, alas, that was a halcyon rate-cutting, pro-leverage era unlikely to repeat soon. A more meaningful optimistic reference point is 1982 when we saw a 70 per cent rally over about nine months, but again too much to hope for since it was preceded by a long consolidation phase over a decade when equities were range bound.

Finally, looking back to the distant Great Depression era, there were seven rallies of more than 20 per cent in 1929-34, including five powerful ones that exceeded 30 per cent. A lot of spark yet no fire - the end result remained a market which was 75 per cent lower in 1934 and which did not recover to its peak levels nearly two decades later in 1953. In an eastern parallel, Japan's Nikkei index peaked in 1989 at 39,000 and despite over a dozen significant attempts to rally remains about 75 per cent lower today. As an aside, while markets lacked, humanity gained by unlearning hubris and discovering old fashioned values of patience and fortitude.

Closer to home in the Middle East, the largest market in this volatile region, Saudi Arabia's Tadawul, is still down over 70 per cent from its March 2006 high of near 20,000, but in the intervening three years has attempted five forceful yet failed rallies ranging between 20 and 50 per cent each and an additional five fizzled rallies ranging between 10 and 20 per cent. Similarly, the broader MSCI Arabia index, now trading at 435, is up 33 per cent from its March lows, abetted by a 70 per cent rise in oil, but remains 53 per cent below its recent January 2008 peak despite three strong attempts to rally; also, it is trading 60 per cent below its February 2006 all-time peak.

Could positive data push the market up?

Could markets rally as long as incremental positive fundamental data keeps rolling in? Yes, but be mindful of what forward looking markets are quickly pricing in. The ISM index rose from 32 at start of year to 40 today, and the market is extrapolating that trend towards 50 which is the approximate pre-Lehman level and generally considered recession's boundary. Looking at past recessions, on average it has taken just under a year for the ISM to fall from the cycle peak to 50 and about just under five months to ascend from trough to 50, meaning it rises faster than it falls. Equities tend to perform substantially better during the trough to 50 recovery phase, averaging about 22 per cent return, than from the 50 to next peak phase, averaging about 13 per cent return, echoing George Soros' famous quote, "the big money is made when things go from God-awful to just plain awful".

Discipline delivers and patience pays

With the above facts as a backdrop, and mindful that statistics can often misguide and history never exactly repeats, I think it is too early to call an end to the bear market. Having said that, the worst of the economic carnage is over since the most desperate phases of indiscriminate selling of good and bad assets alike is behind us, especially if governments continue to aggressively prime the fiscal pump and keep policy errors like protectionism at bay. The latter is vital since the emerging markets are key to recovery and are highly dependent on favourable trade terms they have managed to extract from the developed world in the past decade, and a roll back of which would severely dent confidence.

I expect the optics of a middling recovery will be in place by end of the year with the shove of stimulus programmes and the benefit of easy comparisons. With markets on average bottoming about six months before recession's end, an attractive entry point will present itself later this year and those who average into the market patiently will be able to scrape the bottom and seize the bull. So, the best approach going forward is prudently stepping into risky assets within the limits of our individual risk profile, always using a disciplined value-based cost averaging methodology. MW

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