Thursday, March 20, 2008

Return of the bear market.

A few years ago several economists suggested that the peak of the markets at the end of the dotcom bubble were the top of a long term bull run going back nearly two decades and that we were about to enter a long term bear market. This theory looked fairly realistic for a couple of years as most stock markets headed down and lost a lot of value. However, the rebound in 2002/2003 signalled the end of that particular bear market and the start of a new bull run. Some people labelled this as a bear market bounce but the longevity and the strength of the bull run outlived that theory and markets rose to their recent peaks at the end of 2007.

The bubble in equities collapsed in 2000 and whilst there was a bear market for two years there was also another bull run going on in property. This parallel boom helped retain confidence amongst more experienced investors and also helped most countries avoid recession as it helped drive household wealth creation and activity in the construction industry that fed through into the wider economy. There is even some debate about whether or not the US really went into recession when the stock markets collapsed. So the bubble in equities was followed by the bubble in property, both of which have been driven by the availability of financing that can add leverage to any deal and make it bigger and better.

Until now. The freezing of the credit markets has effectively cut off the flow of money going into both property and equities and the main focus today is not on how to invent new ways to finance deals but on how to get your money back and avoid further losses. The element of fear has returned to investment markets after a prolonged absence and the knock-on effects of this change in the availability of finance are so wide reaching that we are seeing a domino effect in defaults beginning with US sub-prime lending and feeding into hedge fund borrowing, private equity financing, auto loan defaults, contraction in credit card issuance and now spreading into prime lending markets. Remember, this is during a period of high employment whereas historically such defaults started to occur as businesses slowed and laid off workers.

We are even seeing market interest rates on mortgages heading in the opposite direction from central bank base rates as the spreads widen at an alarming rate. And after two decades of rapidly expanding household and corporate indebtedness, the last thing the world economy needs is a credit crunch. There have been credit crunches before but this could be a big one.

This leads me onto my next suggestion: the economists who called the top of the multi-decade bull market were right all along. It just didn't look like it until now. A look at the charts of several major stock markets illustrates certain similarities that suggest we could already have seen the top. (Unfortunately I can't illustrate the charts here)

My chart for the FTSE100 goes back 14 years and it looks very much as though we have recently seen a double top formation with strong resistance around the 6700 level. The

market has recently hit the same ceiling twice, around the level it hit at the end of the 90s, and it has failed to go through that level and its next path could well be down, to a much lower level. The 2000 peak and the recent two peaks suggest significant resistance at this level and viewed over a 14 year period they look like two double tops in a longer market cycle.

Take a look at the German market. The chart of the Dax indicates that the market has twice now hit resistance around the 8000 level and failed to go higher. The French CAC40 shows a similar pattern but the rally didn't even reach the previous high before starting a downward slide again and the current 'correction' is bigger than anything seen since 2003. This chart, if extrapolated forwards, would clearly indicate that the market has failed to reach a new high since the 2000 peak.

The S&P500 appears to corroborate the evidence, even though it seems to have pushed a little bit higher with the recent peak, it certainly isn't a significant push through the resistance level. The difference between the 2000 peak and the 2007 peak could be attributed to a few days of over-exuberance that pushed it a little higher than before but the long term chart looks very much like these two peaks are forming a double top in a much longer cycle.

Not all stock markets exhibit the same pattern but it does look like some of the most significant ones do show a double top pattern forming out of the peak at the dotcom boom and the peak of the credit/property boom. Normally the next move would be a longer slide to a much lower level of support. Is this likely?

The credit crunch we are experiencing today was preceded by a similar, although certainly not identical, credit implosion in Japan at the beginning of the 90s, after a decade of unprecedented economic expansion and the formation of a huge bubble in both stocks and property. Whilst most people believe that the two scenarios are too different to be totally relevant, I believe there are very significant similarities that could indicate where we are headed today (that I have described several times before and won't go into again here). My point is, we shouldn't be too surprised if bubbles in stocks and property that are burst by a severe crunch in the financial system cause a long economic slide in some economies. It's happened before and there are a lot of signs indicating that it is happening again.

In summary, there are a lot of arguments for a sustained slide in equity markets that may actually only be part of a longer term bear market. There will be plenty of ups and downs along the way but the drivers of the global economy are weakening rather than strengthening. Emerging economies such as China and India could still continue to grow rapidly for many years but a lot of future growth has already been priced into markets and whilst their domestic demand should continue to expand, they will be missing that extra push from overseas export growth. China, for example, is primarily an export-focussed economy and its largest export customers are either in recession or facing a severe slowdown.

The whole financial system needs a good clean out. We need to get rid of excess debt and excess liquidity. The Fed is trying to pump more liquidity into the financial system but the

fundamental problems we are experiencing today have been caused by too much money, not too little. Over the course of the next 2-3 years we will see if it really is possible to avoid recession, as the central bankers say we will, but there have been recessions in the past and there will be recessions in the future so if we don't have one now, after such a false economic boom, when are we going to see one? All the signs of excess that precede a downturn are there and that Japanese scenario is looking more likely every day. I think it will be a miracle if we don't see a lot more bad news during the next 2-3 years.