Approaching a cliff

The third year after a major trough in equity markets tends to be a difficult one for investors, especially in a challenging structure

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THE global economic scene over the past few years resembles that arcade game called whac-a-mole. Problems keep popping up at random around the world and policymakers are constantly trying to keep a lid on the serial eruptions. When one mole is forced back into its hole, another one jumps out and the game just goes on.

From sovereign debt crises in Europe to the threat of a double-dip in the US and now fears of inflation in emerging markets, it seems as if tackling one economic issue results in problems elsewhere. For instance, US authorities believe quantitative easing is the right policy prescription for their economy but as excess liquidity bids up commodities, it fuels inflation in emerging markets.

Financial markets were able to tiptoe their way around this treacherous course rather adroitly in 2010, with most asset classes generating decent returns as the waves of liquidity injections from US to Europe kept the global economy afloat despite all the structural issues. Will the good times roll on in 2011?

The consensus certainly seems to think so. Many talking heads on Wall Street are calling for double-digit returns this year on the conviction that the US economy is finally entering a more virtuous phase of the economic cycle. After all, economic data has consistently surprised on the upside since the dog days of summer, capital spending is accelerating, and with extended tax cuts and a pick up in job growth, the consumer too is facing less pressure to deleverage.

But if history is any guide, then contrary to the current wisdom, equity markets could face a tough struggle in 2011. The third year following a major trough in equity markets typically tends to be difficult for investors, particularly amid a challenging structural backdrop. In the past century, the US witnessed three major secular bear markets — defined as long periods of poor equity returns on the back of structural problems in the underlying economy.

The first stretched from 1907 to 1921 and was followed by the Great Depression of 1929-42, while the last secular bear market from 1973 to 1981 was due to high inflation that undermined equity market performance.

These spells tracked a similar pattern that initially saw a waterfall decline to mark the start of the lean period and then a significant rally in the subsequent year due to policy interventions. The second year after the trough was usually lacklustre with moderate returns, and in the third year, some sort of a relapse occurred with structural weaknesses in the economy coming back to haunt investors.

Rallies during these periods — labelled cyclical bull markets within secular bear phases — usually lasted two years, followed by a decline of around 30% at the start of the third year.

By this count, the current bull market that dates back to March 2009 should begin to run into trouble in the next few months. The April-September period tends to be seasonally weak for markets in any case, but this year, equities could struggle to break out of the funk in the last quarter as they otherwise commonly do.

With the prevailing optimism on the marketplace though, it is hard to imagine what will sour investor sentiment. But it is precisely when sentiment is extremely positive that markets are most susceptible to setbacks. The persistent pessimism over the staying power of the current bull market rally has now given way to remarkable calmness about the prospects for 2011. Sentiment indicators from bull/bear ratios to put/call spreads all indicate that markets do not have much of a wall of worry left to climb.

Some catalyst typically breaks the market's back, and while no factor yet appears decisive enough to snap the uptrend, trouble is brewing in the background. Credit default spreads, or CDS, levels in countries of southern Europe are rising sharply and, once again, approaching record highs. The blowing out of Spanish and even Italian spreads is worrisome as these are large economies, and in Spain's case, the banking sector is sizeable and vulnerable enough to pose a risk to the entire euro-region. Spain's funding needs are set to increase meaningfully in March-April 2011 given the debt repayment schedule and how it manages through that period will be critical in determining the path that broader markets pursue during the rest of the year.

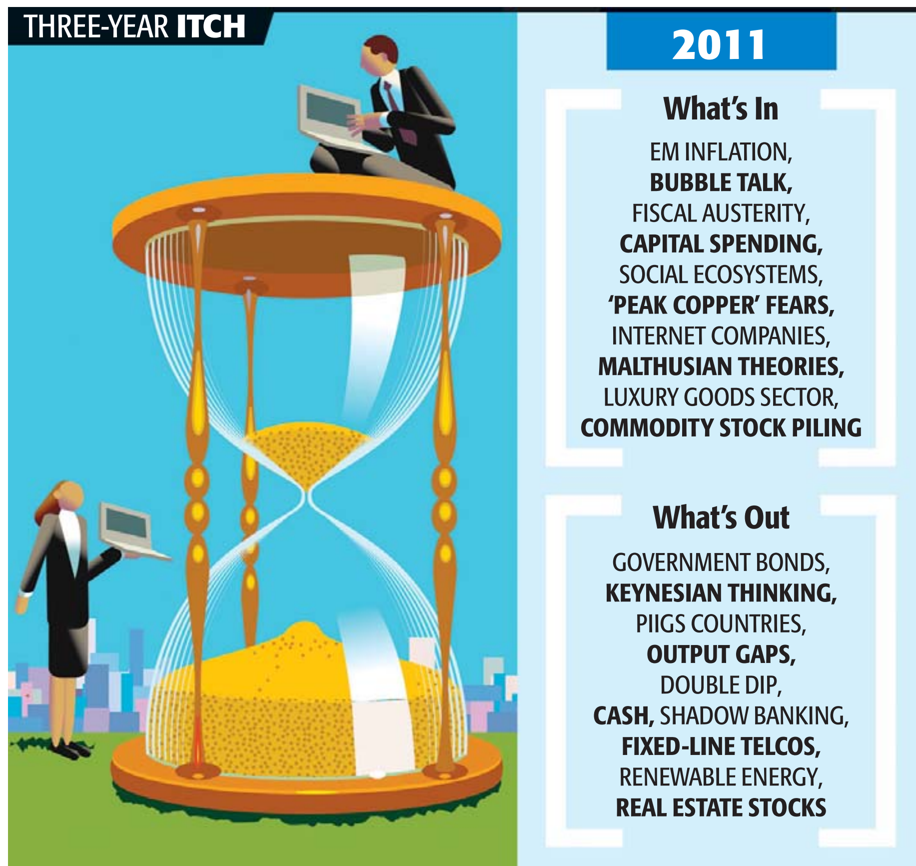
On the other side of the Atlantic, the trajectory of US debt too looks unsustainable with public debt as a share of the economy heading to 90% — a level at which, economists Kenneth Rogoff and Carmen Reinhart show in their paper *Growth in time of debt*, it begins to seriously impact the economy. The low cost of funding is keeping worries over debt at bay for now, but if the yields of US government paper rise much further after the recent bond selloff, higher interest rates will become a concern for markets.

Given the already high leverage in the economy, it will not take much of a rise in interest rates to destabilise the financial system. And if by any chance economic growth falters again, public appetite in the US for another round of monetary and fiscal stimulus is very limited amid the popular view that such stimulus benefits the rich — who own a disproportionate share of inflating assets such as stocks — at the cost of the poor — who are hurt most by the liquidity-related rise in food and energy prices. With oil trading around $90 a barrel, oil expenditure as a share of the US economy is already running above 4% — a level that in past has hurt economic growth.

Policymakers are, in effect, running out of ammunition and getting tired of propping up rickety economic structures after two years of providing extensive support. The European Central Bank, or ECB, is particularly wary of a situation where nations become addicted to central bank liquidity. The ECB fears that such extensive support will undermine its independence and raise inflationary expectations.

Apart from solvency risks in the developed world, inflation in emerging markets is the other major threat to the current bull run. Over the past few months, commodity prices have surged in a similar fashion to the 2007-08 episode that generated broad-reaching inflationary pressures on many developing economies. A further rise in commodity prices will exacerbate the inflation situation, prompting more aggressive monetary tightening in China and other developing economies that then will increase the odds of a hard landing for the global economy.

Excess liquidity has largely driven the current bull market and worked to reflate all assets simultaneously. But this uptrend is self-limiting in nature as the increase in commodity prices beyond a point comes back to bite other asset classes. Therefore, from a long-term perspective, the present rally resembles a cyclical bull run within a structural bear regime rather than an enduring secular bull market.



In secular bull periods, such as what the US witnessed in the 1980s and 1990s and what emerging markets experienced in the previous decade, inflation was much less of an issue until very late in the cycle and commodity prices were far less correlated to other asset classes. High correlations have historically been a sign of stress in the system and they typically tend to weaken in bull markets and strengthen in bear phases.

It would take some sort of a miracle for the cyclical bull market to morph into a secular bull run that would involve a combination of equities cutting loose from the commodities ball-and-chain and European debt rolling over smoothly. With commodity prices breaching threshold levels and sovereign debt troubles continuing to fester in Europe, 2011 will more likely turn out to be a year when policymakers finally run out of stamina to keep the moles in their holes.

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