

Bulls versus Bears: Battle After the Storm

The third year of a market recovery is decisive and investors have to decide whether to follow bulls or bears. Unless the beast of commodities is slain, the bears will prevail



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The behaviour of the wild in the jungles of Africa holds important lessons for students of the investing game. Heavy afternoon thundershowers that are a common occurrence in the plains of the Masai Mara bring life to a sudden and complete halt. Prey and predator alike stay in suspended animation with the implicit understanding that an impulsive action — such as everyone running for cover at the same time — will be counterproductive during the storm.

Investors too are probably better off adopting a similar strategy during natural disasters as these lie outside the core competence of most investors and are, therefore, hard to analyse from a financial market perspective. The correct approach after the devastating earthquake in Japan was to stand still and do nothing. And, indeed, following wild talk of mushroom cloud formations and Chernobyl redux, almost all assets have now returned to levels similar to early March, if not higher.

The bulls and bears can now get back to slugging it out over what sort of economic environment lies ahead and the likely trajectory of global equities. The bulls are feeling emboldened as the market has been able to show incredible resilience over the past few months. From geopolitical tensions in the Arab world to higher interest rates in emerging markets, stocks have easily shrugged off the bad news. This is characteristic of a typical expansion, even in countries such as the debt-laden US, where all the underlying structural problems persist.

The bulls argue that the US in on a standard expansion cycle, which on average has lasted five years in post-World War-II history. With the economy on such a self-sustaining path, minor external shocks are unlikely to derail the equity market. The US manufacturing sector is booming and jobs have started growing. Companies flush with cash are increasing dividends, buying back shares, and seeing value in the market by engaging in sizeable mergers and acquisition activity. Liquidity is abundant with record low interest rates and even the political environment has turned for the better with the Obama administration softening its earlier anti-business attitude.

The third year of a US presidential cycle also tends to be the strongest for the market, with US equities rising an average 18% in such a year compared to the long-term 10%.

Institutional investors have less exposure to equities than they did a decade ago while retail investors have for the most part missed the comeback rally of the past two years. Many asset allocators also point out that other investment options from bonds to cash offer little value given the low yields. A rise in inflation or increased concerns about government indebtedness will particularly



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hurt asset classes such as bonds and, so, equities are the safest house in a bad neighbourhood.

Emerging markets too seem to be breaking out of their recent funk amid the growing belief that inflation is set to peak by mid-year and central banks will not have to tighten policy much further. Such hopes are pinned on the base-effect phenomenon: since the surge in commodity prices that began in July 2010 was largely responsible for the subsequent pickup in inflation in emerging markets, the year-over-year changes in commodity prices will turn negative in the second half of 2011. The stabilisation in some commodity prices over the past few weeks combined with expectations of a better harvest in key food-exporting markets from Russia to Australia is reinforcing the belief that inflation will moderate in the months ahead.

All the arguments put forth by the bulls indicate that the most important assumption behind their optimism is that this is a normal cycle. The bears, in contrast, believe this premise is just wrong, as the current environment is anything but normal. Extraordinary loose policy settings have facilitated this recovery and the moment any monetary or fiscal props are removed, the economy will stumble again.

With headline inflation breaching 2%, the US Federal Reserve is unlikely to extend the purchase of treasuries and, so, its quantitative easing programme is set to end by mid-2011. The fiscal boost too is going to fade and with the rate of government spending about to decline, it will begin to subtract from growth starting the fourth quarter.

In fact, the sharp increase in oil prices over the past few months is already offsetting the fiscal transfers from the government to households in the developed world and the hit to disposable income is resulting in a

reduction of growth estimates.

Earnings growth too is set to slow meaningfully with input costs exploding due to the commodity price surge at a time when companies are not in a position to pass on much of the increase given the still anaemic final demand. A majority of company analysts may be underestimating the hit to margins from commodity price inflation and after normalising the abnormally high margins, the valuation of the market looks a lot less appealing. US housing prices are also a risk as they continue to decline given the large levels of 'shadow inventory' and aversion towards new home purchases that is only natural after a boom-bust cycle.

In Europe, the debt problem refuses to go away with spreads on the debt of the PIIGS nations still on the rise. A record amount of debt is due to mature in the coming months in southern European countries and rollover is unlikely to be all smooth sailing.

Furthermore, it is far from clear if commodity prices will start to behave in a quiescent manner, which is a prerequisite to rein in inflation. The same liquidity that has boosted global economic growth and stock markets keeps flowing into commodity funds, in turn causing an inflation problem.

And with enough evidence indicating that wages are rising more rapidly in many large developing countries from China to Brazil, the inflation problem in emerging markets may be more than just an oil-and-food price rise story. Academic research anyway shows that over the past 40 years, rising food prices have always preceded an upturn in global inflation and is a more reliable

predictor of inflation cycles than even oil. If the current episode of a surge in food prices leads to more generalised inflation, then central banks in emerging markets will have to tighten policy much further.

Investors have to decide now whether to go with the worldview of the bulls or the bears. The third year of a market recovery tends to be decisive. Secular bull markets get a second wind as valuations increase on rising confidence that the expansion is indeed self-sustaining. However, cyclical bulls fade in the third year as structural problems in the economy come back to haunt the market once the stimulus effects wear out.

Arguments on both sides are compelling but, at this stage of the cycle, my sympathies lie with the bears. A recent study of boom-bust episodes over the past century shows that after declining by nearly 60%, the affected market tends to rebound by 75% over the next two years, and then correct by 25% before finally settling into a sideways trading range. This timeline would suggest that global equities are close to a peak and are now about to enter a corrective stage as they have nearly doubled off the 2009 lows.

For stock markets to keep powering ahead, commodity prices have to calm down at the very least. Inflation typically kills bull markets and the unusually sharp increase in commodity prices has resulted in it surfacing far too prematurely in the current cycle. However, without withdrawing much of the excess liquidity in the system, it will be hard to tame commodity prices. Any contraction in global liquidity has the potential to cause collateral damage to other asset classes such as stocks. Unless commodity prices magically decline on their own, the bears have the edge in the year ahead.

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