

# Still stuck in the mud

Price action of the past month does not bode well for markets this year. However, if the US market holds the 2008 lows, there's still hope that equities can gravitate back to the top of their trading range, says **Ruchir Sharma**.

**A**S JANUARY goes, so goes the year. If that popular trading rule on Wall Street is any guide, then the fact that US equities recorded their worst January in recent history is a bad omen for 2009. After all, over the past 50 years, 70% of the time the US market has followed the same path from February through December as it has taken in January.

Following the excitement at the beginning of the year that 2009 might usher in a different trend there's a growing resignation that a new year doesn't necessarily imply a new trend. But since it is human nature to engage in drama with many twists and turns along the way, even if there's no change in the overall market regime it will be rather unusual for the same script to play out for two consecutive years. So, while the basic premise remains that the US is just at the start of a multi-year deleveraging process and the global economy will keep keying off trends in the US until it finds new leadership, it's worth exploring the various ways the market can move in 2009. There are three possible scenarios:

*Scenario 1. A W-shaped economic recovery for the US and the rest of the world:* While sentiment on growth keeps deteriorating, there are some early signs to suggest the downward momentum is stabilising. For one, the latest data out of China shows a marked pickup in growth of bank lending. Global credit markets are also better bid in recent weeks, which is comforting as the credit space has been at the heart of all troubles.

A likely implication of these developments is that equity markets hold the lows made late 2008 and rally for a few months. Sentiment is certainly bearish enough to trigger a rally. Cash levels are at extremely high levels with money market funds in the US forming a record 37% of market cap and yielding next to nothing. Nobody is prepared for an imminent rally as even the few relatively bullish investors left standing are calling for a recovery in the second half of the year at the earliest.

## ANATOMY OF US BEAR MARKETS

	DATE BEGINNING	CLOSE BEGINNING	DATE END	MAGNITUDE	DURATION
In price terms, the current bear market is the third worst in recorded history. However, from a duration perspective the bear phase is still well short of the historical norm for secular declines	16 Sep 1929	31.86	8 Jul 1932	-86.2	<b>704</b>
	10 Mar 1937	18.68	28 Apr 1942	-60	<b>1,284</b>
	9 Oct 2007	1,565.15	20 Nov	-51.9	<b>283</b>
	24 Mar 2000	1,527.46	9 Oct 2002	-49.1	<b>637</b>
	19 Jan 1906	75.45	15 Nov 1907	-48.5	<b>459</b>
	11 Jan 1973	120.24	3 Oct 1974	-48.2	<b>436</b>
	17 Jun 1901	57.33	9 Nov 1903	-46.1	<b>602</b>
	3 Nov 1919	119.62	21 Dec 1920	-44.2	<b>283</b>
	21 Nov 1916	110.15	19 Dec 1917	-40.1	<b>268</b>
	29 Nov 1968	108.37	26 May 1970	-36.1	<b>369</b>
	25 Aug 1987	336.77	4 Dec 1987	-33.5	<b>71</b>
	29 May 1946	19.25	13 Jun 1949	-29.6	<b>761</b>
	19 Nov 1909	73.64	30 Jul 1914	-29.0	<b>1,178</b>
	11 Dec 1961	72.39	26 Jun 1962	-27.7	<b>136</b>
	28 Nov 1980	140.52	12 Aug 1982	-27.1	<b>430</b>

Note: Current Bear market calculated from peak to the last bottom in Nov 2008  
Source: ISI

However, any revival could be short-lived as it's too soon for a sustainable recovery. Equity markets and the economy could relapse into a deflationary funk in the second half of 2009 as the mini-inventory cycle runs its course and the effects of the stimulus plans start to wear off. It typically takes three years before a cyclical revival occurs within a secular downtrend. That was the case during the Great Depression when an upturn took place in 1932 following a peak in economic activity in 1929. Japan witnessed a similar recovery in 1992 following a top in late 1989.

*Scenario 2. A longer lasting cyclical bull market takes shape:* If the Japanese experience of the 1990s is the base case for the US, then it's important to remember that there were a few rallies of up to 50% in that market. Those rallies coincided with a cyclical economic recovery even though the overall growth rates and equity returns for the decade were lacklustre. Based on the Japanese roadmap it's too early to look for any recovery now as it's only the second year of the deflation episode and the period before the first rebound usually lasts three years. However, one difference this time

could be the swifter policy response. Policymakers across the world are throwing the kitchen sink at the problem with aggressive stimulus packages worldwide totalling a staggering \$2 trillion.

**U**NDER such a scenario, the global economy should start to recover by the second quarter of 2009. This is the most optimistic scenario given the structurally negative backdrop and could lead to a stocks across the world rallying of 40 to 50% by year-end. Another Great Depression would be avoided and although growth may start to fade again in a year's time — *a la* the Japanese growth pattern in the 1990s — at least the recovery and rally process will provide some serious relief this year.

*Scenario 3. The deleveraging process continues unabated resulting in fresh new lows for global markets:* There is still something incomplete about the current downturn; overall leverage ratios are way above trend and after the overshoot on the upside valuations need to fall to bargain-basement levels to form a true bottom for equities. The current consensus among opinion makers is for governments to end

the downturn through intervention and aggressive spending. But the recognition that excess debt in the system needs to be liquidated — a situation that involves sacrificing growth in the short term for long-term economic renewal — is largely missing from the public discourse.

The small but not insignificant threat of global bond markets revolting at the prospect of governments forcing huge amounts of debt down their throats also remains. The ambitious countercyclical spending plans need a lot of funding, which should ordinarily be possible given the decline in credit demand by the private sector. However, if fears increase that governments are debasing their currencies and risking hyperinflation then bond yields could rise sharply, leading to an even greater mess.

Under the scenario that the fiscal stimulus plans either prove to be ineffective or are scuttled by an uncooperative bond market, the US economy will continue to contract at the Great Depression pace through 2009 and keep choking the world's economy. Stock markets will then easily pierce the lows recorded in late November with the S&P 500 heading towards the 500-600 area in next few months. Those levels will be more consistent with valuations seen at the end of previous major secular bear markets, such as in 1932 and 1982.

The base case here still is that the US and the global economies avoid an Armageddon-type scenario in the wake of all the concerted policy action. But it would still not be possible to engineer a new growth cycle until excessive debt in the system is purged. As a result, equity markets will continue to trade in the range established since the lows were hit in November 2008. However, the odds of the third scenario materialising have increased in recent weeks as treasury yields in the US have risen sharply and the price of gold has broken out on the upside. It's key that these disturbing trends reverse quickly and the US market holds the November lows for Scenario 1 or 2 to have a chance to play out in 2009.